April 17, 1998
Approval: 4/24/98

# INTERNATIONAL MONETARY FUND

## Minutes of Executive Board Meeting 97/74

10:00 a.m., July 18, 1997

## Contents



### Decisions Taken Since Previous Board Meeting

**Executive Board Attendance**

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

| Executive Directors | Alternate Executive Directors |
| --- | --- |
| A.A. Al-Tuwaijri | S.M. Al-Turki |
| M.-A. Autheman | A. Fayolle |
| T.A. Bernes | C.X. O'Loghlin |
| | W.-D. Donecker |
| | R.J. Heinbuecher, Temporary |
| E.R. Grilli | F. Mercusa, Temporary |
| D.Z. Guti | L.J.F. Erasmus, Temporary |
| D. Kaeser | W.K. Gruber, Temporary |
| | H.F. O'Brien |
| | M.A. Coronel, Temporary |
| W. Kiekens | |
| K. Lissakers | B.S. Newman |
| A. Mirakhor | M. Daïri |
| A.V. Mozhin | A. Vernikov |
| | J. Shields |
| | M.S. Kell, Temporary |
| A.S. Shaalan | Y.Y. Mohammed |
| M.R. Sivaraman | H.B. Disanayaka |
| | R.P. Watal, Temporary |
| E. Srejber | B. Andersen |
| G.F. Taylor | O. Kwon |
| J.J. Toribio | J. Guzmán-Calafell |
| J. de Beaufort Wijnholds | A. Levy, Temporary |
| K. Yao | A. Barro Chambrier |
| | T.-M. Kudiwu, Temporary |
| Y. Yoshimura | H. Ono |
| | S. Joyosumarto |
| Zhang Z. | Han M. |
| A.G. Zoccali | N. Eyzaguirre |

R.H. Munzberg, Secretary
W.S. Tseng, Acting Secretary
S. Bhatia, Assistant
P. Cirillo, Assistant
M.J. Miller, Assistant

**Also Present**

IBRD: S.K. Dhar, East Asia and Pacific Regional Office. External Evaluators: K. Botchwey, P. Collier, J.W. Gunning, K. Hamada. African Department: E.A. Calamitsis, Director; A. Basu, Deputy Director; C.A. François. Asia and Pacific Department: H. Neiss, Director; B. B. Aghevli, Deputy Director; A. Singh, Deputy Director; J. Hicklin, K. Kochhar, C.H. Lim, T. Wang, N.E. Weerasinghe. European I Department: H.M. Flickenschild. European II Department: I. Kapur. External Relations Department: S.J. Anjaria, Director; D.R. Hawley, R.W. Russell. Fiscal Affairs Department: V. Tanzi, Director; G.T. Abed, L.P. Ebrill, S. Gupta, A.J. Pellechio, V.P. Summers. Legal Department: W.E. Holder, Deputy General Counsel; R.C. Baban, R.B. Leckow, D.E. Siegel. Monetary and Exchange Affairs Department: E.G. de la Piedra, C.A. Enoch, M. Farahbaksh, R.B. Johnston, J.E. Leimone, H. Mehran. Policy Development and Review Department: J.T. Boorman, Director; J. Ferran, Deputy Director; O. Havrylyshyn, Deputy Director; H.W. Bredenkamp, S.A. Coorey, J.W. Decressin, L.D. Dicks-Mireaux, T.W. Dorsey, U. Erickson von Allmen, M. Fisher, A.R. Ghosh, M. Mecagni, R.H. Nord, S.T. Phillips, S.M. Schadler, R.L. Sharer, P. Sorsa, K. Thugge, T.M. Tsikata, S.K. Wajid, T. van der Willigen. Research Department: M. Mussa, Economic Counsellor and Director; D. Folkerts-Landau, J. Santaella, G.J. Schinasi, P. Wickham. Secretary's Department: P. Gotur, A. Mountford. Treasurer's Department: D. Gupta, Deputy Treasurer; K. Boese, S.T. Lurie, T.M. Mast, P.R. Menon. Western Hemisphere Department: T.M. Ter-Minassian, Deputy Director; C. Cha, F. van Beek. Office of the Managing Director: M. Russo, Special Advisor; E. Brau, J.A.P. Clément, O.J. Evans. Advisors to Executive Directors: P.A. Akatu, M. Askari-Rankouhi, O.L. Bernal, S.S. Farid, P.M. Fremann, A. Giustiniani, C.M. Gonzalez, K.M. Heinonen, G.M. Iradian, J.M. Jones, R. Kannan, M.F. Melhem, H. Mori, S. N'guiamba, J.-C. Obame, T. Turner-Huggins, L.B.J. van Geest. Assistants to Executive Directors: W.F. Abdelati, N.R.F. Blancher, J.G. Borpujari, J. Chelsky, M.A. Cilento, D.A.A. Daco, M.H. Elhage, L. Fontaine, S. Fukushima, D. Giga, J.K. Honeyfield, O. Issaev, H. Kaufmann, K. Kpetigo, Lai K., J.P. Leijdekker, D.G. Loevinger, A. Lucenti, M.Z. Maatan, J. Mafararikwa, D. Merino, M. Nemli, L. Palei, A.R. Palmason, Qi J., G.P. Ramdas, S. Rouai, D. Saha, J. Salleh, O. Schmalzriedt, T. Schneider, M. Vismantas, Zheng H., Zubir bin Abdullah.

## 1. REPORT BY FIRST DEPUTY MANAGING DIRECTOR

The First Deputy Managing Director said that he had visited Mexico the preceding day at the invitation of the Finance Minister of Mexico, and had had meetings with the finance minister, the board of the central bank, and the president. He had not announced his visit prior to his travel, because the authorities had requested that it be kept confidential. The authorities had subsequently made an announcement of his visit.

The discussions had not involved negotiations about the Extended Arrangement, the First Deputy Managing Director continued. The authorities were taking stock of the reform program, as the president approached the middle of his term in office, and it was in that context that they had invited him. The discussions had been wide-ranging and had included a review of the current economic situation—which was quite good—the exchange rate, and other issues about which the authorities were concerned. There were no major problems, but the authorities did not want problems, which in the past had characterized the second half of presidential terms, to surface during President Zedillo's term.

He wished to thank the authorities for the arrangements for his visit, the First Deputy Managing Director concluded.

Mr. Guzmán-Calafell said that, on behalf of his Mexican authorities, he wished to thank the First Deputy Managing Director for his visit and advice, which were highly appreciated in Mexico.

Mr. Shaalan asked whether the authorities were concerned about the recent nominal appreciation of the peso vis-à-vis the dollar.

The First Deputy Managing Director responded that they had discussed ways of dealing with exchange rate appreciation, as confidence increased and capital flowed in. The authorities wished to avoid a repeat of the events of 1994, that is, a substantial appreciation of the exchange rate, and recognized that developments on the current account were critical. Quoting the Economic Counsellor, he had observed that no matter which exchange rate system a country chose, a time came when action was needed to defend it. At that time, the authorities probably had wished that they had a different exchange rate system.

## 2. CAPITAL ACCOUNT CONVERTIBILITY—TRANSITIONAL ARRANGEMENTS, APPROVAL POLICIES, AND FINANCING UNDER AN AMENDMENT OF THE ARTICLES OF AGREEMENT; AND CAPITAL MOVEMENTS UNDER AN AMENDMENT OF THE ARTICLES OF AGREEMENT—TREATMENT OF INWARD DIRECT INVESTMENT

The Executive Directors continued from Executive Board Meeting 97/72 (7/15/97) their consideration of a staff paper on capital account convertibility—transitional arrangements, approval policies, and financing under an amendment of the Articles of Agreement (SM/97/173, 7/1/97; and Cor. 1, 7/9/97), together with a paper on capital movements under an amendment of the Articles of Agreement—the treatment of inward direct investment (SM/97/168, 6/27/97; Cor. 1, 7/8/97; and Sup. 1, 7/11/97).

The Acting Chairman made the following concluding remarks:

This discussion has moved us forward on the various aspects of an amendment to extend Fund jurisdiction to capital movements. Executive Directors focused on the key policy aspects, including transitional arrangements, approval policies, and implications for financing on the basis of the staff paper (SM/97/173). They also considered issues relating to the treatment of inward direct investment under an amendment covered in another staff paper (SM/97/168). The discussion clarified a number of issues in those areas, although Directors emphasized that, in light of the complexity of the issues involved and the need to consult more widely with their authorities, their views were only preliminary and were stated without prejudice to their final positions.

Transitional Arrangements, Approval Policies and Financing

On the design of transitional provisions and approval policies, Directors generally agreed that it would be useful to build upon the principles underlying the Fund's existing jurisdiction. Specifically, they considered that the principles of avoiding backsliding, clear signaling regarding a member's commitment to liberalization, and flexibility in approval policies were generally appropriate. Policies based on those principles should strike an appropriate balance between promoting the liberalization of capital movements and paying due regard to the varying circumstances of members.

With those principles in mind, most Directors supported an extension of the present interpretation of transitional provisions to capital movements. That would permit members that avail themselves of the transitional arrangements to maintain restrictions in place when the amendment comes into effect and, subsequently, to adapt them to changing circumstances. All new restrictions would be subject to approval by the Fund. A few Directors suggested that, consistent with the principle of no backsliding, the provision for adaptation should be structured to allow a reduction in the restrictiveness of the protected measures, but avoid accommodating their intensification. The latter would then be subject to approval by the Fund.

Some Directors favored enhancing the scope of Fund involvement as compared to what has been the policy under current jurisdiction to help ensure that members relying on the transitional arrangements neither unduly delayed accepting the obligations of freedom of capital movements nor moved prematurely to accept those obligations. Some Directors were of the view that greater reliance should be placed on members' own convictions that conditions for accepting such obligations were met, thereby allowing members to proceed with liberalization at their own pace. A few Directors suggested that consideration be given to a post-ratification transition period for the amendment to come into effect, which would allow members to take stock of their systems in relation to the amended Articles. Other Directors considered that that would be adequately addressed by the transitional provisions as well as the flexible treatment of measures introduced for prudential and market and institutional evolution reasons. The staff will need to consider those issues further.

Directors emphasized the importance of liberalizing capital flows in the broader context of appropriate macroeconomic policies and reforms. They generally agreed that, in order to provide a clear signal to the international community, members should be encouraged to accept the obligations of the new Article only when the configuration of macroeconomic policies, the situation of the financial system, and the institutional infrastructure provided sufficient confidence that they would not need to rely on restrictions. In that regard, emphasis would need to be given to the development of financial institutions and markets as part of the process of appropriately sequencing capital account liberalization. Accordingly, most Directors were of the view that the conditions under which a member would cease to avail itself of the transitional arrangements should be broader than under current jurisdiction in order to encompass the development of the member's financial system.

Directors stressed that approval policies would need to be developed that would provide sufficient flexibility to allow members to introduce or retain controls on capital movements as required by their circumstances. In that connection, they discussed the staff's suggestion that approval policies be developed to cover restrictions imposed for: (i) balance of payments and macroeconomic management purposes; (ii) market and institutional evolution reasons; (iii) prudential considerations; and (iv) reasons of national and international security. Some Directors, however, considered the concept of market and institutional evolution ambiguous. Those Directors were concerned that a separate approval policy in that area could create a significant loophole in Fund jurisdiction, and suggested that restrictions imposed for such reasons be brought under the policies addressing prudential considerations. Some other Directors, however, underscored the importance of the development and soundness of financial institutions in the liberalization process and considered it appropriate that approval policies be tailored to address such concerns.

Concerning temporary approval of restrictions imposed for balance of payments and macroeconomic reasons, Directors supported the view that the criteria applied to the approval of restrictions under the Fund's existing jurisdiction were broadly appropriate with suitable modifications. Specifically, with respect to capital outflows, Directors agreed that approval should be based on whether the restriction was imposed for balance of payments reasons, was nondiscriminatory among Fund members, and was temporary. They considered that it would be appropriate for the Fund to develop a policy for the emergency approval of restrictions on capital outflows to provide members with the flexibility to respond to crisis situations. Specific modalities, in that regard, would need to be developed to allow members sufficient time to elaborate policies in response to the crisis. Directors also agreed that, when imposing restrictions, members should, to the extent possible, employ controls that were least disruptive to their international financial relations and to their ability to maintain access to international capital markets. Several Directors considered that any Fund role in the prioritization of payments should be of an advisory nature and not part of approval criteria, while others were more willing to examine the feasibility of incorporating prioritization in approval criteria.

With respect to restrictions on capital inflows, Directors were generally in favor of approval criteria analogous to those suggested for capital outflows. They agreed that such criteria should require that the restriction was needed for reasons of macroeconomic management, was nondiscriminatory among Fund members, and was temporary. With respect to an emergency approval procedure for the imposition of restrictions on capital inflows, most Directors felt that such a procedure would give members flexibility in responding to destabilizing inflows when their room for maneuver with traditional policy instruments was constrained. A few Directors, however, noted that, since inflows usually build gradually, and considering the nature of the threat to macroeconomic stability they pose, an emergency approval procedure for restrictions on capital inflows may not be necessary.

Directors considered that members may need to impose restrictions on capital movements in the process of financial market development and in order to limit the vulnerability of the financial system in situations where there were weaknesses in financial institutions or markets, or where financial instruments were inadequate. Directors generally agreed that approval criteria for such measures should be based on an assessment of whether the measures were part of a process that would in time reduce the general restrictiveness of the system and place the member in a better position to observe the obligations for liberalization of capital movements. The period of approval would have to be considered: the time frame could be similar to that for macroeconomic and balance of payments purposes, but longer periods could be considered in appropriate circumstances. Most Directors noted that, consistent with the objective of clear signaling, members' recourse to controls for such reasons would be expected to be limited once the member accepted the obligations for the freedom of capital movements.

Views differed on how to treat prudential measures that give rise to restrictions under the amendment. Most Directors were of the view that, given the mandate of the Fund, it would be appropriate for the Fund's jurisdiction to cover prudential measures that give rise to restrictions, recognizing that in most instances prudential measures would not give rise to restrictions. The period of approval of the restrictions would take into account the extent to which the restrictions conformed to existence of best practices and norms and the country's capacity to implement those norms. One Director also called for a detailed examination of the institutional architecture for prudential measures in considering their treatment under an amendment. A few Directors suggested that the treatment of prudential measures should carry a presumption in favor of the member about the need for such restrictions. However, it was broadly agreed that any treatment of prudential regulations should seek to minimize abuse, recognizing that that would involve the Fund in an examination of such measures and a right to challenge them in appropriate circumstances. Some Directors also supported extending the procedures for prudential measures to restrictions maintained because of institutional constraints on the effectiveness of monetary control instruments.

Most Directors agreed that the existing procedures for restrictions imposed for national and international security could be applied under the Fund's extended jurisdiction. A few Directors, however, cautioned against members abusing those provisions in order to impose or maintain restrictions for macroeconomic and balance of payments reasons.

Turning to financing implications of the amendment, most Directors emphasized that capital account liberalization would substantially increase access of members to private capital and, to that extent, would reduce reliance on official financing. Nevertheless, many Directors recognized that the increased magnitudes and volatility of capital flows could episodically result in cases of large need for Fund and other official financing, including where a systemic risk was involved. All Directors cautioned that the provision of such financing in individual cases would need to be carefully considered. Particular attention would need to be given to the adequacy of safeguards for Fund resources; the effect on the Fund's liquidity position and capacity to provide financing to other members; and the concentration of the Fund's exposure.

Several Directors considered that it was important for the Fund to provide the assurance that its resources would be available, if necessary, to support members' liberalization policies. All Directors agreed that in providing Fund financing it was important to avoid engendering moral hazard and sending markets a wrong signal about the Fund's willingness to finance capital outflows, and also to ensure adequate safeguards for Fund resources. Accordingly, some Directors preferred to retain the existing prohibition in the Articles on the financing of "large or sustained" capital outflows on the grounds that the provision provided additional safeguards for the use of Fund resources. Several other Directors noted that, under an amendment establishing obligations of freedom of capital movements, it would not be appropriate to retain that provision in its present form, which reflected the priority accorded under the existing Articles to the financing of current account deficits. Recognizing that there may be occasions where financing balance of payments deficits stemming from large capital outflows would be appropriate, they considered that more evenhanded language referring to limitations on financing of payments imbalances rather than capital outflows might be preferable. At the same time, in light of the Fund's purposes, particularly to shorten the duration and lessen the degree of disequilibrium in the balance of payments, as well as the requirement to safeguard the temporary use of its resources, those Directors did not consider it appropriate for the Fund to finance sustained capital outflows. They observed, however, that it was large and sustained use of Fund resources in the context of capital outflows that would raise serious concerns about the impact on the Fund's liquidity, safeguards, and concentration of exposure. Accordingly, those Directors favored reformulating the relevant provision of Article VI with a view to protecting against "large and sustained" use of Fund resources.

Some other Directors noted that Article V, Section 3(a) already provided for adequate safeguards for the temporary use of the Fund's general resources, which was reflected in the Fund's policies on conditionality and access. Accordingly, they felt that the constraint in Article VI on Fund financing of "large or sustained" capital outflows would not be necessary under an amendment extending Fund jurisdiction to capital movements. Deletion of that provision would give members confidence to accept the obligation to liberalize capital movements. A few Directors suggested that it would be appropriate to give consideration to a possible role for higher charges in that context.

Some Directors also noted that, in the formulation and implementation of its policies on conditionality and access, the Fund may find it necessary to include the recommendation of controls on capital outflows, as a temporary measure, to limit the use of its resources. Accordingly, an explicit provision in the Articles allowing the Fund to request members, in the context of conditionality, to impose controls on capital outflows should be considered. A few other Directors considered that the Fund should not be able to require members to impose restrictions.

Treatment of Inward Direct Investment

Executive Directors engaged in a wide-ranging discussion on the treatment of inward direct investment under the amended Articles.

A number of Directors supported the staff's proposal to use a tripartite classification of inward direct investment consisting of: (i) the acquisition of real estate and nonfinancial intangible assets; (ii) the acquisition of an interest of 10 percent or more of the total ordinary shares or voting power in an incorporated enterprise, or the equivalent in an unincorporated enterprise; and (iii) the acquisition of an interest of less than 10 percent in an enterprise whose activities were regarded by the relevant member as necessary for its essential interests.

It was generally agreed that restrictions on the first category of direct investment—that is, acquisition of real estate and nonfinancial intangible assets—should remain outside Fund jurisdiction, and a number of Directors also agreed that the second and third categories should be excluded as proposed by the staff.

With respect to the second and third categories, however, a number of Directors took the view that an equity threshold such as 10 percent was an artificial yardstick. Moreover, a few Directors considered that all restrictions on inward equity investment should be regarded as restrictions on inward direct investment and should remain outside Fund jurisdiction. One Director suggested that the Fund should also exclude from its jurisdiction loans made for the purpose of exercising an effective influence over the management of an enterprise, for example, a loan by a parent company to a subsidiary.

Some Directors advocated a different approach under which it would be left to each member to define inward direct investment and, thus, decide which restrictions would fall within or outside the Fund's jurisdiction, although different views were expressed as to whether the Fund should have the power to challenge members' views in that area.

One Director suggested that the goal of capital account liberalization could be more effectively achieved through the use of the Fund's conditionality without extending Fund jurisdiction to restrictions on capital movements. According to that Director, such an approach could apply not only to restrictions imposed on inward direct investment but also to restrictions imposed on other capital movements.

A suggested possible alternative approach—for which some Directors expressed support—was to recognize, in principle, the jurisdiction of the Fund over all inward capital movements subject to the following qualification: it would be agreed at the time of the amendment that the Fund would grant a general waiver with respect to all restrictions on the making of inward direct investment. It would also be agreed that this policy of waiver could be reviewed by the Fund from time to time taking into account the evolution of members' practices.

There was broad support for the position that restrictions imposed on the right of establishment should remain outside the jurisdiction of the Fund.

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In light of the Board discussion and the request by Directors for additional work in certain areas, the staff will prepare two papers for Board discussion prior to its consideration of a report to the Interim Committee. The first paper will elaborate further on the scope of the amendment, its relationship with other treaties, and related legal issues. The second paper will address further the other issues raised during this discussion. These will include, inter alia, restrictions imposed for prudential and market evolution reasons, the modalities of emergency approval, and the treatment of an intensification of restrictions under the transitional provisions. Board discussion of these papers will form the basis of the report to the Interim Committee. Further issues will be addressed in papers for consideration after the Annual Meetings.

On the whole, we have made considerable progress, although it must be made explicit again that many Directors have indicated that their views are preliminary and that they will need to consult further with their authorities. Nevertheless, these concluding remarks should provide an indication of where there is a meeting of minds and where there are matters requiring further consideration, on which basis the two papers will be prepared. These remarks will remain without prejudice to Directors' final positions.

Mr. Daïri, noting that the discussions had been preliminary, remarked that it would be useful at a later stage to discuss the same issues so that Directors could consider them further and state their positions on various aspects of the amendment.

Mr. Yoshimura requested that a future paper clarify the relationship between the GATS and the Fund's jurisdiction under an amendment.

Mr. Bernes said that he hoped that the paper covering restrictions for prudential reasons would also cover the existing institutional architecture in that area. Also he would like the staff to explore the possibility of sanctions under an amendment.

The Deputy General Counsel noted that the paper dealing with the legal aspects of an amendment would address the institutional architecture for prudential measures and conflicting rights and obligations under different international agreements. However, it would not be possible to address the question of sanctions in the forthcoming papers for consideration prior to the Annual Meetings. The staff could cover that in a subsequent paper.

Mr. Daïri considered that the staff should address the topic of sanctions together with the topic of members' obligations under an amendment.

Mr. Taylor wondered whether the issues that had emerged in their discussion on inward direct investment would be covered in the forthcoming papers.

The Deputy General Counsel responded that the paper on the legal aspects of the amendment would discuss the scope of Fund jurisdiction, including the treatment of inward direct investment and the related issue of the right of establishment.

Mr. Yao observed that his authorities would be interested in a discussion of appropriate exchange rate regimes in an environment of free capital movements, as well as a discussion of the kinds of financial instruments countries would need to introduce as a prerequisite to capital account convertibility. He wondered whether future staff papers would address those topics.

Mr. Andersen, noting that the Board would discuss two more papers on the capital account prior to the Interim Committee meeting, asked whether those papers would form the basis of the report to the Interim Committee.

Mr. Taylor said that he hoped that, in discussing such subjective concepts as national interest and effective influence, the staff would not take an overly legalistic approach. Such an approach was more suitable for concepts such as obligations and sanctions, which could be defined objectively.

The Director of the Policy Development and Review Department explained that the two papers that would be discussed by the Board prior to the Interim Committee meeting would address the issues mentioned by the Acting Chairman in his concluding remarks. The introductory sections of the two papers would outline the progress that had been made on the issues thus far. Those two sections, together with the outcome of the next discussion, would form the basis of the report to the Interim Committee, which would then be reviewed by the Board. The papers would address several issues raised at the discussions; however, in view of the time constraint, the remaining issues would be addressed after the Annual Meetings. It might be necessary at some stage to have informal discussions to help resolve some of the contentious issues.

## 3. PHILIPPINES—EXTENDED ARRANGEMENT—REVIEW, AND EXTENSION, AUGMENTATION, AND REPHASING

The Executive Directors considered the staff paper for the fourth review under the Extended Arrangement (EFF) for the Philippines, and its request for extension, rephasing, and augmentation of the arrangement (EBS/97/70, 4/10/97; Sup. 1, 7/14/97; and Sup. 2, 7/18/97).

The Deputy Director of the Asia and Pacific Department made the following statement:

> I will provide a brief description of how the negotiations with the Philippines went and how rapidly events moved, in order to explain the reason for the use of the emergency procedures.
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> As the Executive Directors are aware, the Philippines' macroeconomic performance has been quite favorable. The extension of the Philippines' EFF was initially requested by the Philippine authorities in order to enable them to fulfill their commitment to legislate a comprehensive tax reform which had been a structural element of the EFF. In the meantime, management and the staff had become increasingly concerned about the policy of maintaining essentially a pegged exchange rate, given the Philippines' large trade deficit and recent developments in the regional financial markets. Therefore, allowing some degree of exchange rate flexibility had become an additional issue for the extension of the EFF.
>
> The staff mission that arrived in Manila initially focused on negotiating the fiscal and monetary programs, allowing the discussion on exchange rate to be initiated by Mr. Sugisaki, who was accompanied by Mr. Taylor and myself. As Mr. Sugisaki has explained to the Board, the baht was effectively devalued minutes before the discussions were to start with the Governor of the central bank on Wednesday, July 2. Mr. Sugisaki took advantage of this opportunity to urge the authorities to allow for greater exchange rate flexibility. After Mr. Sugisaki's departure, the mission continued to argue for greater exchange rate flexibility. The governor was initially reluctant to allow this while speculative pressures on the peso were present, but agreed by Monday, July 7, to allow a limited degree of exchange rate flexibility. However, on the same day (Monday July 7), the peso came under another attack and it was clear that the strategy of allowing only a limited adjustment in the peso could indeed be counterproductive as it could set in motion an even larger attack on the peso. The mission took the view that the rapid depletion of reserves could not continue and the authorities should float the peso forthwith. We were not, however, successful in persuading the authorities to undertake such a drastic action. On Wednesday, July 9, following another, and the largest yet, speculative attack against the peso, the Managing Director called Governor Singson who ultimately agreed to float the rate.
>
> On Thursday, July 10, with continued large intervention in the afternoon, the governor met the president and quickly secured his agreement to float the peso Friday morning (July 11). As you know, the market was closed after half an hour, following a decision of the bankers' association. Much of

Friday was spent trying to ensure that the market reopened as soon as possible. To gain maximum speed, the program was finalized late in the evening of Thursday and Friday. The float of the peso was, of course, a major new element of the program that had not been anticipated. To support this action, it was essential that we move as rapidly as possible. The preliminary draft of the papers were therefore prepared on Friday and faxed to head-quarters before the mission's departure on Friday evening. The paper was finalized over the weekend and issued late Monday, July 14.

Mr. Taylor made the following statement:

My Philippine authorities had originally intended to request an extension of the EFF to allow time for Congress to pass the remaining items in the tax agenda, and so provide a graceful exit from Fund programs. However, conditions have changed much in the last month and they now wish not only to extend the arrangement but also to resume purchases and request an augmentation of resources available under the arrangement.

The Philippine economy has strengthened significantly in the last few years because of political stability, prudent macroeconomic policies, and the benefits of sustained implementation of bold and broad-based structural reforms. This has been recognized by the markets through strong capital inflows, the successive upgrading by several rating agencies of the country's sovereign credit rating to just below investment grade in the first half this year, and the successful flotation by the Bangko Sentral of 30-year and 100-year bonds at narrow spreads. So far in 1997, economic performance has remained robust and even exceeded program expectations in some areas—real GNP grew by 6.1 percent in the first quarter while annual inflation averaged lower at 4.6 percent from January through June. Exports expanded by 22.7 percent year-on-year during the first five months resulting in a lower trade deficit than in the program. The National government posted a surplus in the period ending June, albeit smaller than expected because of partly temporary shortfalls in revenue collections during the second quarter. The expansion in commercial bank credit was already slowing in the first five months of the year.

The staff report makes clear the events that had taken place—the sustained heavy speculative attacks on the peso which intensified with the float of the Thai baht in early July. The difficult situation in the regional market has led to increasingly volatile financial market conditions in the Philippines. In the beginning, my authorities were convinced that the pressure against the peso was speculative and opportunistic in nature. In their view, speculation should not be allowed to determine the exchange rate of the peso. They had hoped that the attacks would subside quickly because of the relatively strong economic fundamentals. To stabilize the market, they aggressively intervened using international reserves and large adjustments in interest rates. However, it became clear that intervention was not enough; greater exchange rate flexibility was necessary to prevent a further loss of reserves and further discourage speculative activities. Accordingly, my authorities took the policy decision on July 11 initially to allow the peso to seek its own level and then move within a target range.

Precautionary measures were implemented even before the decision to float the peso was taken to address potential sources of destabilization such as those relating to increases in bank lending to the real estate sector and in bank short-term foreign liabilities. While the exposure of the banking system to the real estate sector remained comfortable (estimated at 10.9 percent of banks' total loan portfolio as of end-1996), in April the Bangko Sentral moved to further tighten the regulatory limit on bank lending to the real estate sector to not more than 20 percent from 30 percent previously. The collateral value of real estate assets was also lowered to 60 percent from 70 percent. Loans to low and medium-scale housing were subsequently exempted from these adjustments.

On banks' foreign exchange position, banks are required to observe, at any time, limits of an overbought position of 20 percent of unimpaired capital and oversold position of 10 percent of unimpaired capital. These limits are strictly enforced. In June, the Bangko Sentral imposed a liquidity requirement on foreign currency liabilities of Foreign Currency Deposit Units (FCDUs), and mandated that 30 percent of these liabilities be maintained in short-term liquid assets. Separate books for their regular banking and FCDU activities are required for the purpose of determining compliance with this measure.

Another important step to further strengthen the banking system was the increase in minimum capital requirements for banks which became effective in January. Philippine banks continue to count among the most highly-capitalized in Asia. They have a networth-to-risk assets ratio of 17 percent which is considerably higher than the statutory requirement of 10 percent.

Turning to policies under the program, monetary policy will remain cautiously tight; the program ceiling on base money is being lowered and short-term interest rates will be kept high until the market settles down. Although in principle a high level of reserves is not necessary under a flexible exchange rate system, my authorities intend to resume the build-up in international reserves as soon as conditions improve. Fiscal policy will be tightened further in the next five months through a combination of improved revenue collection procedures and cuts in expenditures. Together these measures are expected to achieve the originally programmed public sector surplus of 0.2 percent of GNP for the current year. For 1998, a higher surplus is targeted and will be made possible by the full implementation of the comprehensive tax reform package whose remaining elements are provided in a legislation expected to be passed by both houses of Congress by end-October.

In short, my authorities reiterate their firm commitment to sound macroeconomic policies and structural reforms. The resources that would be available under an augmented EFF (together with the parallel financing from the JEXIM) will provide needed stabilization funds to help support the modified exchange rate arrangement in the context of strong macroeconomic policies. Once stability and confidence are restored, my authorities look forward to an orderly exit from this proposed arrangement at the end of this year. I and my authorities would like to thank management and staff for their efforts and prompt cooperation in meeting the unwonted situation that developed.

Mr. Autheman made the following statement:

I approve the proposed extension and augmentation of access of the Philippines to Fund resources in the present circumstances.

I would, nevertheless, like to ask clarification from the staff on one point: under the proposed access, Philippines would be allowed to purchase 757 mns SDR in 1997, which represents 119.2 percent of the quota. Out of this total, 69.2 percent of the quota would consist of resources made previously available under the EFF agreement but not purchased. Could the staff confirm that by not taking into account these purchases in the computation of the annual access limit, the staff has followed previous interpretations of the guidelines and is not creating a precedent?

The recent exchange rate adjustment should help put Philippines' external position on a more sustainable footing. In this respect, the Fund support should not only aim at providing financial resources but also at helping secure real adjustments in the Philippine economy that will avoid the reappearance of recent difficulties. In particular, the Philippine authorities should fully implement the financial tightening required in order to more than compensate the expansionist impact of the devaluation. I would like to express briefly some concerns on the fiscal and monetary policies.

The authorities' commitment to a stronger fiscal stance in the remaining of the year is welcome. But I think that two conditions should be made more explicit for the conclusion of the review. The first is the enactment of the Comprehensive Tax Reform Package. Like under the previous terms of the EFF, the completion of the final review of the agreement should not be considered possible without full implementation of this reform. In this respect, I am concerned by the wording of the Staff Representative in his statement to the Board, on July 11, 1997. The second condition is the establishment of clear and firm fiscal objectives for 1998. I can understand the difficulty in preparing today the budget for 1998, but I am not convinced that relying on an overall forecast of "continued strong growth" constitutes a sufficiently solid scenario for fiscal consolidation.

On the monetary front, some persistent uncertainties need to be addressed. In December 1996, at the occasion of the EFF review, the issue of unchecked extension of domestic credit funded from foreign liabilities, especially foreign currency deposits (FCD), was raised. This worrisome trend has been confirmed in early 1997: while broad money growth reached only 17 percent in March, private sector credit still grew by as much as 37 percent, largely as a consequence of further increases in FCD. At the same time, concerns related to the weaknesses of the Philippine banking system have also been mounting in view of the rapid expansion in bank lending to real estate and consumption.

Since 1996, the staff has repeatedly advocated an adjustment in the reserve requirement (RR) system, a position that I strongly supported. Indeed, equalizing the levels of RR on FCD and peso deposits would eliminate the bias against peso intermediation. Such a distortion, as well as the fixed exchange rate regime, has contributed significantly to the rapid build-up in short-term capital inflows. After the recent floating of the peso, the RR system remains an obstacle to efficient monetary management.

Obviously, I can understand that the introduction of the same RR on FCD as on peso deposits needs to be carefully designed since, at least in the short term, it could prove risky in view of the situation of foreign exchange reserves, market instability, and uncertainty on the banking sector side. However, such a step will be essential in order to secure a more durable monetary control.

The Deputy Director of the Policy Development and Review Department, responding to Mr. Autheman's question about whether a precedent was being set in how the amount of access for the Philippines was being calculated, explained that the amount of access that had been available to the Philippines under the Extended Arrangement prior to late 1996, and on which it had been entitled to draw but had not, had not been counted against the annual access limit of 100 percent of quota. The annual access limits applied to a running 12-month period, and not to the calendar year. The 69.2 percent of quota to which Mr. Autheman had referred included two drawings, equivalent to 27½ percent of quota, that had become available in the summer of 1996—outside of the running 12-month period, which ran from November to November. The amount of access that would be counted against the 100 percent annual access limit was 91.7 percent of quota—which also included the amount of augmentation of the Extended Arrangement.

Mr. Shaalan made the following statement:

We appreciate the prompt response of the Fund and the Philippine authorities to recent events in the region that spread to the Philippines.

First, some relevant background. It is to be recalled that consideration of the fourth review had been postponed because of the delay in the passage by Parliament of certain elements of the Comprehensive Tax Reform Package (CTRP). Since then we learnt that the fiscal situation deteriorated in the second quarter of 1997 and the tax package was not passed. During that time pressures on the peso were clearly evident and were most likely accentuated by developments in Thailand.

The policy response of the authorities described in their request for the extension, rephasing and augmentation of the EFF is possibly the best that can reasonably be expected at this time to address the slippages in fiscal performance as well as the weakest links in the financial and structural areas to support the floatation of the peso. It should be recognized, however, that the fiscal measures being undertaken continue to be of an ad hoc nature and are not expected to address the underlying weakness and inflexibility on the fiscal structure. We also would note here that the staff report does not provide a clear assessment of the effectiveness of the revenue measures undertaken nor does it contain sufficient specification of the planned expenditure reductions. We are therefore concerned that the fiscal target may not be achievable and at the same time we fear that once again capital expenditures will be reduced in an effort to offset revenue shortfalls.

Looking further ahead, raising the level of public saving must be the centerpiece of the authorities' medium term strategy to allow for a significant increase in investment without a widening of the current account deficit. As indicated in the April 10 staff report, the current account was likely to be underestimated. I assume this is still the case and if so, the focus on containing it assumes added importance. It is evident that without improving the fiscal structure public finances are not likely to be sustainable over the medium term. We would note here that the tax ratio and capital expenditure levels remain low in comparison to other countries in a similar stage of development and to others in the region. We therefore would urge the authorities, in addition to ensuring the inclusion of the CTRP in appropriate form in the fiscal program for 1998, to also pursue other key fiscal reforms expeditiously, particularly the review of local government finance which was pointed out by staff in the April report.

While we welcome the authorities' announced measures to strengthen the banking system we are concerned that the issue of large scale foreign currency intermediation remains inadequately addressed. Previous staff reports have stressed the urgency of sharply reducing or eliminating the disincentives against peso intermediation that arise from a number of institutional arrangements. I refer here in particular to the elimination of tax advantages from dollar intermediation and the establishment of the same reserve requirements on peso and dollar deposits. While I can understand the risk of moving abruptly on these issues at this time, I would note that these are very important measures that would need to be taken in a relatively short time frame if the vulnerability of the financial sector is to be seriously addressed. We believe it would be useful for the authorities in collaboration with the staff to set an appropriate timetable for their implementation.

We look forward to a successful completion of the EFF's extension, to be followed by more durable measures to strengthen the fiscal stance and bank soundness. We support the proposed decision.

Mr. Toribio made the following statement:

The staff paper makes clear that until very recently (first quarter of 1997) the macroeconomic program of the Philippines was almost totally on track. Monetary policy remained relatively tightened and adequate measures had been taken on the realm of government expenditures to match lower than expected fiscal revenues. As a result, the Philippine economy experienced a substantial growth during the past three years, with a declining inflation rate, job creation, an export boom, and higher gross foreign reserves.

The report points out several policy challenges starting the second quarter of 1997. Among them, it is explained that the fiscal performance weakened somewhat as a result of a new minor revenue shortfall which was, once more, partially offset by adjustments in public expenditures. There were also some difficulties on the control of net domestic assets and some fiscal distortions for money-market operations. Finally, a delay was registered on the Parliamentary approval of the new tax system, which comes as no surprise for anyone familiarized with the complexities of the political process in modern democracies.

But none of this seem to be especially relevant to explain the present economic circumstances in the Philippines which have led the authorities to request an urgent extension of the current EFF and an augmentation of such an arrangement. If nothing else had happened, we would certainly not be talking today about the Philippine economy as a problem.

The core of the present difficulties lays, once more, on an ill-conceived exchange rate policy, an issue which we have discussed at length in this Board during the last few weeks. As in other cases, we find in the Philippines a substantial current account deficit generated as the by-product of a large inflow of external resources (mainly short-term) which was, in turn, fostered by a combination of a "de facto"exchange rate peg and high domestic interest rates. Such is the summary of the situation that the staff correctly makes on paragraph 22 of the paper.

Once created, the current account imbalance persisted during more than five years without corrective action being taken by the authorities. On the contrary, some tax and reserve requirement advantages were maintained for banks to engage in dollar intermediation. The subsequent boom in private credit did presumably increase the profitability of the banking system in the short term, but it may also have weakened its financial strength. Events were recently precipitated by an external shock whose intensity was initially miscalculated by the Philippine monetary authorities who let foreign reserves be drained through an impossible attempt to keep unchanged the external parity of the peso. Unfortunately, such a sequence of events is becoming too familiar nowadays in the international financial system.

In the Philippine case, the authorities have, however, had the courage to react as soon as they recognized that the situation could not be maintained. As the old saying goes, "late is better than never." We should, therefore, welcome the floating of the peso and the policy measures that have been designed by the Philippine authorities to stabilize foreign exchange market pressures. The announced monetary and fiscal policies seem to be consistent with that purpose and, from my point of view, they deserve the full support of this Board.

There are, however, two points that—in my opinion—should be emphasized in any message that may be conveyed to the attention of the Philippine authorities. The first point would be a reasonable concern about the impact that this imported crises may have had on the financial health of the Philippine banking system, a question on which I would also like to hear the opinion of the staff, however premature a judgment could be at this stage. As a minimum, I think the Board could indicate to the Philippine authorities how much value we would attach to an open and transparent assessment of the situation before recommending new policy measures that could impinge on the financial strength of banks. If needed, we should not hesitate to provide technical assistance in this respect and to make available to the Philippine banking authorities any kind of help they may choose to draw from the wide experience of the Fund staff about financial sector turmoils.

The second point has to do with the new exchange rate policy to be applied after the peso reaches a relatively stable level vis-à-vis the US dollar. In my opinion, the Philippine authorities would do well in trying to smooth out violent turbulences in the exchange rate, provided they let the average trend to keep in synchrony with underlying market conditions. But I do not think they should be in any hurry to return to an openly declared band of fluctuation for the peso, however wide that band may be. There is not immediate need to announce any specific exchange rate commitment that, in connection with interest rate differentials, could again provoke a substantial flow of capitals in any of the two directions. Better let each of the participants in the foreign exchange market freely create their own expectations and take their own chances, with the aim at discouraging speculations, however legitimate they may be. After the experience of the immediate past, I do not think sending any signal to the markets about the intention of the monetary authorities would serve any useful purpose.

Once these two points have been made, let me express my full confidence in the ability of the Philippine authorities to effectively manage the current situation, if they receive enough financial help. There may have been some misjudgments about the vulnerability of the foreign exchange position and, perhaps, about the real exposure of the financial sector, but the fundamentals of the Philippine economy seem to be based on solid grounds, given the responsible fiscal and monetary policies consistently applied in recent years by the Philippine government.

I, therefore, support the decision proposed by the staff to extend the current arrangement until next December, to augment its amount up to the requested limit, and to allow the suggested purchase in the amount equivalent to SDR 508.75 million. I wish the Philippine authorities my best.

Mr. Ono made the following statement:

During recent years the economic fundamentals of the Philippines have continued to improve mainly because of appropriate macroeconomic policies and structural reforms implemented by the authorities.

Despite the economy's good shape, however, the Philippines is now facing a serious currency problem which is a spillover from the speculative attacks against the Thai baht since May. I sympathize with the authorities's feeling that the contagion effect on the Philippines of these speculative attacks is unlucky or unreasonable.

However, in my opinion, one important lesson to be drawn from the recent Philippines experience is that many emerging market economies, after achieving impressive economic growth over a number of years, are now approaching a stage where they are facing difficulties with, or limits to, a rigid foreign exchange system. From this point of view, the decisive action taken by the authorities on July 11 of floating the peso is most welcome. I also commend the staff and management for their efforts during the intensive consultations with the Philippine authorities and for their rapid response to this very difficult issue.

As the staff correctly pointed out, under the new exchange policy it is particularly important for the authorities to conduct more prudent macro-economic policy which includes a strengthening of fiscal policy in order to achieve sustainable growth. In addition, I would like to urge the authorities to make their utmost effort to get final approval of key tax reform legislation by the Senate as soon as possible.

With these brief remarks, this chair broadly agrees with the staff's appraisal and supports the proposed decision.

Let me add one final word on parallel financing from the Export-Import Bank of Japan, which is mentioned int he staff paper. Regarding the availability of this financing, which amounts to about $400 million, I understand that intensive consultations among the relevant parties is under way, and that a Fund decision on this matter is also being awaited. This chair strongly hopes that the Philippines authorities will overcome the current difficult situation with strong international support, mainly from the Fund, but also from JEXIM.

Mr. Bernes made the following statement:

I join colleagues in thanking Staff for the quick and excellent manner in which the recent developments in the Phillippines have been brought to our attention. This experience speaks well of the Fund's surveillance and our ability to respond rapidly and appropriately to members' needs. In general, I concur with the staff's recommendations as outlined in their appraisal and have no difficulty in supporting the request for extending the current EFF, rephasing of the purchases and augmentation. Let me highlight a few areas which we think might help the Phillippines to address their macroeconomic problems and better achieve their program objectives.

We see the Philippine economy operating in excess demand. The incomplete sterilization of large capital flows has resulted in very rapid credit growth which fueled further expansion. Given the large trade deficit, such robust domestic demand is not sustainable. In addition, the banking system has taken on currency and portfolio risks that may add to macroeconomic instability. We applaud the recent action by the authorities to float the peso, but would encourage them to go a step further and forget about a target range for the exchange rate. We would consider efforts to prop up the peso within a specific range to be counterproductive, particularly given the current struggle to bring the level of international reserves more in line with the 3-month import coverage standard. The authorities should let the market determine where the peso should stabilize. Emphasis under the program should be placed on bringing the economic fundamentals in line, and in this regard, we think the Staff have outlined the risks associated with the current situation cogently. Fiscal responsibility, rapid and decisive action of the part of the government to meet the program targets—are key to a successful outcome. So far, the Philippine track record is encouraging and we expect this to continue.

On the overall economy, both price and output data indicate that the economy is in excess demand, while consumer price index inflation fell significantly from December 1995 to December 1996, the Staff state that this was largely the result of a sharp fall in food price inflation and unlikely to persist. It appears that underlying (non-food) inflation accelerated early this year, which indicates that demand pressures are increasing.

The growth of domestic demand, which accelerated from 4 percent in 1993–95 to more than 7 percent in 1996, is responsible for the tightness in the economy. According to the Staff, much of the increase in domestic demand was investment- rather than consumption-based. While investment growth may have been rapid in 1996, it appears that the level of investment spending was quite low in 1995 and that consumption was also fairly strong. We are concerned that excessive credit expansion will exacerbate the current situation. Indeed, the Staff are also concerned about the significant rise in lending. While special factors may explain a portion of the 51 percent increase in private sector credit growth in 1996, clearly such a rapid pace of loan expansion cannot persist.

The deterioration in the external position is worrying, we note that the effect of the larger trade deficit has been mitigated by remittances (a large surplus of the services account) so that the current account deficit is only forecast at 4.2 percent of GDP. The current account is largely funded by (non-FDI) capital inflows. The Staff note that the current account deficit may be underestimated due to a misclassification of capital inflows as remittances. Such a misclassification would understate the true current account deficit.

On the adequacy of fiscal policy to deal with capital inflows, we have some concerns, as the staff recommends further fiscal tightening should large capital inflows persist in 1997. We would agree that an increase in the value-added tax would be appropriate in the face of a consumption boom. However, it is not clear, given the problems with the current fiscal package, that the authorities have the needed flexibility to adjust fiscal policy in a timely manner. Moreover, cutting government spending (especially capital spending) may be inimical to growth prospects. Therefore, we would favor the complete sterilization of capital inflows in the very short-run and accepting an appreciation of the peso should the inflows persist.

The financial sector could be the source of macroeconomic instability, as we see it Philippine banks face both portfolio risk and currency risk and it is not clear that these will be adequately managed to avoid a boom and bust cycle.

The staff are concerned about the significant rise in lending for real estate and consumption. We note that the Philippine central bank is reviewing the exposure of the banks to the property sector to ensure that their exposure does not exceed 30 percent of assets and that the loans are fully collateralized. The Bank is also considering capping the exposure of consumer loans to between 20 percent and 30 percent assets. Currently, the commercial banks' exposure is unlimited and many of the loans could be uncollateralized.

While portfolio diversification is prudent, it is essential that the banks begin to take provisions against bad debts in a timely manner. This solution is painful and there is often the risk that losses will not be recognized and the necessary write-offs be delayed. In addition, regulation and supervision should be strengthened and banks should receive adequate tax relief for provisioning against bad debts.

The staff indicate that there has been a large increase in the number of banks and that this, in turn, was responsible for part of the rapid expansion of credit. In the cases of other countries, an increase in the number of banks has pointed to lax licensing practices, the dangers of which become evident once the economy begins to slow. We urge the authorities to be cautious in the licensing of new banks at this time. Newly licensed banks should be well capitalized, not connected to nonfinancial firms and understand the business of commercial banking.

We are concerned about the apparent currency risk being borne by the financial system. According to the staff, at the end of 1996, the banks had a net foreign liability position (of all maturities) of $6 billion while residents' foreign currency deposits totaled $12 billion. We agree with the staff that the incentives for foreign currency intermediation (differential tax treatment and reserve requirements) should be eliminated as soon as possible.

While it is true that the banks can hedge their exposure by lending in foreign exchange and by holding offsetting forward exposures, this is not sufficient to reduce the risks to the system as a whole. In the case of Mexico in 1994, the currency exposure of the banks was not excessive but, after the sharp depreciation of the peso, the inability of borrowers to service their foreign currency obligations resulted in a sizable increase in nonperforming loans. We wonder if Mexico's example of the central bank providing a foreign currency window to banks might not be applied in this case. In our opinion, this would be appropriate usage of Fund resources.

On fiscal reform measures, it appears that the Comprehensive Tax Reform Package (CTRP) is bogged down in the Senate. The CTRP is essential not only for keeping the deficit on-track in 1997, but also for raising public sector (and national) savings in the medium-term. Failure to pass this package could have a negative impact on investor confidence. Does the Staff believe that the CTRP will indeed become law soon?

We wish the authorities well in their future endeavors.

Mr. Kiekens made the following statement:

Developments in the Philippines show that neither relatively "sound economic fundamentals" nor satisfactory economic progress provides protection against financial market turbulence. The Philippines have achieved a prolonged expansion, falling inflation, near balance in the public sector accounts, a manageable current account deficit, and problem-free external competitiveness reflected by a continuous robust export growth in recent years. Despite all these accomplishments, the recent turmoil in the region's capital markets spilled over in the form of strong pressure on the peso, bringing about a sharp decrease in the Philippines' international reserves in the past few months. If nothing else, this illustrates the necessity of paying more attention to those aspects of economic developments that make an economy more vulnerable to market turbulence.

In the Philippines, the relatively rigid exchange rate, high short-term foreign borrowing by the commercial banks, and fast growing bank credit to the private sector have played an important role in the recent turbulence and point toward the main vulnerabilities that the authorities need to address.

The de facto exchange rate peg since late 1995 combined with high domestic interest rates, encouraged short-term capital inflows that have increased domestic credit, domestic demand, and the trade deficits. Such a pattern is not sustainable.

Sizable short-term capital inflows have made the economy more vulnerable to changes of sentiment in the financial markets. Short-term debt as a percent of reserves rose from its already high level of 106 percent in 1995 to reach 115 percent in 1996. I would appreciate it if the staff could provide us with more recent data for the ratio of international reserves to short-term external debt.

Large short-term foreign borrowings by the commercial banks have further destabilized the economy: the rapid expansion of credit from the banks to the private sector has increasingly been financed by borrowing abroad. The banks' net foreign liabilities have increased from $6 billion at the end of 1996 to $7 billion in 1997. And while these numbers indicate that the banking system is highly vulnerable, the lack of basic data on the banking sector in both the present staff report and the most recent RED paper leave the situation unclear. I would appreciate some information about the ratio of the open foreign currency position of the banks to their paid-in capital. This information is important given the recent depreciation.

As to the needed policies, I hail the authorities' decision to increase the flexibility of the exchange rate. This should eliminate an important source of economic instability by reducing the incentive for capital flows, thereby protecting the Philippines' international reserves, which have declined to dangerously low levels. The target range should be wide enough to permit the exchange rate to find its market-determined level. The authorities should aim at keeping interventions at a minimum by using the interest rates more actively and allowing the exchange rate to depreciate whenever market pressures lower reserves below the targeted level.

It should also be kept in mind that the main factor driving these large short-term capital inflows is the low level of domestic savings. The authorities should therefore target an increase in public savings. This calls for more ambitious fiscal surplus targets for 1997 and 1998. In 1997, the consolidated public sector surplus is targeted to be increased only by 0.2 percent of GNP over 1996. Although I realize that achieving this target will require a stronger fiscal effort during the second half, to compensate the shortfall of the first half, I am not sure that the markets will perceive such a minor improvement over last year as an indicator of a strong fiscal stance. In addition, the change in the composition of the national government accounts will not be in the desired direction. The shortfall in the tax revenues will be compensated mostly by cuts in the capital expenditure. Additional measures to strengthen the tax performance are needed. The most important of these is the Comprehensive Tax Reform Program. It is worrisome that the House of Representative version of the tax reform would result in sizable revenue losses. I hope the Senate will make needed changes in the bill to make it meet the government's original revenue target. If the package is not available this year, or does not contain amendments enabling it to meet the original revenue targets, the authorities must be ready to take additional revenue and expenditure measures to compensate for the shortfall.

The banking system of the Philippines needs to be strengthened. I welcome the additional measures that the authorities have taken to that end, including reducing the incentives to rely on short-term foreign currency liabilities and limiting the banks' exposure to the real estate sector. The next review should further clarify the situation of the Filipino banking sector.

The Filipino authorities have shown their determination and ability to stick to prudent policies. I agree with the staff that the fundamentals of the Philippine economy have greatly strengthened in recent years, and that no drastic reorientation of macroeconomic policies is needed. I am convinced that the authorities are perfectly aware of the economy's vulnerabilities and will promptly address them.

I think that the size of the financial assistance and the use of the emergency procedure are warranted. I would nonetheless like to suggest, to the Managing Director, that in such cases any supportive press communiqué that announces the reaching of understandings with a country on a Fund supported program should not be issued until all performance criteria and other essential conditions for a program have been agreed on.

Today's emergency assistance to the Philippines is being provided under an EFF program only because there was an existing program that could in extremis be reactivated, extended and augmented. The normal instrument for such assistance would have been a new Stand-By Arrangement. Indeed, EFFs can only apply—and I quote from the Fund's decision on EFFs—to economies "suffering a serious payments imbalance relating to serious maladjustments in production and trade, and where prices and cost distortions have been widespread" or to "an economy characterized by slow growth and an inherently weak balance of payments position which prevents pursuit of an active development policy." Repurchases under an EFF arrangement normally take place within the period of four to ten years after each purchase. Such a long repurchase period is justified, since access to Fund resources under an EFF is reserved to members "whose balance of payments problem will require a longer period than the period for which the resources of the Fund are available under existing tranche policies."

I can agree with the proposed decisions, but only with the understanding that the Filipino authorities will make repurchases of any drawings as soon as the balance of payments problem has been overcome. My expectation is that this will be well within the period for repurchases under a Stand-By Arrangement, or even sooner. I would appreciate it if Mr. Taylor could confirm to the Board that his authorities agree with this understanding.

In a more general way, I require that the Board revisit, in coming months, the issue of whether the repurchase period of four to ten years under EFF programs is still appropriate for emerging market economies that have ample access to the financial markets.

Mr. Donecker made the following statement:

Let me first of all commend the authorities for the way they have handled the somewhat difficult situation so far. Of special importance in this context—of course—was the decision to allow greater flexibility for the exchange rate of the peso. In our view it is of crucial importance for the period ahead that the authorities strengthen their credibility by pursuing appropriately sound macro policies and structural reforms along the lines recommended by staff.

In this context—and not only in the case of the Philippines—it is important to avoid taboo areas of economic policies—such as the exchange rate policy—that give rise to the perception that certain policy options can be ruled out when assessing risks.

The proposed support for the authorities' efforts in the immediate period ahead in the form of providing a "quality seal" for the agreed policies and of providing sizable funds, should help to assure the markets that the Philippine economy is on the right track and equipped to handle current difficulties. We can support the proposed decision. However, it is disappointing that the Philippines have become subject to severe questions by markets about the actual soundness of its economic situation so close to the much anticipated graduation from their 23rd or so Fund supported adjustment program.

Although the previous level of the exchange rate peg in the case of the Philippines was not severely out of line with fundamentals—as staff has pointed out—the official support of the perception respectively expectation by market participants that the exchange rate risk was almost nil has certainly contributed to problematic investment and lending decisions. Thus earlier exchange rate flexibility would have been preferable, as many members of this Board had already stressed at previous occasions. But that is water under the bridge now.

There are other countries that had to make the same experience in the recent past, namely that the prolonged maintenance of an exchange rate peg—or its level—can have significant costs to the economy as a whole as well as for the credibility of the authorities.

A lesson for the Fund—especially against the background of increased globalization—should be to give the evaluation of exchange rate policies—the actual core business of Fund's surveillance—the due central role in discussions with national authorities. Important in this context is also a timely consideration of appropriate exit strategies from fixed exchange rate regimes. For this reason we need clear and frank assessments of these critical issues in reports to the Board and communications to the authorities. The staff report in front of us today and the frank way in which Mr. Neiss has informed the Board in his statement on July 11, 1997, are positive examples in this respect. If the exchange rate policy in one country must be regarded as "an important element of instability in the economy," staff clearly should say so and we should even question to continue a Fund supported program in such a case, if the authorities are not prepared to take corrective actions.

Let me now turn to the elements of the proposed program. We can support the thrust of it and I would like to comment only on a few aspects.

First, on exchange rate policy. In our view the authorities should refrain from actively trying to influence the level of the exchange rate. When setting a target range for the peso at a later stage as indicated by Mr. Taylor in his helpful statement, the width of the range or band, in our view, should not be too narrow. In the immediate period ahead the authorities should limit their interventions in the foreign exchange market to smooth market developments and to gradually increase their foreign exchange reserves. We are not sure, however, whether the recommendation by staff that "the authorities should move as quickly as possible" (TZ 23) to rebuilt reserves after the turmoil has calmed down will not create a new element of uncertainty about the exchange rate policy of the authorities. In this area a more gradual and cautious approach seems preferable, particularly so since a floating exchange rate regime does not really require a high level of reserves, as also observed by Mr. Taylor.

Secondly, on monetary policy and the regulatory framework for the use of different currencies, staff and the authorities seem to have differing views whether and how to "level the playing field between peso and dollar intermediation" (TZ 21). On this issue we like to support staff's view and Mr. Autheman that distortions and biases toward the intermediation and use of one currency should be dismantled as soon as market have calmed down.

Thirdly, on fiscal policy. According to staff's report the measures to secure the 1997 fiscal targets are not yet agreed upon. However staff seems to have assurances that the targets will be achievable. Failure to meet the agreed targets would adversely affect the credibility of the authorities. Besides short-term ad hoc efforts to deal with current circumstances measures should also include adjustments for permanent cuts of current expenditures and the reform of the civil service in the near future. With respect to the Tax Reform package and the budget for 1998 we share Mr. Autheman's views.

On custom duties and privatization receipts staff has noted that the budget is confronted with a "continuing shortfall ... totaling 0.6 percent of GDP" (TZ 15). I would appreciate staff's comments on the background for these ongoing shortfalls and what corrective measures are planned.

Finally I have already indicated that we can support the proposed decisions. I wonder, however, whether any thought has been given to the possibility of early repurchases of the sizable drawings once the situation has stabilized again. I very much share Mr. Kiekens's concerns here. The staff comments would be welcome.

Mr. Taylor made the following additional statement:

This has a difficult aspect, in coming up at such a late stage in consideration of the issues, particularly after the system in the Philippines has signed off, as it were. My understanding is that it is not a legal issue that is involved, but that there may be an implied moral obligation on the Philippines.

I have had the opportunity to discuss this with the authorities last night, and the authorities would like me to say that the Philippines has always sought to cooperate with the Fund and to be a good citizen of the Fund and, in this context, what that would mean is that, depending on how circumstances unfold in the presently uncertain situation but hopefully one which strengthens sufficiently in the future, the Philippines will not act unreasonably in seeking to maintain any undue use of Fund resources. I hope that that is a sufficient indication of intention.

I think that if there is an issue here, it ought to be discussed in general, not against any particular country or particular situation, and some general approach to the matter developed if the existing law and decisions are considered inadequate.

Mr. Daïri observed that Mr. Donecker had said that, under a flexible exchange rate regime, the need for reserves was lower than it was under a pegged system. In that case, he wondered whether it was appropriate to consider the floor on net international reserves as a key target to guide monetary and exchange rate policy.

The Deputy Director of the Asia and Pacific Department replied that the floor on the net international reserves had been designed to ensure that intervention in the market was kept to an absolute minimum. Over the longer period, some accumulation of reserves had been targeted, simply because the level of reserves was so low. The experience of other countries suggested that, even with a flexible exchange rate regime, some reserves were necessary, unless the authorities were prepared to conduct a completely clean float with no intervention at all, which would not be realistic.

Ms. Lissakers said that she recalled that the Board had agreed to come back to the question of early repurchases at the general policy level at some time. The interventions of Directors that morning suggested to her that that discussion should be held in the not too distant future.

Mr. Levy made the following statement:

> I would like to convey my appreciation for the quality of the documents that have been prepared by the staff in a remarkably short time span.
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> On the issue itself, given the substantial strengthening of the Philippines' economic fundamentals over the past decade and the unexpected contagion effects of a crisis that had its roots elsewhere, I would view this as a typical case for which the Extended Arrangement and the emergency procedures were created. Thus, I concur with the accelerated provision of a front-loaded, larger amount of resources from the Fund to support the Philippines, particularly as the policy efforts have remained broadly on track under the current Extended Arrangement. However, to the extent that financial markets stabilize and confidence in the currency recovers, I would hope that the authorities would consider the Fund's support, and especially the drawing of the last tranche of SDR 246 million, as precautionary in nature. In addition, since the funds are intended primarily to build up confidence rather than to directly increase reserves, and given Mr. Kiekens's convincing arguments regarding the use of the Extended Arrangement in this case, I would like to join Messrs. Kiekens and Donecker in asking the authorities to make repurchases soon after confidence is regained. I was glad to hear the assurances in this respect from Mr. Taylor.
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> I also welcome the additional adjustment efforts envisaged under this program review. In particular, I would underscore the importance of maintaining sufficient exchange rate flexibility in accordance with the policy of a market-determined floating exchange rate, of keeping the envisaged budget consolidation program on track, of fully implementing without further delay the structural reform program, especially the comprehensive tax reform package, of strengthening the banking system, and of firmly adhering to the initial inflation target of 7 percent.
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> With respect to the inflation target, I have some concerns that the monetary program may be somewhat loose. The staff notes in the staff paper that M3 growth has become a less useful indicator of broad liquidity, and that the base money target has been set in the framework of broad liquidity growth M4, which includes foreign currency deposits. Given this assumption, the staff could have directly reported to us in Table 6, which presents the monetary survey, on M4 velocity as well, as it is assumed to decrease by 7 percent by December 1997 in comparison with a year earlier, which is a much greater decline than that attributed to M3, which is directly reported in the monetary

survey. If the staff's assessment regarding the role of M4 in the economy is correct, then the assumption on the decline of the M4 multiplier may turn out to be overly optimistic, as the depreciation of the peso may generate an inflationary impulse and, therefore, a tighter monetary program may be required in order to achieve the initial inflation target of 7 percent.

At a more general level, I would urge the authorities to watch the development of the monetary aggregates very closely in the next few months, and on a longer-term basis, to consider the adoption of a clearly-defined monetary strategy that would provide a firm and sustainable nominal anchor to guide policies toward the achievement of durable noninflationary growth.

Regarding the measures taken to reduce the advantage of foreign exchange intermediation relative to peso intermediation, increased exchange rate volatility due to the recent floating of the peso will obviously reduce incentives for dollar borrowing. However, as pointed out by some of the previous speakers, the remaining high, mostly nonremunerated reserve requirement of 15 percent on peso deposits—in comparison with no reserve requirement on foreign exchange deposits—still places peso intermediation at a disadvantage. The recent requirement to maintain 30 percent of foreign currency deposits in short-term liquid assets certainly has merits from a prudential point of view, but it only slightly reduces the advantage of dollar intermediation, since these assets earn market interest rates. The authorities should, therefore, adopt a longer-term strategy to reduce the reserve ratio on peso deposits to increase substantially the capitalization of the central bank, and to substitute the reserve ratios with open-market operations, as recommended by the staff.

I support the proposed decision to extend the arrangement until end-December and to augment it by an additional SDR 158 million.

Mr. Shields made the following statement:

Like others, I would like to thank the staff for another very clear and concise report, written under tight deadlines, and for the explanation of what has been happening over the last 10 days, because it is important, under the emergency financing procedures, that we know precisely what the circumstances are, and that we are kept informed about the relationship between the management, the staff, and the authorities.

I agree with what other Directors have said about the situation in which the Philippines has found itself. The country seems to have only partially deserved what has happened over the last few weeks. Had it not been for the spillover from Thailand, the peso peg might have survived at a relatively small cost, although it is clear that the seeds of disaster were sown in the form of a peg that was probably inappropriately centered on the U.S. dollar, with consequent perceptions of some overvaluation. Also as others had mentioned, the slippages in fiscal policy and the recent slight lag on the structural policy commitments were beginning to become clear.

The strong growth of private credit on the basis of mutual fund currency funding was another worrying factor. As so often in the past, the Philippines has suffered from nasty exogenous shocks, accentuating its own policy shortcomings. An important question for the Fund is whether the Fund could have done more to insulate the Philippines from the effects of developments in Thailand. One way would have been to press the authorities even more strongly to move away from the peso peg sooner than they did. Perhaps the Fund could have made that message even clearer, or used other ways of conveying it. At the same time, given the resistance of the authorities, it would have been difficult to move them. Another thought is whether the Fund should be more public in its assessment of problems in specific countries. In the case of Thailand, much of that was done privately. The Fund had put to the authorities very clearly the message that they were running into problems, but the Fund had kept away from public comment, as in the past. Of course, there is always the fear that some statement by the Managing Director or others will precipitate a strong reaction by the markets; but that need not necessarily be a bad thing, because, as has been noted before, it is better to have a small early shock than a delayed large one. Also, in not commenting on Thailand, we had the interests of the Thai economy in mind, but are we necessarily doing the best for the rest of the region? It could well be that had we made clearer our concerns on Thailand, markets might have discriminated more wisely between Thai problems and those of other countries.

There has been a significant improvement in the Philippines' economy in recent years. This reflects good macroeconomic policies, and laterally good progress on structural reforms, but there are still plenty of macroeconomic risks remaining, including the widening trade deficit because of what has happened in the past on the real exchange rate, the weakness of the banking system, and the inappropriate incentives for foreign currency intermediation.

Concerning the size of the program and the speed of the Fund's response, I agree that we needed to act quickly in using the emergency procedures. It is harder to justify the use of a large amount of additional resources given the reasonable current and capital account situation, so I think that the only justification for the additional Fund resources is to increase reserves and thus promote confidence in the markets. Therefore, it is appropriate that the program allow specifically for an increase in reserves.

The critical areas in the program are improving banking sector soundness and fiscal policy. Like others, I think that the crucial issues in the banking sector are structural distortions and general prudential standards. While I agree about the importance of eliminating the incentives for foreign currency intermediation, I disagree with what Mr. Autheman said about reserve requirements. The best way of removing the distortions regarding domestic against foreign currency deposits is to reduce reserve requirements on domestic currency deposits so that they are at the same level as those for foreign currency deposits. Especially in an economy that is already pretty dollarized, and which could do with more intermediation, particularly, in domestic currency, the objective should be to reduce the disincentives to intermediation. On general banking sector soundness, I support the central bank's recent initiatives, and would urge it to stand ready to take additional actions, as necessary.

As others have said on fiscal policy, the key issue is clearly the enactment and implementation of the comprehensive tax reform program. Given the inevitable short-term inflation impact of the depreciation and the current levels of interest rates, it seems right that the policymakers should rebalance toward greater fiscal consolidation. The fact that there has been some weakening of the revenue implications of the tax reform program by the house of representatives is regrettable, and we need to send yet another strong message to the authorities that the tax reform package needs to enhance revenues as well as improve the structure of the tax system. Like Mr. Shaalan and others, I do not find the assurances about the 1998 fiscal deficit particularly convincing; and the fact that there will be a presidential election campaign makes me doubt even more whether this will actually be realized.

I agree very much with what Messrs. Kiekens, Donecker, and Levy had to say about early repurchase. I would hope that the policy measures included in the program, and the hoped-for return to general stability in the region, will allow the authorities to rebuild their reserves over a relatively short period. Therefore, the provision of money on terms of the Extended Arrangement does not seem appropriate. Concerning Mr. Taylor's assurances that the Philippines' authorities would bear these points very much in mind, we need to talk about the question of early repurchase again, but my understanding is that, under the existing arrangements, the Fund's Treasurer would bring to the notice of the authorities the fact that they were in a position to make early repurchases in any case, and presumably put pressure on them to do so. I would hope that under existing arrangements, the combination of the moral obligation of the Philippines' authorities, and action by our Treasurer, would make sure that an early repurchase takes place.

The Acting Chairman said that he could confirm that the staff had worked very hard to get the authorities to move away from a rigid exchange rate, as had the Fund management and Mr. Taylor. Of course, the markets probably had given more effective pressure than the Fund could have given.

Mr. Eyzaguirre made the following statement:

I would like to join the staff and previous speakers in welcoming the recent actions taken by the Philippine authorities and support their request for an extension, rephasing and augmentation of the current Extended Arrangement. In this regard, I would emphasize the importance of the prompt actions taken by the authorities and the Fund and the desirability of similar actions elsewhere in the region to quickly address a situation of spreading financial market disturbances that has not limited itself to emerging market countries.

With regard to the present situation of the Philippines, we consider it predominantly a liquidity problem stemming from the regional financial markets turmoil, rather than a situation where solvency considerations are at stake. International support for the authorities' policy actions, as the staff suggests, will be instrumental in bolstering confidence, thereby assisting the Philippines in dealing with this financial market turmoil.

We believe that the Philippines' economy continues to have solid economic fundamentals brought about by the implementation of appropriate macroeconomic policies and structural reforms. Given these strong fundamentals and the remarkable continued performance of the export sector, we do not consider that there is a need for a significative realignment of the real exchange rate.

It is worth noting the significant volatility of capital flows, specially those of short-term nature. While the Philippines were enjoying successive upgrades by several rating agencies of the country's sovereign credit rating, including one given earlier this year, and having to cope with problems stemming from excessive capital inflows until recently, the situation has turned around very quickly and today's policy efforts are aimed at restoring confidence, and avoiding sizable capital outflows.

It has to be recognized, however, that in the context of fast growing small open economies, which normally require sizable amounts of complementary external savings, every effort has to be made to avoid inducing short-term capital inflows. In that regard, the balance between the monetary stance and the exchange rate policy has to be chosen carefully. The greater exchange rate flexibility introduced recently is expected to reduce incentives for speculative behavior. However, while interventions will be kept to a minimum and used only to provide the markets with a signal, we wonder to what extent this signal may end up encouraging some degree of speculative behavior.

In relation to the present situation and the intended measures we welcome the fiscal surplus achieved in the period ending June and the authorities' ambitious fiscal target for 1998. Given the critical importance of fiscal performance both in promoting a stable exchange rate in the context of globalized financial markets, as well as maintaining credibility and restoring confidence when speculative pressures developed we note with concern that the fiscal impulse seems to be very sensitive to the legislative process. In this connection, it is noteworthy that while the government's aim was to increase the tax reform package revenues by about ½ percent of GNP, the House of Representatives' version of the tax reform package would result in sizable revenue losses. We believe that this may represent a significant institutional limitation. If Congress can reverse the macroeconomic impact of fiscal measures, the policy stance may lack the necessary degree of consistency and predictability.

On the banking system, it is comforting to read in Mr. Taylor's informative buff, that limits are imposed, and strictly enforced, on banks' foreign exchange positions. The high level of capitalization of banks coupled with the new liquidity requirements on foreign currency deposit units, should limit banks' vulnerability to exchange rate volatility. We wonder, however, given the sizable amount of inflows in the recent past, what is the extent of maturity mismatches of foreign assets and liabilities in the banking sector as well as the foreign exchange positions in the corporate sector, where banks should have a high proportion of their assets. We highlight in this connection the importance of adequate precautionary measures and prudential regulations which in the circumstances of higher volatility facing emerging market countries may even need to exceed internationally agreed "best practices." .

We also welcome efforts made by the authorities in trying to lengthen the maturity structure of the central bank's repurchase arrangements in order to reduce instability in domestic money and foreign exchange markets. It is difficult to understand, however, the opportunity and advisability of previous tax changes that made longer-maturity central bank management instruments less attractive .

Finally, we should not exclude the possibility of revising downwards growth targets for 97 and 98, in light of the need to reduce the trade deficit during this turmoil period, and maintaining momentum in reducing inflation when upward pressures are expected to come from the depreciation of the currency and the pick-up in food prices.

To conclude, we wish the authorities every success in their future endeavors.

Ms. Lissakers made the following statement:

In recent years, the Philippine government, working closely with the Fund, has been able to improve the performance of the Philippine economy quite dramatically. As Mr. Mussa said on Wednesday, we should view recent events as a bump on an otherwise solid path of reform. Given this track record, we certainly agree that the Philippine authorities deserve our support in the current difficulties, and we support the proposed decision. Nevertheless, I agree with the comments that many of my colleagues have made, that there have been weaknesses in some Philippine policies, which this Board and the staff have pointed out to the authorities over the years, and which the authorities have unfortunately chosen not to correct. They are now paying the price.

I do not agree with the assessment in Mr. Taylor's statement that all of the inflows in the past were in response to prudent and bold policies while the outflows in the recent weeks are purely speculative and opportunistic. In fact, one could turn that argument on its head. Certain policies that were followed attracted unsustainable speculative inflows. As a result of these unsustainable policies, the markets have forced a correction.

I am a little surprised the staff projects that the current account deficit will still be 4.5 percent this year. I would be surprised if the current account, in fact, does not end up smaller, given the exchange rate adjustment and would be interested in the staff's comments on why they think the recent devaluation will not have a larger impact on exports and imports. If staff is confident about this projection, then I have concerns about whether the program provides for enough external adjustment, on which I will elaborate in a moment.

I agree with the authorities' decision to allow the peso to float. However, having done this, it is important that the authorities not repeat the mistakes of the past by claiming that there is a floating rate, while, in fact, pursuing a fixed regime. I do not think it helps to talk about their past, "market-oriented exchange rate arrangement," when, as Mr. Mussa said the other day, the graph of the peso-dollar looked like a cardiogram of a rock. Mr. Taylor says the authorities intend to let the peso find its own level. It would be useful if Mr. Taylor or the staff could explain how this policy is consistent with reports that the Bank of the Philippines continues to intervene in the market. Could he also elaborate on what his authorities mean when they say that eventually a target range will be established that will be large enough to permit market forces to operate fully?

On the question of bank intermediation in dollars, the staff and members of the Board have urged the Philippine authorities to eliminate the incentive for such intermediation and create a level playing field between peso and dollar deposits. The authorities are now requiring that 30 percent of the value of banks' foreign exchange liabilities be held in short-term liquid assets. As Mr. Levy pointed out, while this may be useful from a prudential standpoint, it does not really do much to eliminate the incentive for continued dollar intermediation. I can only conclude that the authorities do not want to eliminate the incentive for dollar intermediation. I suppose this is somewhat understandable given current reserve circumstances. While staff proposed a level playing field, I wonder why they did not insist that there at least be an agreed timetable to achieve one.

On the need to build reserves, the program would allow for a decline in reserves, and then calls for only a modest accumulation of $500 million for the rest of the year. I wonder whether this is ambitious enough. Philippine reserves are already quite low. Other countries that have come under pressure have had much larger reserves. It seems to me that it would be desirable to have a more ambitious reserve accumulation target, even with a floating exchange regime, particularly given the size of the expected continued current account gap and need for continued external financing.

On base money targets, in several Board meetings over the past two years, we and several other Directors expressed concern that the targets, which allowed for both a substantial increase and an adjustor to allow for an even greater expansion in response to capital inflows, were too generous. As I pointed out several times, the authorities seemed to share these concerns, always keeping base money below the program targets. I see that the money targets have been reduced again in the program, but the authorities say in paragraph 12 of the letter of intent that meeting the inflation and NDR targets will again require that base money be kept below targets. Why not just have lower targets?

It is not clear to us that the fiscal adjustment called for in the program is sufficient, given the large expected current account deficit and low reserves. In addition, there do not seem to be many specific measures enumerated to ensure that even the revised fiscal targets will actually be met. Instead, there are general, vague promises to improve enforcement of tax collection, and half of the fiscal adjustment next year is supposed to come from higher growth. If this was some other policy area where there had not been the kind of slippages that we have seen in the Philippines, I would be more willing to give the authorities the benefit of the doubt. But revenue mobilization has been a particular area of weakness in the performance.

One of my concerns about recent fiscal performance is that operations and maintenance and public investment have taken the brunt of making up for revenue shortfalls, even though inadequate public infrastructure has created serious bottlenecks in many sectors. Therefore, staff will need to take a close look at whether the government's revenue efforts are adequate to meet the targets.

Finally, I want to comment on the use of the emergency mechanism procedures. Given the fact that the Board, in these circumstances, needs to move quickly when there is a high degree of market volatility, and thus have a very short period of time to consider our decision and not really much scope for saying no, it is very important that the programs presented under these circumstances are very tough. It seems to me that the staff could have been more insistent with the authorities than they were on a couple of issues. I would expect that if we are presented with another program under the emergency mechanism in the near future, that we are presented with a program that covers all of the areas of weakness the institution has highlighted in the past and that corrective actions in these areas be specific requirements in any program. This is particularly important for countries where the authorities have resisted taking early corrective measures and where they have resisted giving adequate information to this institution.

Mr. Zhang made the following statement:

With stronger GDP growth and subdued inflation, the main economic indicators of the Philippines registered a significant improvement in the economy in last few years. The economic tension in the second quarter has been unavoidable due to the heavy regional currency speculative attack, given the small size of the economy, and external vulnerability as a byproduct of integration into the world economy. The authorities' timely adjustment of the exchange rate regime would help mitigate the speculative attack, however, the final removal of the tension relies on the further strengthening of the Philippines' economy and the smoothing out of the regional environment. In light of the good performance of the economy under the Fund program and the current emergency situation, I would like to endorse the staff proposed extension and augmentation of the Philippines' access to Fund resources. Since I basically agree with the staff appraisal, I would like to make a few comments on some policy issues.

The weakness in the policy side, if any, could be attributed to a still relatively high current account deficit and the weakened fiscal performance. In the wave of currency attack, I share Mr. Taylor's candid analysis in his helpful statement that the authorities had hoped "the attack would subside quickly because of the relatively strong economic fundamentals," however, the authorities finally floated the peso when intervention was not sufficient to combat the sizable attack. Therefore, I support the Fund's financial assistance to the Philippines in a timely fashion.

In addressing the present situation, two priorities should be dealt with immediately: strengthening public finance and improving the current account position. Since the depreciation of peso could add inflation pressure, fiscal and monetary tightening is all the more important to support the whole policy objectives.

With regard to fiscal policy, I welcome the policy packages to secure the 1997 fiscal targets as outlined on page 17, and the message that the Comprehensive Tax Reform Program is to be enacted by the end of October. Timely introduction of this Program is of great importance. I support the authorities' effort to enhance the revenue by strengthening the tax administration. However, the expenditure cut effort should also be emphasized.

Monetary policy should play a central role to underpin the whole macroeconomic policy framework, especially to support the new exchange rate regime. The authorities' timely action on raising interest rates is appropriate for resisting the currency attack. This impact is also reflected in the strong decline of NDA in 1996. In the near future, given the depreciation of the peso, tight monetary policy should be firmly maintained to withstand possible inflation pressure. Furthermore, NDA should be closely monitored and kept within the program target.

Finally, I would like to emphasize the issue of banking supervision, which is usually an important testimony of an economy's capacity to withstand crisis. Sound monetary policy can only take full effect with a well supervised banking system. The significant rise in lending for real estate and consumption should be cautioned and analyzed carefully in order to assess whether there is speculative and excessive investment. I welcome the authorities' action to limit banks' exposure to the real estate sector as well as the action toward leveling the playing field between peso and dollar intermediation. I also welcome the imposition of liquidity ratio requirements by the Bangko Sentral on the FCDUs.

With these remarks, I would again support the proposed decision and wish the authorities success in combating the present economic difficulties.

Ms. Mercusa made the following statement:

In the past few days we had several occasions to discuss recent developments in financial markets that forced the floating of two currencies in the East Asia region. Since I do not believe that speculators are totally blind, I welcome the request of Philippines authorities for an extension and augmentation of the current EFF program. This is both an explicit recognition of the need for further macroeconomic adjustment and structural reforms and a deterrent against further turmoil in foreign exchange markets.

In asking a continuation of the program the authorities show commendable perseverance in the objectives stated in the 1994 EFF program, and offer a candid assessment of the sensitiveness of the current situation. Moreover we appreciate the efforts made toward maintaining transparency and accessibility to relevant financial information.

By granting access to exceptional financing the Fund will clearly signal to the market that it considers the situation in the Philippines sustainable and that it supports current reform efforts being undertaken in the country.

Having said this, let me make a few specific considerations on the program itself. I will mention three points: tax reforms, the current account and bank surveillance.

With respect to tax reform, I remain doubtful of the efficacy of the signal that the approval of this program will have if the long awaited for Comprehensive Tax Reform Package will not become a structural parameter for the next review. I agree with Mr. Autheman that "the completion of the final review should not be considered possible without full implementation of this reform." Moreover, in view of the alarmed exhortation of Mr. Sivaraman (during the last WEMD session) on the negative revenue effects of recent tax reforms in other Asian countries, I urge quick decisions on the Package. This should be embedded in the review's targets.

Concerning the current account, the devaluation of the peso will undoubtedly help the trade sector to regain competitiveness, as the real effective exchange rate against the major trading partners had appreciated by 6 percent in the past year. On the other hand, however, the inflow of foreign exchange—via remittances, and foreign direct and portfolio investments, will be probably be negatively affected by the greater uncertainty of a floating currency. These inflows have so far helped to sustain the widening trade deficit. While it is reasonable that the authorities aim at maintaining in 1997 the same current account deficit that they reached in 1996, the recent experience shows that large current account deficits are not sustainable in the long term.

Measures to reduce substantially the CA deficit are therefore crucial beginning in 1998. The program should be strengthened in this respect, if an improvement will not occur in the trade balance as a result of improved price competitiveness.

With regard to banking system surveillance, the Philippines' banks will be severely hit by the recent devaluation, to the extent that they are exposed to dollar borrowings.

Apparently and fortunately they are not too exposed in the real estate sector, that has experienced a property boom in the last three years. Such an exposure was instead a critical factor for Thai banks. Mr. Taylor statement is reassuring in explaining recent measures adopted for the banking sector. It is nonetheless very important that the system be kept under constant surveillance and that early crisis detection mechanisms be put in place. What the Philippines do not need at this point are emerging weaknesses in the banking sector.

We believe that with continued good policies, continued strong credibility that follows from there and from regional and the Fund support, the Philippines can overcome present uncertainties and difficulties and have further successes in their economic and social performance.

Mr. Mozhin made the following statement:

Over the past couple of years, the Philippines' economy has performed reasonably well. The year 1996 was especially strong, characterized by healthy growth, falling inflation, and an almost eliminated fiscal deficit. At 4.3 percent of GNP, the current account deficit does not seem to be excessively large, although its heavy dependence on remittances could be seen as a source of vulnerability. We have not heard about any serious problems in the Philippines' banking sector. Therefore, I find it somewhat odd that, for the first time ever, we have had to activate the emergency financing mechanism in connection with the Philippines.

I have to say that I do not see any obvious reasons why the peso should have come under such strong downward pressure. The absence of any obvious reasons is perhaps the most peculiar feature of the current financial turmoil in the Philippines. My impression is that the financial markets have come to the view that whenever there is an exchange rate peg, it should be seen as an invitation for their attack. If this is true, then we are going to have more and more such attacks for no obvious reasons.

Only six months ago, we had an Article IV consultation discussion on the Philippines. Let me quote from the Acting Chairman's summing up: "Some Directors were of the view that allowing some additional degree of exchange rate flexibility would help maintain monetary control and also discourage short-term and potentially volatile inflows. Some other Directors thought that monetary tightening could be effected without necessarily an appreciation of the exchange rate. They were cautious about recommending appreciation in view of the large current account deficit." Obviously, when talking about allowing some additional degree of exchange rate flexibility, nominal appreciation was meant.

Regardless of what has recently happened in the Philippines, this part of the Acting Chairman's summing up can hardly be seen as meaningful advice to the authorities. Of course, our basic problem is that we simply do not have clear views on several most relevant issues. For example, would the flotation of the peso at the time of strong capital inflows and upward pressure really have led to a significant nominal appreciation and a further increase in the current account deficit, or would the withdrawal of the exchange rate guarantee have led to a more responsible financial market behavior and a reduction in short-term capital inflows? Do we know any cases of exiting from the exchange rate peg under conditions of upward pressure and large current account deficits? Perhaps the staff would want to comment on this.

Whatever the reasons for the recent financial turmoil in the Philippines, I do not think that anything really serious has happened. The flotation of the peso was the right step and perhaps long overdue. Given reasonably strong fundamentals and the preparedness of the Philippines' authorities to respond promptly and appropriately, the peso should stabilize in a relatively short period. The fact that neither the Philippines' authorities nor the staff felt it necessary to revise growth projections or inflation targets for 1997 seems to be quite reassuring. Of course, I do not mean to say that there are absolutely no problems. Clearly, there is a need to recover the fiscal revenue shortfall that occurred in the first half of the year. There seems to be some room for further reduction in fiscal expenditures. There is also a need for some further monetary tightening, especially since international reserves will have to be gradually replenished. Of course, the developments in the banking sector will have to be closely monitored.

It is indicated in the staff paper that the authorities are opposed to the introduction of reserve requirements on foreign currency deposits. Like several other Directors, I am curious what exactly makes them so willing to discriminate against peso deposits.

I believe that under the circumstances, the Fund's financial assistance to the Philippines would be appropriate and should help the authorities to restore confidence and stability in the foreign exchange market. Therefore, I support the proposed decision, as amended.

Mr. Daïri made the following statement:

We commend the staff and management for the timely response to the authorities' request for Fund support and for the concise and well written paper. We also commend the authorities for their vigorous reaction and close cooperation with the Fund. While the performance of the Philippines' economy in recent years has improved significantly, we wonder if it is appropriate after a crisis of this magnitude to maintain unchanged the initial objectives for growth, inflation, and the external current account. Already, the central bank has announced that average inflation would reach 8.5 percent in 1997, as against the 6.5 percent of the program, a very likely outcome in view of the effect of the depreciation of the peso and the basically unchanged fiscal stance. More importantly, one wonders if the unchanged objective for the current account deficit for 1996—0.4 percent of GNP higher than the original program—is consistent with the need to strengthen the fundamentals, reduce reliance on volatile capital inflows, and avoid further market turbulence. In such circumstances, Fund resources may well be seen as used to finance capital outflows rather than adjustment. I would also welcome some clarification from the staff on whether the catalytic role of the Fund, as underlined in the emergency financing mechanism guidelines, does apply in this program.

The strengthening of fiscal policy referred to as key to securing the real and external sector objectives is limited to 0.2 percent of GNP more than in the original program, improving only by 0.4 percent of GNP over 1996. Such a fiscal tightening may not give sufficient confidence to market participants, as indicated by Mr. Kiekens. Furthermore, the revenue measures referred to in the staff paper do not seem structural, and they lack definition—a point already made by Mr. Shaalan—whereas expenditure cuts are modest and consist mainly of the sequestration of maintenance and capital expenditures.

The staff projects a stronger outcome for 1998 with respect to the current account and the public finances. However, except for the projected passage of the comprehensive tax reform package—with an expected yield of 0.2 percent of GNP in 1998—there is no indication of significant measures to improve revenue performance, as indicated by Ms. Lissakers. The strengthening of the revenue-to-GNP ratio is expected to come to a large extent from higher growth performance.

Could the staff comment on how a strong growth performance would necessarily lead to a higher revenue-to-GNP ratio? Meanwhile, expenditures are expected to increase by 0.2 percent of GNP, including the effect of wage increases announced for 1997. Could the staff comment on the prospects for achieving the 1998 expenditure target and the sustainability of the reduction in maintenance and investment spending that occurred in 1997? In view of an expected increase in public enterprise investment in 1997, is the targeted deficit of 0.4 percent of GNP for public enterprises in 1998 attainable? Some clarification regarding measures envisaged by the authorities to avoid a repetition of the episode of 1997 would be helpful.

The float of the Philippine peso is an appropriate and bold reaction to speculative attacks. There are, however, a number of points that need clarification. First, we are not convinced that the float should be seen as a recognition that exchange rate pegs should be floated as a matter of principal. Is it the staff view that exchange rate pegs are more appropriate in the case of capital controls than in the context of liberalized capital transactions? The float should be viewed rather as having been made necessary by an inadequate policy mix that maintained a high current account deficit financed through short-term borrowing, thereby triggering speculation as soon as the regional environment was conducive to such speculation.

Second, the fact that the exchange rate action succeeded in calming the markets somewhat should not be seen as a lasting elimination of the risk of market disturbances, as long as the roots of the crisis—in particular, the high current account deficit—are not properly addressed.

Third, the success achieved in facing the crisis was in part explained by a significant increase in interest rates. In view of the risks attached to maintaining high interest rates, in terms of the effect on growth, consideration should be given to a bolder fiscal stance, in order to reduce the burden on monetary and exchange rate policies. Reliance on the exchange rate and monetary policy to achieve the net international reserve target may bring the authorities to a position where they have to choose between lower growth and a higher, exchange rate-induced, inflation rate. It is well known that countries that have liberalized their capital account transactions need a much stronger fiscal position than others.

The authorities' intention to monitor carefully developments in the banking sector is appropriate. We were pleased to learn from Mr. Taylor that the equity-to-asset ratio of Philippine banks is well above international standards. However, the large increase in credit to the private sector, particularly when financed through short-term foreign borrowing and directed to a large extent to financing real estate and consumption, is not sustainable. The authorities efforts to limit the vulnerability of the banking sector are welcome. Bolder action to further reduce this vulnerability should not be ruled out, including the elimination of the incentives for foreign currency intermediation.

On the monitoring of the program, we wonder whether the scheduling of the remaining review in November is consistent with the understanding in the Chairman's summing up on the emergency financing mechanism that the authorities' policy actions and the market's response should be reviewed within one to two months. While we support the proposed decision, which is well justified under present circumstances, we encourage the authorities to consider a bolder program to address the external imbalances and reduce the vulnerability of the economy to external shocks, without jeopardizing the growth and inflation objectives. To this end, a stronger fiscal policy is clearly warranted. We wish the authorities success in their endeavors.

Mr. Shaalan observed that a number of his colleagues had mentioned that the pegged exchange rate regime was a factor in the present crisis in the Philippines. Even if the Philippines were to have adopted a relatively clean floating exchange system six months or a year before, he wondered what the chances would have been that, once the crisis in Thailand had broken in June 1997, the floating rate would not have come under downward pressure. In his view, there clearly would have been such pressure. If that were the case, then the problem might not be with the exchange rate peg, and the wrong reason for the crisis was being targeted.

Ms. Lissakers said that Mr. Shaalan's point was well taken. The question that was probably impossible to answer was whether or not the exchange rate regime had produced inadvertently a bigger current account deficit than the country could sustain, and whether it also had fed inflows that, in turn, had fed excessive domestic credit growth.

Mr. Eyzaguirre remarked that some degree of flexibility in the exchange rate was desirable for fast-growing emerging market countries. A peg might provide insurance to speculators, and lead them to misprice risks. However, it needed to be borne in mind that if the banking system were not properly regulated and supervised, many perverse incentives could be introduced that would lead to an oversupply of credit or misallocation of credit, regardless of the type of exchange rate regime that was in place. He would not want to draw the conclusion that good fiscal policy and a floating exchange rate were sufficient conditions for achieving healthy financial intermediation; the reality was much more complex.

Mr. Andersen said that he also believed that Mr. Shaalan's point was well taken. It reminded him once again of the importance of having in place appropriate supporting policies under fixed exchange rate regimes, and of convincing markets that the authorities would be willing to take measures to support the rate, if necessary. No exchange rate regime was in itself a panacea; in the end, only the underlying policies really mattered.

The Acting Chairman said that he agreed with Mr. Andersen.

Mr. Yao said that he also supported Mr. Shaalan's view. He wondered whether, at the current juncture, the equilibrium exchange rate would have been any different under a flexible regime than under a fixed regime.

Mr. Mozhin indicated that he would probably agree with Mr. Shaalan that, regardless of the exchange rate regime, the peso would have come under pressure given the circumstances in the region. However, had the authorities adopted sooner the floating exchange rate system, there would not have been the sense of crisis and the loss of the authorities' credibility that had occurred at present; rather, it would have been seen as just an ordinary depreciation of the currency.

Mr. Heinbuecher added that had the Philippines moved to a floating exchange rate a year earlier, the lending and—especially—the borrowing decisions taken by market participants over the preceding year might have been different.

The Deputy Director of the Asia and Pacific Department stated that, with respect to the question on the exchange rate, until recently, the pressure on the peso had been for an appreciation, rather than a depreciation. Prior to February 1997, the authorities had intervened in the market to accumulate reserves. The staff had consistently advocated more exchange rate flexibility, and the Board had endorsed that view. The concern had been that a pegged exchange rate and the associated large interest rate differential between domestic and foreign markets were encouraging large short-term borrowings at a time when there was already a large amount of autonomous capital inflows into the Phillippines. Those inflows had put upward pressure on the exchange rate that had been resisted through intervention. The staff's concern had been that, given the large trade deficit and the volatile nature of the capital flows, any shift in sentiment, either on the capital side or on the remittances side, could reverse the situation drastically. In such circumstances, the authorities might be unwilling to allow the exchange rate to depreciate so as to protect borrowers who had borrowed in U.S. dollars at a low interest rate and with an implicit exchange rate guarantee. In the event, those concerns had been validated.

In retrospect, the staff might have been more critical of the policy of maintaining the peg while reserves were being accumulated, the Deputy Director acknowledged. Earlier adoption of a managed float would certainly have eliminated the implicit exchange rate guarantee, and reduced pressures for capital inflows, and the corresponding widening of the current account deficit. Thus, the exchange rate movements and the whole adjustment process could then have taken place more smoothly and without creating a crisis situation.

Other countries in the region had also been affected adversely by developments in Thailand, the Deputy Director continued, but they had coped better than the Philippines. The Indonesian authorities, for example, had widened their exchange rate band in the aftermath of the Thai crisis. In the case of the Philippines, once the crisis began to develop, the fixed exchange rate became increasingly more costly to maintain; the longer the crisis continued, the more assured the markets became that ultimately the fixed rate would be abandoned, thus generating a one-way bet for speculators. Under such circumstances, the danger was that there would be little time to design the necessary supporting policies for allowing the exchange rate to float.

Fortunately, in the case of the Philippines, the fundamentals were sound, the Deputy Director considered. Fiscal and monetary policies were broadly appropriate. It had therefore not been difficult to come up with the package of policies to support the float of the peso. Also, the peso was not that far out of equilibrium—before the current crisis, the staff had judged the overvaluation to be less than 10 percent, which in fact seemed to be borne out by the recent market movements, which in any case had not been that large.

Intervention in the first few days had averaged about $8 million—a small amount, but not in relation to the very small volume of trade in the first few days, the Deputy Director reported. In recent days, when the volume of trade in foreign exchange had reached a normal level—$175 million on the preceding day, and $144 million on the current day—intervention had been minuscule, perhaps $1–3 million. The exchange rate had appreciated somewhat, and altogether the depreciation since the float had only been 6 percent. The shock to the economy from the exchange rate depreciation should not be that large.

Regarding the basic elements of the program, with the float, the base money performance criterion assumed even greater importance because that was the main anchor for monetary policy, the Deputy Director pointed out. The link between base money and broader aggregates of liquidity was imprecise, but base money would be tightened to the extent possible to ensure that there was no excess liquidity in the system. In the past, the authorities had conducted a prudent monetary policy. It was likely that the performance criterion for reserve recovery would be met with some margin left for maneuver. Regarding the financial program, the expansion of base money in the quarter July through September 1997—the critical period after the devaluation—would be only 2.4 percent, compared to the 5.7 percent envisaged in the earlier program. On a 12-month basis, the increase in reserve money at end-September 1997 would be 19.1 percent, compared with nearly 23 percent under the previous program, and for end-December 1997, the increase would be about 12 percent compared with 16 percent. He would emphasize that those numbers represented what could be accommodated under the performance criteria, but the staff expected the outturn to be below those ceilings.

In the short term, the reserve money program would not be operative, because of the need to give attention to containing the net domestic assets of the banking system and to focus interest rate policy on ensuring that there were no excessive pressures on the exchange rate, the Deputy Director explained. The authorities had committed to doing that in the letter of intent. In view of the rapid stabilization of the exchange rate over the preceding few days, the authorities had reduced the short-term interest rate from 32 percent to 25 percent. The staff recommended that the authorities move more slowly on any further interest rate reductions pending an assessment of the reaction of the foreign exchange market, and the latest indications were that the authorities were following that recommendation. One of the main benefits of the floating exchange rate was that the authorities would no longer have to maintain high interest rates in order to defend the rate, which would be counterproductive from the perspective of the domestic economy. The authorities were now seeking to find the right balance in the pace of interest rate reduction.

After adjourning at 1:10 p.m., the Executive Board reconvened at 2:30 p.m.

The Deputy Director of the Asia and Pacific Department made the following additional statement:

> The Philippines' fiscal policy has generally been quite sound in recent years. The fiscal target for 1997 of a small surplus of about 0.3 percent of GNP for the national government is consistent with the target indicated in the December staff report for the Article IV consultation and the third review, which was concluded by the Board on December 20, 1996. In the event, there was a revenue shortfall of some one-half of one percent of GNP in the first half of 1997. This shortfall was mainly associated with difficulties in implementing a new tax payment system and large shortfalls in customs duties owing to lower imports and exemptions given through duty-free shops. While a corresponding shortfall in expenditure during the first half of the year kept the fiscal deterioration to a minimum, it was clear that in the absence of additional measures, the fiscal position would deteriorate by about 1 percent of GNP during 1997.
>
> The authorities have put in place a strong package of revenue and expenditure measures to realize the initial fiscal target. On the revenue side, a number of tax administration measures have been put in place to correct the slippage. These include actions to correct tax evasion in respect of a newly-enacted excise tax that was put in place at the end of 1996, actions to stem leakage through duty-free arrangements, and continuing action to reverse losses in income tax revenues as a result of changes in the payment system. These measures altogether are expected to raise revenue by an additional 0.3 percent of GNP.
>
> On the expenditure side, measures that were announced in June include cancellation of contingency reserves for maintenance and general capital outlays, keeping capital spending on congressional initiatives well below budget, and reducing slightly capital transfers to local governments. These spending cuts will amount to 0.7 percent of GNP. In addition, the depreciation of the peso is expected to have a positive, albeit a small, impact on the budget. Altogether, we are reasonably confident that the fiscal targets for 1997 will be met.
>
> Regarding fiscal policy in 1998, the surplus target of nearly 1 percent of GNP is about half a percent of GNP more ambitious than the target set out in the December paper. Part of this improvement is expected to come through higher growth, because the newly-instituted value-added tax, which was put in place two years ago, is highly elastic with respect to income—the income elasticity of the value-added tax is higher than unity. With high growth, the value-added tax is expected to generate more revenue. The Philippines' authorities are now in a position to reap the benefits of the tax reform they put in place as part of the Extended Arrangement earlier.
>
> The most important element of the fiscal program is the completion of the comprehensive tax reform. A number of Directors had asked about our assessment of the prospects for the tax reform. The Senate version is being coordinated very closely with the President and Treasury officials. We are very

optimistic that that version is going to be very close to the initially planned reform. Of course, after that, there has to be a negotiation through a bicameral committee, to reach a consensus between the House and the Senate versions. It is always difficult to predict how these things will come out, but we are reasonably confident of a satisfactory outcome, which should provide the additional revenues in addition to removing the distortions in the current system.

The authorities have also made the commitment that, should these measures not get through, they would put together other revenue and spending measures to meet the 1998 targets. They are loath to discuss specific measures that they could put in place if the tax reform package fails, because all the effort now is to make sure that it does not, and that it does go through. Here, the concern of a number of Directors is well founded. If the revenue measures are not put in place, then we would be put in the unfortunate situation again that the fiscal targets would be met through cutting spending, and the quality of adjustment would suffer. We are thus urging the authorities to make strong efforts to see that the tax reform package is approved and that it will have beneficial effects on revenue. Passage of the tax reform package will be the important element in the final review of the program.

Many Directors have raised the issue of distortions introduced by the reserve requirements and other tax incentives, which increase currency substitution and dollarization. The staff has highlighted that problem to the authorities for some time, and will continue to do so. It is always hard to judge how far we can go in urging or insisting. In the end, we try to reach a compromise. The float of the peso, supported by strong macroeconomic policies, should go far in alleviating some of the other concerns that speakers have voiced, but we will keep raising our concerns on the remaining issues in our discussions with the authorities.

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

Many Directors referred to the importance of strengthening the banking system and the ability of the system to withstand shocks such as the recent float of the peso. In this area it is much easier to point out the structural problems that do exist than it is to quantify the implications of those problems. The data provided by the authorities suggests good indications of banking health at present. For example, nonperforming loans total only about 3 percent of loans, surveys of exposure to the real estate sector suggest low exposure levels of about 10 percent of total loans, and the authorities have strictly imposed the requirement that banks cover their foreign exchange position. A check in the last few days showed that no bank had exceeded the limits of its overbought or oversold ratio—the ratio as a proportion of unimpaired capital. However, there are clearly some early warning signs. The first is the rapid rate of credit growth in recent years, which would stretch the capability of any supervisory authorities and the credit assessment section of any bank. The second is the increasing foreign currency liabilities. Here, the staff estimates that the ratio of short-term debt and net foreign liabilities to foreign exchange reserves has risen to about 140 percent. The third is the significant disincentives against peso intermediation. It is highly likely that the expectations of a continuing fixed exchange rate, combined with tax incentives and discriminatory reserve requirements, will have tempted some banks or some borrowers of foreign exchange not to price the foreign exchange risk appropriately. Although it is very difficult to assess the significance of the change in the exchange regime in the last week or so, the central bank is now trying to make such an assessment. We shall no doubt find out in the next few weeks or months.

The Fund's Monetary and Exchange Affairs Department has provided technical assistance to the central bank in the past three weeks on assessing market risks and providing other prudential advice. An important issue is the extent to which the structure of the banking system, with the plethora of types of banks and nonbank subsidiaries, can raise difficulties and increase the risks of some types of exposure, including foreign exchange risk. Of the three factors highlighted that encourage dollar intermediation, the floating of the peso in the last week will certainly correct the first distortion arising from the fixed regime. Of the other two distortions, the authorities are extremely reluctant to eliminate in the short term the tax and the reserve requirement distortions, but the staff will continue to discuss this with them.

One option was to try, as an interim step, to fully remunerate the peso reserves, as a first step to minimize the wage intermediation costs for pesos. However, the central bank pointed out that the costs to it would be very high, and the prospect of increased capitalization of the central bank does not seem immediately likely. That is an issue that the staff will pursue with the authorities further.

Regarding the impact of the float on the macroeconomic objectives, the current account, and the inflation rate, so far this year, the trade deficit has been somewhat smaller than projected. Other things equal, that would lead to a lower current account deficit this year. However, that has been offset by suggestions that remittances will be somewhat lower than earlier thought. Those therefore tend to offset each other, although the current account ratio is a little higher than we had initially projected. In the short run, we would not expect the depreciation to have a significant impact on the current account position.

In the first half year, the inflation rate was significantly lower than programmed. Therefore, there is some margin in the second half of the year before the average projected by the authorities of 6½ percent will be exceeded, even if there is some depreciation in the next few months.

Regarding the extent to which the arrangement with the Fund and the augmentation would catalyze other resources, the staff is aware so far only of the discussions under way between the authorities and the Japan Export-Import Bank (JEXIM).

Ms. Lissakers asked what reason the authorities offered for not following the staff's advice regarding the removal of disincentives for peso intermediation.

The staff representative from the Asia and Pacific Department replied that part of the explanation was that, until recently, the central bank did not have any dollars. It was not an easy change to move from a position of trying to attract dollars to a position of trying to discourage dollars. The psychological change remained to be made. Some time would be needed before the authorities realized that it was not always a good thing to encourage dollar intermediation. It also should be borne in mind that the banking system had large foreign currency liabilities to both residents and nonresidents.

Ms. Lissakers remarked that one of the sources of vulnerability in the case of Thailand had been the high ratio of short-term external liabilities of banks and finance companies and the ratio of those liabilities to reserves; that ratio appeared to be even worse in the case of the Philippines. The Philippines' current account deficit was not as large as that of Thailand, so the Philippines must not be as dependent on the continued availability of additional short-term financial inflows as Thailand. The refusal of the Philippines' authorities to come to grips with the source of vulnerability—the differentiation of peso and dollar transactions by the banking system was troubling—one could well ask whether the events of the preceding few weeks might not repeat themselves, this time with the Fund's money at risk. The floating of the peso had eliminated one of the risk factors, but the other risk factor, related to economic instability arising from interest rate pressures and banking system problems, remained, which suggested that the country was still vulnerable.

The staff representative from the Asia and Pacific Department commented that the float increased the element of uncertainty about the exchange rate. It should focus the attention of those who had been taking foreign exchange risks without being fully hedged. He agreed with Ms. Lissakers that aspects of the Philippines' banking system needed to be changed.

Mr. Levy observed that, with respect to the reserve requirements, it was his understanding that speakers were not recommending imposing a reserve requirement of 15 percent on foreign exchange deposits, which would obviously kill that market and affect some remittances. He wondered whether there was a program to reduce the reserve ratios, and if so, what the timetable might be, and whether it could be included in the program.

The staff representative from the Asia and Pacific Department replied that there had been a timetable of a reduction of 1 percentage point on the peso reserve requirement every six months, but the staff did not know whether that continued to apply in the wake of the peso float on July 4. The authorities were not opposed to such a gradual timetable, however.

The Deputy Director of the Policy Development and Review Department stated that the staff was reviewing the policy on early repurchases, which was in the work program, and expected to finalize a paper for Board consideration near the end of the year. As speakers had recommended, that paper would be broadened to encompass the question of early repurchases in the context of use of the emergency procedures.

Regarding the timing of the program review, the conclusion of the review scheduled for late November 1997 would be required to release resources under the last tranche of the Extended Arrangement, the Deputy Director explained. Under the emergency procedures, it was expected that a full review of the initial policy response and the reaction of markets to those policies would be conducted within one to two months of the approval of the arrangement. The intention was to conduct such a review on the basis of a staff visit, and the Board would be kept informed of the outcome. That would not be a formal review that would release Fund resources.

Mr. Shields said that he understood that, under the current policy on early repurchases, pressure would be exerted on the Philippines to make early repurchases if its balance of payments position improved.

The Deputy Director of the Policy Development and Review Department replied that, under the standard procedures—applying to emergency procedures as well as to other kinds of drawings—if the reserve position of the country improved more than anticipated and the balance of payments was restored. The Treasurer's Department automatically contacted the authorities and raised the possibility of an early repurchase. A repurchase expectation was not, however, a legal obligation.

The Acting Chairman emphasized that it was an expectation, not a legal obligation.

Mr. Toribio, recalling a comment by the Deputy Director of the Asia and Pacific Department, said that he wondered where the positive impact of the depreciation of the peso on the budget would come from.

The Deputy Director of the Asia and Pacific Department replied that the first impact of the exchange rate depreciation would be to raise the price of traded goods, which would affect trade revenues, while also raising import costs on the spending side of the government. The net effect in the case of the Philippines would be positive, but small.

Mr. Daïri wondered what the staff's recommendation would be on possible policy reactions, if there were further disturbances in the region and changes in market sentiment, in particular, whether the exchange rate would be able to absorb all the shocks, or whether some additional contingency measures would be needed.

The Deputy Director of the Asia and Pacific Department replied that that would depend on the source of the crisis. It should be borne in mind that the exchange rate had moved very little—about 6 percent. An external shock could be absorbed by considerably more movement in the exchange rate, but obviously, if the crisis were such as to require a sharp reduction in the current account deficit, more fiscal adjustment and a tighter monetary policy would be called for. However, at the current stage, the staff did not believe that such an eventuality was a serious risk.

Mr. Joyosumarto made the following statement:

> This chair strongly supports the Philippines' request for the extension, rephasing and augmentation of its present Extended Arrangement. This request clearly meets both the balance of payments and precautionary needs criteria for the use of Fund resources. The Philippines' international reserves has fallen sharply in recent weeks due to the intervention required to combat speculative forces. While financial conditions in the Philippines have calmed down after the peso float and the authorities have implemented prudent macroeconomic

policies to support a new exchange rate regime, it is likely that, given the present sentiments in the market, there will be some further pressure for some time.

Mr. Taylor has pointed out the significant progress of the Philippines' economy in the last few years, due to political stability, prudent macroeconomic policies, and the benefits of sustained implementation of bold and broad-based structural reform. However, it is now clear that the markets need further convincing that the authorities are indeed serious in implementing permanent structural reform. The willingness of the authorities to submit to an extension of Fund conditionality in order to successfully complete the present Extended Arrangement, as well as the augmentation of Fund resources for the Philippines at this critical juncture, should send a clear signal to the market of the Philippines' viability and the considerable progress made in the restructuring effort. To underline the seriousness of their restructuring effort, we urge the Philippines' authorities to expedite the legislative approval of the new tax measures so as to further strengthen their fiscal position and overall savings. We commend the authorities for the recent implementation of prudential financial regulations.

To complement this regulation, the central bank may also want to consider a measure that would further enhance the effectiveness of its financial sector supervision. As an added precaution against asset price inflation, the authorities could consider developing more investment instruments that would absorb the capital inflows as well as further fostering savings. Examining the experiences of the broad range of economies would be useful in determining what more needs to be done to further deepen and strengthen the Philippines' financial system. In this context, I support the idea of Fund technical assistance to strengthen the financial and banking sector. I support the proposed decision.

Mrs. Coronel made the following statement:

We support the proposed decision. In doing so, we acknowledge the achievement of most targets under the Extended Arrangement, as well as the timely response of the Philippines' authorities to avoid further negative effects coming from the increasing pressures on the peso. The solid macroeconomic setting of the Philippines' economy, the decision of the authorities to persevere in the use of healthy policies, and the availability of financial support should help return financial markets to normal and maintain the confidence of investors.

The new exchange rate mechanism is a flexible tool that would help bring the needed stability to the economy if it is supported by strong monetary and fiscal policies. Sound policies are needed to improve over the medium term the level of national savings so as to finance investment without affecting the external position. Sound policies would also send the right signals to the market to allow a buildup of net international reserves.

On monetary policy, we concur with the authorities' intention to keep interest rates high and to slow the rate of growth of the monetary aggregates with the aim of reducing inflation. Nevertheless, we are not sure if the achievement of the inflation target for year-end, as originally envisaged, would still be feasible, given the effects on prices of the exchange rate depreciation. We would also urge the authorities to eliminate incentives for foreign currency intermediation and take actions to ensure the health of the financial system.

On fiscal policy, the targeted public sector surplus will only be possible with additional revenue efforts and a careful screening of expenditures, which should be appropriately scheduled. The expected comprehensive tax reform package, if approved by Congress in a version similar to the bill suggested by the government, would be very helpful in enhancing revenues, improving the structure of the tax system, and enhancing economic growth.

In the face of a relatively large current account gap and a substantial trade deficit, the external sector needs to be carefully monitored. Faster export growth is warranted to balance growing imports, and reforms to improve competitiveness have to be considered.

A crucial challenge for the Philippines is to alleviate poverty and improve income distribution. Toward this end, sustained economic growth rates should be attained in the medium term, as well as an improvement in the quality of fiscal expenditure to devote additional resources to social spending.

We appreciate the rapid response of the Fund to the Philippines' situation. We welcome the program of the authorities, and we wish them every success.

Mr. Al-Tuwaijri made the following statement:

The continued strong performance of the Philippine economy has been overshadowed during the past few months by increased turbulence in foreign exchange markets which culminated in the recent floating of the peso. Indeed, despite the uncertainties in the financial markets, inflation declined, and both growth and export performance were strong.

Having said this, it is clear that pressures on the exchange rate reflected not only contagion effects, but also concerns regarding the banking sector and policy slippages. The floating of the peso coupled with strengthened macroeconomic and structural policies along the lines of the staff paper should help consolidate the Philippines good performance. Indeed, the limited depreciation of the peso since it was floated is encouraging.

While fiscal performance has been strengthened over the past few years, slippage in fiscal implementation in the second quarter of 1997 did not help confidence. The authorities' action to address this issue is a step in the right direction. The measures to reduce expenditures and increase revenues in order to reverse the fiscal shortfall are encouraging. The plan to further strengthen the fiscal accounts in 1998 should send a reassuring signal. Here, the completion of the tax reform in line with the authorities' initial plan is critical.

In the monetary area, I agree with the need to pursue very cautious policies. Indeed, given the floating of the peso, achievement of the inflation target for 1997 requires extra vigilance. Here, however, I will be interested in staff comments on the impact of tight monetary policies and the floating of the peso on the health of the banking sector. In this regard, I welcome the steps to reduce the vulnerability of this sector.

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

Mr. Andersen made the following statement:

I would like to make four set of remarks.

First, I would like to commend the authorities for the overall good implementation of the EFF program and for the swift actions taken under difficult and time-constrained circumstances. Even though I would have welcomed if the situation has been bolstered by even stronger policies in some areas, especially fiscal policy, I consider it justified to go ahead with the extended and augmented arrangement and support the proposed decision. As a more general comment, I think Ms. Lissakers' call for appropriate toughness rather than given the authorities too much the benefit of the doubt when we use the Emergency Financing Mechanism procedures is important to bear in mind in the future.

Second, we have earlier seen a number of examples where authorities in a country with a fixed exchange rate policy and generally sound fundamentals have to give in and allow the exchange rate to adjust to contagious market pressures. In particular, I can recall a few cases in Europe during the 1992–93 exchange rate crises, where it also deserves to be recalled that exchange rates in some cases soon went back to the pre-crises level, showing that sooner or later market developments will reflect sound fundamentals if policies remain appropriately strong and stability-oriented. However, we need to be careful when we label fundamentals as sound without any qualifications. As others have emphasized, even though overall macroeconomic and structural performance of the Philippines has broadly been positive, there have been some weaknesses as well which I will refrain from repeating at this stage, weaknesses that underscore the vulnerability of the achievements as was also emphasized at the time of the Board discussion late 1996.

Third, I have little to add regarding policy recommendations. Clearly, there is no room for complacency or for slippages, and as seen in many other countries, even though the fiscal stance is generally in a relatively sound position, we often see that slippages on the fiscal policy side are triggering market pressures and a need for fiscal policy becoming an essential ingredient of the solution. Accordingly, I agree with those of my colleagues who have stressed that in view of the low level of private savings, more ambitious fiscal surplus targets are called for, and I urge the authorities to ensure that further fiscal tightening goes hand in hand with adequate attention to infrastructure and poverty reduction programs.

Finally, I share the view that it is essential that the Fund devotes sufficient attention to, on a continuous basis, assess whether the exchange rate level and system are appropriate in view of fundamentals as well as the opposite, and I would also like to join those who have cautioned against a premature focus on a new specific level or band for the exchange rate, particularly if not supported by a further tightened policy stance. Last but not least, on early repurchases, I agree very much with what Mr. Kiekens and others have said on this subject.

Mr. Watal stated that he supported the recent initiatives of the authorities, and he supported the request for extension, rephasing, and augmentation of the current Extended Arrangement.

Mr. Kudiwu made the following statement:

After a successful implementation of macroeconomic policies under the current EFF, it is unfortunate that volatility in the regional financial markets has led to less favorable economic and financial developments, during the second quarter of this year. The authorities are therefore faced with a number of policy challenges that should aim at alleviating mounting pressure on the peso, and enhancing fiscal performance.

I understand from the staff report that the authorities have initially responded to pressure on the exchange rate by increasing interest rates and by intervention to maintain a stable peso/dollar exchange rate. I therefore welcome the authorities' decision on July 11 to let the peso float. This step will, no doubt allow the peso to find its appropriate market level. With the expected depreciation of the peso, some tightening of monetary conditions would be appropriate. I am pleased to know that the program implies such a tightening.

Looking ahead, I share the staff's assessment that efforts in the fiscal areas will play a key role in enabling the Philippines to achieve its external sector objective, particularly at a time when regional financial markets are experiencing some turbulence. To that end, I welcome the authorities' decision to implement measures that will contribute to reversing the fiscal shortfall recorded during the first-half of 1997, thereby at least reaching the originally programmed public sector surplus of 0.2 percent of GNP.

It is encouraging to learn from the staff paper that efforts are being made to improve revenue performance and to cancel some expenditure categories. However, it should not be desirable that expenditure cuts should also apply to capital outlays. While questioning the fact that the staff has not yet assessed the impact of peso depreciation, I am pleased to note that the preliminary assessment seems to indicate that the net effect is expected to be positive.

On monetary policy, I share the staff's concern on the existing differences between the reserve requests on domestic currency deposits and those on foreign currency deposits. In particular, I note that the authorities have restated their opposition to imposing reserve requirements on foreign currency deposits. How does the staff assess the impact of the liquidity requirement imposed on Foreign Currency Deposit Units (FCDUs), which mandates that 30 percent of the value of liabilities be maintained as short-term liquid assets, on money supply?

The combination of some flexibility in exchange rate policy, a strong fiscal stance and tight monetary policies creates a more stable environment for economic activity. This combination will also contribute to more normal conditions in financial markets and to an increase in domestic and foreign business confidence. To succeed in these efforts, however, I share the staff's view that the support of the international community will be critical and here, Fund's support will play an important role in catalyzing resources from other sources.

With these remarks, we support the authorities' request for an extension of the current EFF and wish them success in their current policy endeavors.

Mr. Gruber made the following statement:

At this stage of the discussion, and as we can broadly associate ourselves with the thrust of the statements made by the previous speakers, we will be brief.

We would like to begin by commending the Philippine authorities for the actions undertaken to address the current crisis. With the float of the peso an important element of instability in the economy has been removed. We welcome furthermore the measures described in Mr. Taylor's statement to tighten the regulatory limits on bank lending and to impose liquidity requirement of foreign currency liabilities, which can help to re-establish investors' confidence. We agree with the staff that decisive exchange rate action, restrictive monetary policy and an adequate fiscal tightening as well as renewed efforts to secure a strong tax reform package are the key to preserving the significant gains of the reform efforts.

Concerning the submitted policy-program we would like to raise two concerns:

First, in view of the difficulties to reach an agreement between the staff and authorities on the letter of intent, we wonder whether the degree of ownership of the Philippine authorities is sufficiently high. It goes without saying that the implementation of the presented ambitious program can be successful only if it has the full support of the government and of the central bank. Staff's comments on this issue would be appreciated.

Second, we agree with previous speakers that weaknesses in the fiscal structure have to be addressed quickly. The large and probably even underestimated current account deficit certainly asks for coherent and comprehensive fiscal policy actions. In this context, we are quite puzzled about the small amount of fiscal adjustment planned over the next months. One could ask, if it really makes sense that the Fund pledges a heavily front-loaded emergency package while the Philippine Parliament quietly takes its summer leave and intends to decide on the urgently needed fiscal reform package only in October. We thus agree with Mr. Autheman that the completion of the final review should only be considered possible, if fiscal reforms are fully implemented.

On the issue of repurchases, as Mr. Kiekens and other Directors, we expect that repurchases under this augmented EFF will be made as soon as the situation improves and we feel reassured in this respect by Mr. Taylor's statement on this issue.

With these comments we support the authorities' request for an extension, rephasing and augmentation of the Extended Arrangement.

The staff representative from the Asia and Pacific Department said that the authorities had taken full ownership of the letter of intent, which they had considered very carefully. The Governor of the central bank was fully committed to it.

Mr. Erasmus stated that he wished to commend the authorities for their quick reaction to the developments of the preceding few days. He agreed with other speakers that there could be no room for any slippages at the current stage if the authorities were to convince markets of their commitment to sustainable economic policies. He could therefore support the authorities' request.

Mr. Taylor made the following concluding statement:

Well, it has been another very long inning on the Philippines.

In summary, a large number of points have been made, going to the fiscal stance, banking supervision, exchange arrangements, and also, I guess, the pace at which the economy can be run in current circumstances. I think it is a mixture of points that are well taken—some very well taken—but also some concerns which I think are a little bit exaggerated.

I think the time has passed for trying to supplement the staff in any particular areas. Let me just say three or four things.

On this vexed question of reserve requirements on peso and foreign currency deposits, for my money Mr. Levy got pretty close to the mark. There is a need for some adjustment here at some stage. I think Mr. Shields was pointing to the right direction, to adjusting requirements on the peso side. But the authorities feel the need to remain in control of the timetable. I think over time, when the opportunity arises, there may well be some further action there. In the meantime, as the staff has indicated, it will be one of a number of points of ongoing discussion with the authorities, I am sure.

On the fiscal situation, I think Mr. Toribio much earlier in the day pointed out that this is a democracy; the Philippine institutions are highly democratic. It is one thing to urge passage of legislation and another to achieve it. Furthermore, the important thing is not to achieve it, but to achieve it in the right form, and that does take time and involves some risks which are unavoidable.

What strikes me about the economic team in the Philippines is that they are quite determined to hold the fiscal situation together, and I think there is very little doubt that in 1997 it will be held together. The question of composition which many Directors have raised—Mr. Shaalan right from the beginning—is very important. To the extent that development or infrastructure investment is cut back, that would have a temporary cast which would be undesirable.

My understanding of the composition of the cuts is in fact that the composition is better than one might have expected and that some quite soft areas of expenditure have come under notice, and I am reasonably reassured about that. 1998 is, to some extent, an open question, as many people have pointed out, but think about where we are. We have had a week or two; the staff has had a week or two, to be fair to the staff; and the authorities have had a week or two. You cannot make next year's budget in two or three weeks, six months ahead of time. In a sense, this is a bit of a dilemma, but those are the facts. Again, I would underline the determination of the authorities to press on and achieve what they are pointing to in that area.

On the exchange rate, should the staff have pressed more strongly earlier for a change in the arrangements? I do not know about the situation at an earlier stage; I was not involved in that. But I would say that in the past month the staff has pressed this point as strongly as is appropriate, and perhaps even beyond that. I do not think there can be any doubt that the staff pressed that issue very hard in the last month. The difficulty, I think, without making a long story of it, and this is very much a personal remark, is that political and economic stability is not very old in the Philippines. Points of stability are valued, and this was one that was valued, rightly or wrongly. But I feel I can understand perhaps better than some other people where the authorities were coming from on that issue.

But that is now in the past; how will the exchange rate be managed in the future. The first thing is, as the Deputy Director of the Asia and Pacific Department said, information to the Fund is extremely good. It is available on a daily basis. Today, overnight rates were cut. The rate came back a bit in spite of that. Intervention was minimal.

There were concerns from particularly the U.S. chair, but some others, about how the rate will be managed in the future. Of course, I do not necessarily know how that will pan out, but I think it will pan out the way Mr. Toribio was looking for—some smoothing, but no more than that in the short run, and hastening quite slowly to commit to any particular form of wider bands until the authorities have a better understanding of how the market is traveling.

In any event, the transparency of the Philippine situation and the freedom with which information tends to be available to us here will enable a variety of monitoring; we now have a variety of ways of monitoring countries in this Board. Those who have expressed the greatest apprehension about the near-term developments either in the markets or in policy making have a number of opportunities to keep track of the situation. I think we should also remember a point which Mr. Joyosumarto made. The readiness of the Philippine authorities to immediately come to the Fund and deal with the Fund is a point of considerable, or should be a point of considerable, reassurance.

Just for one minute to take my Philippine hat off. There is more than one issue that has come out of the discussion which happens to have arisen in this context but which is of a more general application for us. For example, this is the first case under the accelerated procedures and we are already looking to draw some conclusions for how this works and how well it works and what problems emerge. I assume somebody in the staff will be keeping track of that and at some stage we will need to come back and look at this procedure, but not in the context of any particular country.

Secondly, the repayment period issue, I think it is agreed, happens to have arisen in the case of the Philippines but is a general issue—not a Philippine-specific issue but a general issue—which we have agreed to have a look at fairly soon. Also, a number of the remarks underline the need for what several of us in the past have pointed to—the need to somehow find time in our agenda to consider exit strategies. I think a significant number of interesting points have come up through the day which are relevant to more than one country in that area.

Finally, I would like to underline what I said in my earlier statement about the staff. The staff's efforts in the past few days and the last two or three weeks have been quite extraordinary; they have not involved very much sleep. I know my authorities would want me to express their appreciation for that. I would also like to thank all of my colleagues for their support. I think it is encouraging, actually, that there were so many comments of an analytical nature, and points of concern or criticism were also made in a constructive fashion. The authorities in the Philippines, I am sure, would welcome that approach. This is a country which does listen carefully to what is said by the Fund and by the Board. Some valuable points have been made that we will certainly transmit back in full, which will enter the debate and the ongoing decision-making process in the Philippines.

The Acting Chairman said that he considered the authorities to have been courageous, and to have acted decisively. He also wished to commend the staff for its remarkable efforts.

The Executive Board took the following decision:

1. The Philippines has consulted with the Fund in accordance with paragraph 3(b) of the Extended Arrangement for the Philippines (EBS/94/117, Sup. 2), as amended, and paragraph 4 of each of the letters of June 1, 1994,

September 8, 1995, and June 24, 1996 from the Governor of Bangko Sentral ng Pilipinas and the Secretary of Finance of the Philippines.

2. In a letter dated July 14, 1997 from the Governor of Bangko Sentral ng Pilipinas and the Secretary of Finance of the Philippines, the Philippines has requested that the Fund:

(a) augment the amount of the Extended Arrangement for the Philippines (EBS/94/117, Supplement 2), as amended, by the equivalent of SDR 316.7 million,

(b) extend the period of the Extended Arrangement until December 31, 1997, and

(c) phase future purchases under the Extended Arrangement.

3. The letter dated July 14, 1997 from the Governor of Bangko Sentral ng Pilipinas and the Secretary of Finance of the Philippines, with its attached memorandum, shall be annexed to the Extended Arrangement, and the letters of June 1, 1994, September 8, 1995, and June 24, 1996, with their attached memoranda, shall be read as supplemented and modified by the letter of July 14, 1997 and its attached memorandum.

4. Accordingly,

(a) Paragraph 1 of the Extended Arrangement is amended by substituting "December 31, 1997" for "July 23, 1997" and "SDR 791.20 million" for "SDR 474.50 million";

(b) Paragraph 2 of the Extended Arrangement shall be amended by adding after "May 15, 1997": "and the equivalent of SDR 545.25 million until November 15, 1997."

(c) The limits and floors for end-September 1997 referred to in paragraph 3(a) of the Extended Arrangement shall be as specified in Appendices I through VI of the memorandum attached to the letter of July 14, 1997.

(d) Paragraph 3(b) shall be amended by adding "November 15, 1997," after "March 31, 1997," and "July 14, 1997" after "June 24, 1996."

5. The Fund decides that the fourth review contemplated in paragraph 3(b) of the Extended Arrangement, as amended, and the letter of June 24, 1996 is completed and that, notwithstanding the nonobservance of the performance criterion set forth in paragraph 3(a)(iii), the Philippines may proceed to make a purchase under the Extended Arrangement in an amount equivalent to SDR 508.75 million.

6. The Fund waives the limitation in Article V, Section 3(b)(iii).

Decision No. 11544-(97/74), adopted
July 18, 1997

## 4. REVIEW OF EXPERIENCE UNDER ARRANGEMENTS SUPPORTED BY THE ENHANCED STRUCTURAL ADJUSTMENT FACILITY

The Executive Directors considered a staff paper reviewing the experience under arrangements supported by the Enhanced Structural Adjustment Facility (ESAF) (EBS/97/112, 6/23/97; Cor. 1, 7/8/97; Sup. 1, 7/2/97; Sup. 1, Cor. 1, 7/15/97; and Sup. 2, 7/7/97), together with a background paper on the review of revenue and expenditure policy and performance under adjustment programs supported by the Structural Adjustment Facility and the ESAF (EBS/97/123, 7/2/97; and Sup. 1, 7/2/97).

Mr. Shaalan made the following statement:

> The comprehensive and extremely well-written set of staff papers before us provide a balanced and candid review of the experience under ESAF and offer an opportunity to identify further improvements in program design. This introspective look, and the external evaluation to follow, should contribute to improving the quality and impact of the arrangements being negotiated.
>
> While the main conclusions of this review are not very different from those of the earlier review, the analysis is considerably more focused. Undoubtedly, progress was attained in many areas in ESAF countries. However, less was achieved in the fiscal areas, public enterprise reform and bank restructuring. Inflation in many countries remained stubbornly on the high side. The findings of both reviews indicate that these problems proved more difficult to tackle than was anticipated. But unlike the previous review, where improvements in external viability were compromised by severe deterioration in the terms of trade facing ESAF users, improved economic performance and progress toward external viability in 1994–95 owe much to the favorable global conditions. However, in spite of the improved global conditions, overall current account deficits were barely reduced and debt levels doubled between 1985 and 1995; hence many countries that have had ESAF programs are still overburdened with debt. This is a significant finding that I will come back to later.
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> I tend to share the thrust of much of the staff's broadly favorable assessment of experience under SAF/ESAF arrangements and the proposals put forward for future program design and implementation. Before commenting on the specific issues covered in the review, I wish to offer some general thoughts that hopefully, may shed some light on some of the issues that have clearly come out from the internal evaluation reports. In my view, the less than satisfactory performance on every one of the three major areas resulted from, or were adversely impacted by, over-optimism. In particular, the time frame for ESAF to address these areas was far too short given the level of administrative capabilities and limitations which render implementation

problematic in many ESAF countries. It is possible that because of the Fund's short-term orientation, which has guided the institution over the years, we were biased toward viewing issues in the context of a short term horizon. This being said, a program design based on too constrained a time frame must, by definition, be inappropriate. My second point is related to institution building and durability of reforms. We have often seen in countries performing well under Fund programs, and even in countries that have graduated from the use of Fund resources, that there is a relapse in the post-program period. The reasons for this pattern, I am sure, are most complex. In part, they may be attributed to the lack of institutions to continue with reform absent the discipline that comes with a program. It could also be that our fiscal policy advice was geared, first and foremost, at reaching specific targets without sufficient attention being accorded to the durability of the fiscal improvement, as I refer to in more detail below. Finally, and I only underscore the obvious, most of the major areas where shortcomings emerged belong more in the domain of the Bank rather than the Fund. I am seriously concerned that something is amiss here and there is a need to review the effectiveness of the Bank-Fund working relationship in these areas, particularly in the context of the ESAF. I would be very interested to hear staff views on these general thoughts. I now turn to the specific issues under review.

Although fiscal deficits declined by 2 percent of GDP for ESAF users in the period under review, it is clear that, for the most part, ESAF programs did not achieve the targeted fiscal adjustment. Most programs relied mainly on revenue enhancement as the principal area to improve the primary balance (with the exception of Africa where expenditure cuts were also targeted). The revenue projections tended to be over-optimistic, reflecting, I believe, the fact that administrative capacity constraints encountered in implementing tax reforms were underestimated. As revenues fell short in two thirds of the programs, this created pressures to reduce capital expenditures which had been targeted to increase in the large majority of cases under the initial programs. Unfortunately, cuts in capital expenditures were made for the sole purpose of meeting a programed deficit target. As a result, the composition of expenditures was less than what was hoped for and adversely impacted output growth. It would appear, therefore, that attaining a numerical fiscal adjustment over a short time horizon may have been over-emphasized, while the quality and durability of the adjustment did not receive the required attention. This is a weakness that we need to address in future programs. In addition to capital outlays, greater emphasis would have to be accorded to safeguarding an adequate level of social expenditures and to strengthened monitoring to determine the effectiveness of social safety-nets as well as the impact of expenditures on health, education and basic infrastructure. But while we fully concur with the staff on the need for such monitoring and analysis, some realism is warranted so as not to under-estimate the complexity of the task at hand. These are very difficult public sector 'outputs' to measure, even in advanced economies where detailed data is more readily available. While efforts undertaken by the World Bank in this area are a welcome step, it will be some time before data has been collected, the methodologies used standardized and the results become more robust for purposes of comparisons and policy-making.

Public enterprise reform remains at the top of the unfinished reform agenda although most countries developed comprehensive public enterprise reform plans following the recommendations of the last review. It now appears that there are serious data problems that materially detract from the feasibility of developing meaningful plans. In addition to compilation of consolidated public sector accounts that capture the financial position of state enterprises, it is also essential for policymakers to have access to a complete accounting of indirect assistance and noncash forms of support to state enterprises—such as implicit subsidies, tax relief, loan forgiveness, and loan and exchange rate guarantees—and their quasi-fiscal costs. I join the staff in calling for a concerted effort by the donor community in laying the foundation for effective reform through the provision of long-term technical assistance to facilitate in collecting and analyzing necessary information on the financial position of enterprises and in developing an appropriate regulatory and supervisory framework. Only then can appropriate plans be formulated. Technical assistance should continue into the implementation stage.

Financial sector reform is another area where progress has lagged and performance has been mixed. Banking sector problems remain a pervasive problem in ESAF countries. The nature and causes of these problems—continued government interference in credit allocation, dearth of local banking skills, poor regulatory and supervisory frameworks and financial problems of public enterprises—suggest that the magnitude of the problem and its complexity are considerably greater than has so far been recognized. Here again, we concur with the staff that it is not sufficient for programs to focus only on structural benchmarks related to developing plans and passing laws, but more efforts are needed to strengthen administrative capabilities to enforce best-practice. This is particularly important in the context of globalized financial markets of today. I would place very high priority on technical assistance in this area.

I found the report's discussion on reducing inflation most interesting—where, contrary to expectations, inflation remained stubbornly on the high side (stuck in the intermediate range) in many ESAF countries. The absence of a systematic link between adherence to program targets for NDA and the record in meeting monetary and inflation targets is puzzling and makes one question whether inflation is altogether a monetary phenomenon, particularly in developing countries. Factors that come to mind which may suggest that an element of "structural inflation" may exist, such as the inefficiency (i.e., high cost) of public sector production, which in many cases has been addressed by raising output prices. This is a policy that is tantamount to financing inefficiencies and puts pressure on prices. Another possible factor could be the structure of the markets characterized as it were with monopolies or a limited number of production units where competition is limited. I would suggest that we look at nonmonetary factors in developing countries when analyzing inflation. The report suggests two possible anchors to rein in inflation—an exchange rate peg or a monetary target. I don't find either approach very appealing. Putting aside the issue of whether many of these countries can live with the policy discipline of a peg, there is the still vexing issue of an adequate exit strategy. Rapidly changing demand for money in a disinflationary environment renders targeting of monetary aggregates of limited value. Do we really need an anchor? The staff views would be most appreciated.

The staff's findings on external viability suggest that even greater efforts are needed to provide debt relief to ESAF countries as many of the countries that progressed with respect to external viability indicators continued to have heavy debt burdens. The staff analysis also highlighted that countries achieving higher growth levels, even if this entailed higher initial current account deficits, were more able to improve external viability. Based on the empirical analysis in the staff papers, inadequate investment in human capital was a dominant factor behind the lagging growth levels in Africa. Once more, this underscores the importance of raising health and education standards by safeguarding an adequate level of capital and social expenditures in those countries. As Directors noted during the discussion of the HIPC Initiative, high debt service payments diminish the ability of many heavily indebted countries in maintaining adequate social expenditures. Consideration should be given to providing more conditional debt relief in order to relieve pressures on the budget which tend to squeeze certain essential expenditures. But one time debt relief operations cannot substitute for greater market access for those countries that have embarked on export-oriented growth strategies. While we are encouraged by the continued progress ESAF countries have achieved in opening their economies, restricted access to industrial country markets for key export products—particularly textiles, clothing and agricultural products—remains an area of concern. As staff pointed out, ESAF countries have suffered from this throughout their adjustment period, and we therefore hope this matter will receive greater attention by advanced economies. I find it curious for this institution to counsel developing countries to liberalize their trade regimes in an effort to promote efficiency and export growth, only to be thwarted by export barriers.

Finally, it appears that greater success is attained by countries that had greater staff resources, including in the form of program monitoring. This is a striking finding. The sharp contrast of Fund resources spent on Baltic States and the CIS is particularly noteworthy. "The number of resident representatives, the frequency of missions and the total staff resources per country have all been considerably greater in these countries than in ESAF countries" according to the staff papers. This is in spite of the well-known fact that all ESAF countries have weaker administrative capabilities and that, in some cases, these were found to have been the key factor behind the interruption of a program. Furthermore, the analysis in Chapter IX indicates that many of the programs that were interrupted due to policy slippages did not have a Resident Representative at the time. While we recognize the limitations imposed by our stringent budget policies, this is one clear case where the over-zealous attempts at budget cutting have been counter-productive. I hope in our budget discussion we will pay due attention to the findings of this study.

Extending his remarks, Mr. Shaalan noted that the documentation prepared for a country requesting ESAF support—the Policy Framework Paper, the Memorandum on Economic and Financial Policies, and the staff report—often contained repetitive elements. He wondered whether, in the interest of streamlining, the documents could be made less detailed and less repetitive.

Mr. Sivaraman made the following statement:

> We are thankful to the voluminous but very useful report prepared by the staff. The Review has focused on the design and execution of programs assuming that the basic strategy followed on raising savings ratio, securing macroeconomic stability, liberalizing foreign trade, reducing government intervention and reorienting government spending and revenues along with mobilization of external resources has been the right one. There cannot be a different opinion on this.
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> This review clearly concludes that many countries pursuing reform and adjustment programs with the support of SAF and ESAF have strengthened their economies materially in the last two years. Such clarity was less evident in the last 1993 review. However, progress in a number of areas- both macro and structural—has fallen short of the program objectives and in particular reducing intermediate inflation rates, creating more outward oriented economic conditions, and moving toward external viability has been somewhat uneven. The review gives an overall impression that SAF/ESAF programs have been partly successful in achieving the objectives even though many programs were interrupted owing to various causes including inability to observe conditionalities.
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> In spite of these shortcomings, it is difficult to assail the conclusion that ESAF has been a useful vehicle to carry a strategy of measures to remedy the problems and needs of low income countries. ESAF resources have also played a key role in supporting the bold and broad-based reforms through their catalytic effect although part of the progress could be ascribed to a favorable global environment also. Based on the experience of two countries in my constituency, namely Bangladesh and Sri Lanka, it can be said that the ESAF provided them an opportunity to initiate strategic reforms.
>
> One important finding of this study is the positive correlation between progress toward external viability and domestic economic performance. Hence, favorable external environment is an important prerequisite for the success of the programs in many ESAF countries. This is precisely the reason that we place much emphasis on the access of developing countries to industrial countries' markets. The staff statement that ESAF countries suffered throughout the adjustment period, from restricted access to industrial country markets for key export products, particularly in agriculture, textiles and clothing clearly emphasize the need for greater international coordination. Between 1986 and 1992, a number of ESAF countries suffered terms of trade shock as the prices of principal export commodities dropped by at least 60 percent. Since 1988, nonfuel commodity prices weakened due to industrial countries' recession. Nearly one quarter of ESAF countries experienced severe civil strife or war. All these developments naturally affected the performance criteria. However, it is not clear from the staff paper in how many cases

performance criteria or benchmarks were modified in the light of these exogenous developments. Staff may like to clarify.

Regarding external viability, 22 out of 27 countries appeared to have made some measure of progress even though external current account deficits were barely reduced due to poor response of saving rates to rising growth. While the private creditors substantially reduced their exposure, much larger portion of this debt was provided on concessional terms by multilateral creditors. This underscores the importance of HIPC Initiative. The staff conclude that in cases where there is lack of progress toward external viability, export growth and economic activity suffered very much, which reinforces the importance of promoting growth enhancing policies in these countries. Without economic growth, there cannot be any enhancement in the capacity to save and this is where the role of the World Bank becomes significant. We cannot expect the Fund strategy to work unless concomitant investment takes place in areas which contribute significantly to income growth in these countries. Therefore, one area to look for failure in these countries is to what extent investment was augmented and also contributed in increasing output. This is not clearly brought out in this Report.

While ESAF countries improved their savings performance in 1991/95 to 9.9 percent of GDP from 8.0 percent in 1981/85, only half of the targeted reduction in primary budget deficits was achieved. Moreover, deficit overruns were not significantly correlated with revenue shortfalls. Even expenditure compression beyond a limit would not have been feasible. When it took place, it was the capital account which could affect overall economic growth. There is a limit to expenditure reduction if we have to safeguard the vulnerable section of the population. Hence, we do not recommend conditionalities that are more rigorous in this area.

I fully share the staff assessment of the composition of fiscal adjustment. But the question is how to prioritize these components and in what combination. The administrative capacity of ESAF members must be taken into account while formulating the program. While we agree to various components of fiscal adjustment strategy, the application of a particular combination depends largely on socio-political situation in the ESAF country and its administrative ability to carry out the program. This is purely a matter of judgment and I am afraid that no precise answer is possible.

We are happy to note that the evolving composition of government spending in ESAF countries is reasonably positive even though relative to the pre-ESAF period, the desired shift from current to capital expenditure grew to a lesser extent than what was hoped. Roughly three-quarter of countries succeeded in raising expenditure on health and education since their implementation of this program. Spending on health and education, although classified as government consumption, is more in the nature of investment in human capital. Hence, I support the staff idea that high priority expenditures on health and education could be protected in a "core budget." This must bear close coordination with World Bank in these countries. To ensure this, considerable improvements are needed in the quality and availability of data on a functional basis together with information on the efficiency of such expenditure for which a transparent budgeting, auditing and accounting system must be in place.

With reference to inflation control, we are happy to note that programs had success in tackling high and very high inflation even though considerable number of ESAF users have remained stuck in the intermediate inflation range. In analyzing this, we must take into account both domestic and external factors, mainly the imported inflation etc., although the fiscal and monetary policy pursued in these economies focus on the very basic objective of inflation control. Hence, there is no necessity for added pressure on fiscal and monetary policies as these added actions could have deleterious effects on the output. In controlling inflation, while the need to adhere to financial ceilings is well recognized, the result clearly indicates that inflation in these countries is not a pure monetary phenomenon. Hence, the structural factors must also be taken into account. Although, theoretically one may say that the use of nominal anchors such as exchange rate peg, money supply ceilings, inflation targets etc, would help contribute in containing the inflation, the institutional bottlenecks in these countries must be amply recognized. For example, on the exchange rate side, to peg the exchange rate, we must know what is the equilibrium exchange rate in the country which is very difficult to measure. Without knowing the equilibrium exchange rate, at what level one has to peg is an important question as pegging the exchange rate on the wrong side would result in destabilizing capital flows.

The scope of the reform efforts will need to remain broad-based and the priorities are to be assigned depending on specific country circumstances. The present review clearly indicates that progress has often lacked in public enterprises reform and bank restructuring. But given the circumstances in these low income countries, it is not clear to what extent these two factors deter further fiscal adjustment. While the role played by the first factor namely public enterprise reform in fiscal restructuring is well known, the role of the second factor, namely bank restructuring through the government meeting recapitalization costs could also be significant. Our fear is that such combination with additional conditionalities would further strain the capacity of the countries in delivering the desired results. However, we support the view that future ESAF arrangements be focused more directly on operational measures with a view to strengthening the implementation of banking sector reform in close coordination with the World Bank and assisting the countries in implementing Basle Committee core principles. The line of demarcation of the respective responsibilities of the Fund and the Bank should be clear.

To enhance the policy effectiveness, the staff suggested more widespread use of Resident Representatives. External Audit Department has already initiated a review of the Resident Representative Program and we should await the results of this survey before we proceed on this.

It is somewhat disturbing to note that during the period between 1986 and 1994, 28 of the 36 countries with SAF/ESAF experienced protracted interruptions. The interruptions largely occurred in deviations from policy commitments or inability of the authorities to agree with the staff on financial and structural adjustments to be implemented. I would like to know whether the time period of three years required for implementation of the policy was adequate. Is it possible if the agreed policies had been phased over a longer period, say, four or even five years than the normal three year period prescribed for ESAF, there could have been better results and fewer interruptions.

Another question I want to ask the staff is whether the machinery the authorities had in place were adequately equipped to implement the different aspects of the strategy to achieve the expected results. Could a better equipped and trained staff of the authorities have delivered the results? The report has recognized that in many countries, limited administrative and technical capability did hinder policy implementation. If that were the case, was it an error of judgment on our part to expect the authorities to adhere to the programs.

I would support contingency planning to take care of unexpected events interrupting the program.

I am not able to understand the question relating to greater selectivity in providing Fund support as no program is approved unless there is an agreement between the authorities and the Fund in its implementation. Hence, before embarking on the program, we must ensure the capacity of the member country to implement the same. Where we are doubtful but the authorities are keen, should we not examine a technical assistance program, in coordination with the World Bank, to run concurrently with the main ESAF program in the specified time frame to enhance the capacity of the authorities to implement the same.

Mr. Kaeser made the following statement:

We would first like to thank the staff for the concise summary report and the detailed background papers. We very much appreciated the candidness of the staff papers. Together with the external evaluation, which is scheduled to be completed later this year, they provide a good basis for improving ESAF conditionality and for making the facility more effective in the future. However, a diagnosis of the problems alone is no guarantee for an improvement. In this respect we note that the major weaknesses of ESAF-supported adjustment programs remain broadly the same as those already identified on the occasion of the last review. In addition, some prudence is warranted in the interpretation of the general results of this review, due to the wide diversity of countries covered.

We agree with the staff's overall assessment of the experience under ESAF-supported arrangements. In fact, a mixed picture emerges from the report. On the one hand, some sizable progress has been made by most countries implementing programs with ESAF support. Primary deficits have been slightly cut and inflation rates have been reduced to more moderate levels. Some progress has also been made with respect to structural reforms.

Particularly encouraging is the fact that since the beginning of the 1990s the growth gap between ESAF countries and non-ESAF developing countries has been narrowed—partially thanks to favorable external developments.

On the other hand, however, outcomes have considerably fallen short of program targets. Fiscal adjustment was much more modest than targeted, inflation rates have seldom been reduced to single digit levels and structural reforms progressed more slowly than envisaged, notably in the financial and external sectors. In addition, current account deficits were barely reduced and debt service burden in terms of GDP has remained practically constant. Economic growth also remained insufficient in light of the high rates of population growth in ESAF countries.

As regards the need for more decisive fiscal adjustment, the discrepancies between program targets and outcomes are particularly striking in the fiscal sector. Overall fiscal adjustment was only modest and fiscal slippages were one of the major reasons for program interruptions. Almost half of all programs did not result in an improvement of the primary balance. We therefore concur with the staff that more decisive fiscal adjustment—as initial program targets have aimed for—is needed. This would not only increase national saving rates and, thereby accommodate higher private investment, but also result in lower inflation rates.

As to the composition of fiscal adjustment we agree with the approach to take into account the relative size of the state in the economy. Especially for countries with very low ratios of fiscal revenues to GDP, revenue-raising measures are needed. In this respect, it is important to keep in mind two issues. First, implementation lags must be considered realistically. It often appears that under pressure to conclude program negotiations, the time needed to implement new revenue measures is easily underestimated. Second, as the staff underscores, institutional capacity constraints must be taken into account. In this context, technical assistance can play an important role. In order to ensure effectiveness of technical assistance, progress in implementing recommendations should be formulated more often as benchmarks or prior actions. As to the content of tax policy reforms, more emphasis should be given to a shift toward broad-based consumption taxes, such as the value-added tax.

While recognizing the need for increasing and consolidating revenues in some countries, we also believe that a much larger share of fiscal adjustment should come from the expenditure side. In the period under review, total expenditures as a share of GDP remained constant, although a large potential to reduce unproductive spending exists. In this respect, the staff correctly points to the civil service and the public enterprises sector. We agree that a medium-term strategy is critical for reforms in these two areas and that much of the saving potential will only materialize after some time. However, we have some qualifications with respect to the staff's point of view that in the short-term no major savings can be expected. For example, we have the impression that in almost all ESAF countries there exist obvious areas for a rapid reduction in public employment. The fact that two thirds of the countries had an increase or only modest decline in public sector employment is disturbing.

Waiting for the results of a civil service reform study should not be an excuse to delay obviously needed adjustment. More immediate savings can also be achieved in the public enterprises sector. In our view, direct budget support and price subsidies could be reduced more swiftly. In addition, at least small and medium-sized enterprises could be privatized relatively quickly.

The staff report points to the crucial role of front-loaded structural reforms of the state sector for the achievement of fiscal sustainability. It also shows that countries with structural benchmarks in this area tended to perform better than the overall sample. We, therefore, strongly support the more frequent use of structural conditionality and prior action in the fiscal sector. In our view, these benchmarks should be focused more on the elimination of tax exemptions, the reduction of the size of the civil service, and the institutional framework of expenditure management.

Generally, we would also favor a more frequent use of adjusters which allow to influence the composition of fiscal adjustment. Adjusters could not only be used to protect social spending and capital investment but also to ask for offsetting measures when there are wage increases not included in the budget or revenue shortfalls due to a lack of political commitment.

Turning to social spending and "core budgets", theoretical and empirical studies have shown that the quality of fiscal adjustment is crucial for medium-term growth in developing countries. In particular, spending on primary education and health are often cited as key determinants of growth. The staff report confirms these findings and suggests that there is some need for further improvements in ESAF-supported arrangements. While the composition of expenditures has slightly changed from current to capital expenditures, the shift has significantly fallen short of program objectives. In addition, a substantial part of the slight improvement can be explained by favorable external developments, notably the "peace dividend" which allowed a decline in military outlays. We also note that there is still room for improving the intrasector distribution of social spending.

In many instances, revenue shortfalls have resulted in cuts in expenditures with a high social return. This is one reason why the objectives for reducing population growth and accelerating human capital accumulation have been missed. Therefore, it would be efficient to define "core budgets" to protect high-priority expenditures. These high-priority expenditures would typically include health and education projects, but we would also appreciate if the staff explored the scope for including other expenditure categories with a high social return and a positive influence on real growth. "Core budgets" should, in our view, be designed in order to protect effective programs rather than specific nominal figures.

As to more decisive disinflation, the evidence that countries with low inflation tend to grow faster than those with high inflation indicates that there may be a case for aiming at lower inflation rates. We, therefore, agree with the staff that ESAF programs should aim at single digit inflation. The variability of the inflation rate could also have been examined. The negative incidence on growth of a high but stable inflation rate could be lower than that of a low but variable one.

The design of programs should take into account the factors behind the inflation process. In some cases, a rapid disinflation may be possible. In others, more lengthy solutions have to be devised. Programs should, therefore, aim at a sustainable and realistic reduction in the inflation rate and not necessarily at a rapid one. This does not seem to have been the case in the programs under review.

In designing programs to reduce inflation, we would be very cautious in adopting nominal anchors. Money supply ceilings could be appealing, provided the money demand function remains stable. Very often, however, during disinflation, this is not the case. As for an exchange rate peg it may contribute to break an inflation momentum fed by expectations and forward indexation. It is an easily observable signal for the central bank's commitment to price stability. It may also provide a stable target for monetary policy, if demand for money has shifted and cannot be reasonably estimated. However, this strategy may have costs in terms of competitiveness and increase the economy's vulnerability to shifts in the terms of trade. In addition, exiting such a regime is often problematic.

On structural reforms, we agree that programs could deliver a faster and stronger supply response if structural measures that stimulate private investment and entrepreneurship are carried through. In this respect, public enterprise reforms, bank restructuring, trade and foreign investment liberalization as well as a strengthening of property rights constitute a strategic compact in which more efforts should be invested.

There has been continued progress in the areas of exchange and trade liberalization and the deregulation of prices and marketing. As the staff points out, however, there is still great scope for further gains in trade reform, since trade regimes remain "moderately restrictive" in half of all nontransition ESAF countries. Tariff rates should be further rationalized and reduced. Regarding the remaining price distortions, notably of staple foodstuff, petroleum products, and some construction materials, ESAF arrangements should aim to eliminate them. Whenever required, this elimination should be combined with targeted support for the poor.

The continuously slow progress of public enterprise reform and bank restructuring are areas of greatest concern. With respect to public enterprises, the problems seem to come from the large firms, especially those active in strategic sectors. Governments were reluctant to divest in these sectors and the efforts to harden budget constraints and impose management accountability failed. Performance contracts were poorly designed and government tended to replace direct budgetary support with other, less transparent, measures.

We therefore share the view that greater emphasis should be given to privatization as well as to functioning bankruptcy laws and procedures. The privatization or liquidation of public enterprises could more often be a subject of conditionality. If for strategic reasons, privatization could not be a solution, hard budget constraints have to be imposed and management made effectively accountable. The Fund should monitor this process on a macroeconomic level through the budget and monetary data, requiring the limitation of direct budgetary support and bank borrowing with government guarantees as well as the settlement of tax arrears. Conditionality could be used more extensively in these areas. The Fund should, however, not compile information on the financial position of individual enterprises. This relates to micromanagement and should be done by the World Bank.

With respect to the financial sector, it is encouraging that most countries adopted multiyear bank restructuring plans. However, recapitalizing ailing banks and shifting the responsibility of assuming problem loans to the government will provide little help in restoring bank soundness, if the governments continue to intervene in lending decisions and banking skills are not upgraded. Designing an exit strategy will probably also be needed and strengthening banking supervision will be crucial. In this respect, the Fund has a role to play in monitoring a country's progress in implementing the best practices and standards elaborated by regulatory bodies, such as the Basle Committee's "core principles." Since the fiscal implications of bank recapitalization might be large and the risk of moral hazard high, it is very important that this is done only once—when the incentives have been corrected and the fundamental problems dealt with.

In our discussion on bank restructuring and macroeconomic policy, we had stressed the importance for the budget to comprehensively record the fiscal burden of banking problems. Only then could the Fund assess correctly the fiscal implications of a given instrument to achieve bank restructuring and take them into account when designing a program. We therefore support the staff's suggestion that the Fund be more actively engaged with the World Bank and national authorities to ensure a full accounting of the financial position of banking systems and the fiscal costs of restructuring.

Experience tends to show that bank-specific financial and operational problems need to be addressed. Unless these issues are dealt with, banking problems may reemerge in the future. To manage such measures, however, timely and comprehensive information on individual banks is needed. A national authority, such as the supervisory authority, rather than the Fund, would seem, therefore, the most suited to undertake this task, with the help of the World Bank if necessary.

We could support a more intensive program monitoring for the following reasons: Firstly, it is striking that Stand-By and Extended Arrangements (available for more developed countries with often higher administrative capacities) have quarterly test dates, whereas ESAF-arrangements (available for poorer countries often faced with complex structural problems) have only half-yearly reviews. Quarterly test dates and disbursements may help in some cases keep government's attention focused on the requirements of adjustment policies and may allow early responses to emerging problems and policy slippage's. Secondly, the use of structural performance criteria and benchmarks has not always been effective because of the emphasis on approving plans and passing laws rather than on operational achievements. With quarterly test dates it might be easier to actually monitor policy implementation.

We acknowledge, however, that more intensive program monitoring does not address all the problems leading to program interruptions. We also have some concerns regarding the additional administrative burden—for the Fund and ESAF countries alike—associated with more frequent staff visits. In order to limit the amount of additional work to the staff and the Executive Board we suggest using a similar procedure as with Stand-By Arrangements. For quarterly disbursements we could require the observance of performance criteria whereas for the half-year disbursement the completion of a review would be needed.

Nevertheless, this proposal requires somewhat more staff resources. In this respect we would appreciate an approximative estimate by the staff. In our view, additional resources for the monitoring of ESAF-supported programs should not be mobilized through a reduction in staff currently deployed in the surveillance of nonprogram countries. Before extending the number of Resident Representatives we would like to evaluate their effectiveness based on the forthcoming paper.

The staff proposes to be more selective in providing Fund support in cases where the authorities' ability to implement reform policies is weak. We certainly support an effort to be more selective in these cases. It will not be an easy task to determine operational criteria on what this higher selectivity is based, though. One effective measure could be the use of strong prior actions, in particular when the country has a weak track record. Moreover, we agree that the authorities should be encouraged to strengthen their policy commitment through a more intensive consensus-building process.

We warmly support another review of ESAF arrangements, e.g., in four or five years. In this respect, we have two major suggestions:

We regret that this review analyses SAF and ESAF arrangements indiscriminately. SAF programs had a weaker conditionality than ESAF arrangements. Their structural content tended to be less specified and less action oriented. Furthermore, SAF loans were disbursed only once a year. Looking at both SAF and ESAF may have been appropriate at the time of the first review, in March 1993, when we had only five years of experience with ESAF-supported programs. In the meantime, many additional arrangements have been approved. We should therefore focus on the results of ESAF arrangements. Accordingly, SAF-supported programs should not be part of next review and, if possible, the ongoing external evaluation of the ESAF.

Basically, we liked the methodology used and the focus on assessing how well the ESAF strategy was reflected in the design and execution of programs. However, we think that the "before-after" method emphasized too heavily the comparison between the early 1980s, late 1980s and early 1990s.

The time countries began with their first ESAF arrangement varied between 1988 and 1994. The early 1990s can, therefore, not be used as a proxy for post-adjustment phases. Furthermore, in the early 1980s the world economy was in a different shape than ten years later. Therefore, we rather prefer a comparison between "pre-program" versus "program" and "post program" periods. Moreover, we found regional comparisons very useful and are looking forward to include transition economies in the next review when we will have more data.

Finally, we suggest publishing the results of the current review and possibly of the external evaluation as an occasional paper, as it was done for the last ESAF review and the review of stand-by and Extended Arrangements in 1995. Such a publication would not only improve the transparency of the Fund but could also help to reduce some misunderstandings about Fund-supported programs.

Mr. Bernes made the following statement:

Let me begin be thanking staff for their efforts in undertaking this useful and thought-provoking review of experience under ESAF programs. Their task has been a difficult one, given the complex interaction between economic policy, domestic politics and external developments, all of which have important implications for the success of economic reform.

Their results show clearly that there has been some progress among ESAF users, particularly in the liberalization of exchange rate and trade regimes, prices and interest rates, but that there is an enormous amount left to be done. Interestingly, and as noted by Mr. Kaeser, a number of the areas identified as lacking in success in our 1993 review—more aggressive fiscal adjustment and reform of public enterprises—are the same areas in which failings appear in the current assessment.

Nevertheless, the real value in this review is forward looking—that is, in what it can tell us about how to make more efficient and effective use of our scarce concessional resources. The questions this review raises and the shortcomings it identifies highlight the degree to which all partners in the development process—domestic authorities, the Fund, the World Bank, and bilateral and other multilateral donors—can improve and enhance their efforts to ensure a much-needed acceleration in economic growth and poverty reduction.

Indeed, while the primary responsibility for the success or failure of reform rests with the country itself, our task in this exercise is to ensure that the Fund provides the best and most practical advice, assists in the design of the most appropriate strategies, and is able to respond quickly to changes in circumstances that affect the likelihood that a program will be successful. In this regard, there is no room for complacency and we should be as tough, if not tougher, on ourselves, than we are on ESAF borrowers.

In this regard, I was somewhat troubled by the assertion that "most program interruptions have been the result of factors outside the Fund's control." While there obviously is truth in this statement, I am not convinced that it is constructive—both within and outside of the Fund—to characterize the situation in this manner. Indeed, the fact that at least one of the background studies was unable to statistically distinguish between ESAF-users and nonusers in terms of growth in per capita GDP, draws into question the effectiveness of ESAF programs generally—not just in their implementation, but also in their design.

In this vein, I can't emphasize too strongly the need for constant re-evaluation of an issue as basic as our approach to economic development. While I do agree that our "basic strategy" is broadly correct, prudence should stop us short of assuming, as is done in paragraph 5, that our basic strategy for growth and adjustment underlying ESAF is the "right one." Our understanding of the reform process is not static and we should continue to challenge our assumptions as the world economy evolves.

That being said, I can endorse the core objectives of our strategy as outlined by the staff—with the following caveats. The staff identify first and foremost, the pressing need to raise savings rates as a key objective and note that, particularly in the near term, the most effective policy instrument to achieve this is through a reduction in public dissaving. At the same time, they identify the need to re-orient government spending to more productive purposes. I believe it is critical that these two objectives be closely and inextricably-linked. Indeed, failure to address the quality of expenditure reform and the resulting composition of government expenditure could undermine longer-term efforts to raising savings, even though shorter-term objectives may be met.

I therefore welcome the proposed increased reliance on "core" budgets which aims to preserve spending on health, education, and productive public capital investment, keeping in mind that we need to look beyond the aggregate numbers and have some understanding of the effectiveness and efficiency of spending in these areas. I therefore welcome the World Bank's efforts to pay increased attention to development outcomes rather than just inputs. Fund staff should take note of work in this area and integrate it into their own analysis.

The Review clearly shows that the importance of investment in human capital should not be underestimated. I was pleased to note the conclusion contained in the fifth staff study that the retardation of growth in ESAF countries relative to non-ESAF countries due to the absence of improvement in social indicators was three times as large as was the impact of poorer macroeconomic and structural policies. This suggests that the targeting of government spending on health and education may be even more beneficial to growth than deficit reduction (although the actual outcome likely represents the interplay between both factors.) In light of this, I wonder about the staff's observation that, while most programs in recent years included "pledges" to strengthen health and education spending, "this objective was seldom quantified." Given the importance of these areas to gains in growth, perhaps we should consider clearer targets here. The use of "core budgets" could also provide us with an appropriate vehicle for achieving this.

Let me make one brief comment on the issue of military spending. The staff encourages authorities to seize opportunities to reduce spending in this area "as and when the social and political climate permits." While countries should, of course, undertake the measures necessary to pressure their sovereignty and maintain their territorial integrity, we should not be blind to the fact that excessive military spending can also be responsible for generating the unstable social and political conditions that some authorities may be seeking to address through higher military spending.

Another key objective identified by staff is the need to secure macroeconomic stability, particularly low inflation. I believe that the weight of evidence in this regard is enormous and I can easily agree with the importance which staff assign here. The staff have noted, in this regard, that low inflation is an "important factor in improving the conditions of the poorest sectors of the population" since it is the poorest that often have the least ability to protect themselves against inflation. While I concur with this conclusion, I wonder about the degree to which the process of getting to low inflation has a disproportionate impact on the poorest, and if so, how we might bolster and make more efficient our efforts to offset this during the transitional period. Staff comment would be appreciated on this point.

Mention is also made of the possibility that the ambitiousness of inflation objectives may have been inconsistent with the strength of supporting measures, particularly with respect to fiscal policy. This issue has arisen frequently at the Board and warrants further study by staff since it is an issue of primary relevance to the Fund. Failure to correct for any systematic inconsistency, should it exist, runs the risk of undermining the credibility of our analysis. I would also point out that the importance of enhancing the quality of expenditure is further underlined by the fact that expenditure reduction is deemed to generate more disinflationary impulse than is revenue enhancement.

In the interests of brevity, I won't be exhaustive in my comments. Let me make just a few more points. I was pleased to note the importance assigned by staff to the implementation of measures to: establish a transparent legal framework conducive to private business; protect property rights; tackle tax evasion and discretionary tax exemptions; improve transparency and accountability in expenditure management; enhance public-enterprise management accountability; and improve the transparency of privatization efforts.

What I found surprising was that these "governance" recommendations were scattered throughout the review and little or no attempt was made to provide a more integrated view of the need for reform in this area. In light of our exhaustive (and exhausting) discussions on governance, and the unanimous acknowledgment of the importance of good governance to sustained economic growth, I would hope that future reviews and evaluations will make a better attempt to view the reform effort from the horizontal perspective of governance.

I would have also welcomed a greater emphasis on the links between success or failure in one area of reform with success or failure in other areas. For example, paragraph 82 briefly discuses the linkages between policies aimed at low inflation and their impact on the fiscal balance if not accompanied by fundamental tax and expenditure reform. We might also look more closely at the linkages between trade liberalization and revenue performance and how the sequencing of such reforms can be designed more optimally. These types of linkages underline how important it is that reforms be viewed as a single package, and not as a series of items on a menu from which authorities can pick and choose.

Let me turn to the issue of greater "selectivity" in approving arrangements. I have no hesitation in supporting this basic principle, although the more interesting question pertains to the nature of the associated criteria and the manner in which such "selectivity" is administered. Without question, our scarce concessional resources should be channeled to those with the strongest commitment to reform. At the same time, we must willingly accept our own culpability for past failures and do what is within our power to ensure the most effective management of the resources entrusted to us.

First off, we should not commit scarce resources without an adequate picture of the environment in which we are operating. Data provision on key areas as a prior condition should be the rule, not the exception. To the extent that countries lack the capacity to collect such data, we, or a more appropriate agency, should be prepared to provide significant technical assistance before the start of a program and the Fund should perhaps make better and more targeted use of staff-monitored programs. While I note that staff have found little correlation between staff-monitored programs and successful subsequent ESAF arrangements, we might consider looking more closely at the circumstances under which we undertake staff-monitored programs as well as their content. Perhaps they should be viewed more as preparation for an ESAF program rather than just as an indication of the commitment of the authorities to achieving given targets. This might go a long way to raising the success rate of ESAF programs and avoid the need to increase the frequency of staff-monitoring.

On the issue of increased frequency of monitoring, while this has appeal, I envisage some problems beyond the obvious staff resource constraints. A more optimal approach might be to find ways of enhancing the degree to which authorities assume ownership over their reform process. Increasing the frequency and intensity of Fund oversight might actually undermine this objective. A more productive approach would be to, as mentioned, undertake more up-front technical assistance, but also to, as suggested by staff, assist the authorities in the design of contingency plans. While this may increase the time necessary for program design, it would allow those that are best placed to identify the need for correction—that is, the authorities themselves—to respond to slippages as they occur.

What else can we do? Well, we need to take a closer and more critical look at the quality of communication and co-ordination between ourselves, the World Bank, and perhaps bilateral donors, particularly in the areas of banking and public-enterprise reform. Given the need to ensure objectivity, we should give serious consideration to external evaluation of at least one of these areas.

We need also to be prepared to respond more strongly to program slippages, particularly in the area of civil-service reform, and be less generous in the granting of waivers. In this regard, I would be interested in seeing some summary data which identified any patterns in the frequency or character of waivers the Board has granted over time.

Considerable attention is also focused, rightly, on efforts to reduce the extent of government influence in the economy, particularly through public-enterprise and civil-service reform, with which the track record of ESAF users has not been impressive. As we move to address the shortfalls in these areas, it seems obvious that our first step should be to ensure we have an adequate understanding of the situation in public enterprises and the potential fiscal and macroeconomic consequences of existing and emerging problems. If this means that we need to re-allocate some of our technical assistance to enhance the capacity to prepare the data, then we should do this, particularly given the potential for program slippage originating from this area.

Further, while I appreciate that these are issues for which the World Bank has the lead responsibility in program design, we need to assess the extent to which problems are due to poor program design by the Bank, a lack of co-ordination and communication between the Bank and Fund, or failure in implementation on the part of the authorities. On civil-service reform, the problem appears to be more one of the will of the authorities to follow through on commitments and we should therefore be prepared to enhance the importance we assign to conditionality in this area.

On coordination with the Bank on public-enterprise reform, our role must be to advise clearly—both donors and the Bank—which enterprises are the most relevant from a fiscal standpoint. If the problem rests with implementation, we must be prepared to respond quickly to slippages so as to ensure that all the right incentives are in place to put the process back on track.

The same can be said of banking reform, which staff have identified as the most deficient area in terms of performance. Once again, we must require—as a prior action—the provision of adequate data to assess potential fiscal impacts. Second, we must ensure that coordination and communication with the Bank is of the highest quality so to arrive at the most appropriate program design. And once again, we must be able to respond more quickly to slippages as they occur and take firm action with respect to the continuation of the programme.

Finally, we need to take a broader look at the quality of technical assistance the Fund provides as well as the depth of the information provided to the Board and management in their assessment of program viability. On technical assistance, the availability of highly-qualified and experienced staff is a necessary, but not sufficient, condition for the provision of effective TA. We also need to ensure that those providing such assistance have the communication skills and cultural sensitivities necessary to ensure that the information imparted to officials is received and understood. I would encourage management to give this careful consideration and determine if our staff training efforts in this regard are adequate.

On the nature of information presented to the Board, it has been accepted by the Board that, in designing a program, "it is legitimate for management to seek information about the political situation in member countries as an essential element in judging the prospects for policy implementation." The extent to which "major political upheavals" have been cited as a prevalent reason for policies going off track raises questions about the quality of the political assessments provided. Perhaps we need to take a closer look at the appropriateness of the skills mix of staff providing advice in this area. While often not the case, economics Ph.D.'s do have a reputation for viewing the world from a particular perspective that might not accommodate all relevant considerations.

The issue of the effect of electoral cycles on program slippages is an interesting case. In a perfect world, electoral cycles will not matter to economic policy. But we know that this is not how things work in our world and we therefore need to adapt to this reality. This is not to say that we should accept such slippages, but that, since slippages, particularly on the fiscal side, have a tendency to emerge in the lead up to elections, authorities who desire to go on spending sprees to impress their electorates should be encouraged to undertake higher than normal fiscal savings in the preceding periods so as to achieve the overall targets. In short, we should not pretend this does not happen, but give authorities the option of undertaking such action within the confines of their program commitments.

All that being said, I would urge staff, management and the Board to make the best use of this—and the upcoming external evaluation—not to justify what we have been doing but with the main purpose of improving our effectiveness in future.

Extending his remarks, Mr. Bernes said that he supported the publication of the document.

Mr. Al-Tuwaijri made the following statement:

The staff is to be commended for a comprehensive and very informative successor to the report for the 1993 SAF/ESAF review. I found the update on the extensive analytical literature particularly instructive. Also impressive is the skillful drawing of lessons from the decade-long disparate experience of as many as 36 ESAF-using countries. The task now is to take these lessons into account in ESAF programs and in the design of such reviews in the future.

As in past reviews of this kind, the report tests efficacy of SAF/ESAF programs on the degree of success in promoting sustained growth and a viable external payments position. Here, one is again confronted with the difficulties of drawing strong cross-country conclusions from economies in widely disparate circumstances. Thus, paragraph 197 of the Staff Studies, Vol. 1, only points to "some empirical evidence across a large group of countries in support of the basic orthodoxy of ESAF-supported programs." In sum, the available evidence confirms earlier results regarding the responsiveness of economic growth to macroeconomic stability and basic structural reforms. While I can agree with the main conclusions, I will add a few general remarks and then turn to the issues specifically raised by the staff.

The staff assumes that what is referred to in the report as the basic SAF/ESAF "orthodoxy" is the appropriate strategy for adjustment and growth. Therefore, domestic strife aside, any shortfall in reaching program targets has to be explained by some combination of exogenous shocks, faulty program design, and inadequate implementation. This is shown to be the case for some two thirds of the 51 significant breaks in the SAF/ESAF programs since 1986.

Here, let me note that the staff's reference to a basic SAF/ESAF policy "orthodoxy" somewhat understates the Fund's record of continual adaptation to changing "best practices" for adjustment and growth. Besides, it is clear from the staff overview of the growth literature that there is no alternative yet to the Fund's flexible and pragmatic approach. These points are worth stressing since the empirical results, which cannot in any case be conclusive, are yet to indicate full success. As the report concludes, there is ample evidence of a significant material strengthening of the economies implementing SAF/ESAF programs. However, economic growth and progress toward external viability have unfortunately fallen well below expectations.

Regarding exogenous shocks, the review finds only a limited number of cases where better contingency planning might have improved program performance. Also, anticipation of such risks is in any case inherently difficult so that adjustments have to be in subsequent reviews of a program. However, given the external vulnerability of ESAF countries, the case for enhanced use of built-in contingency mechanisms deserves a more systematic consideration. This is especially the case in view of the risks these countries continue to face from recurring terms of trade losses and uncertainties over access to export markets.

The review finds little evidence that program design and inadequacy of technical assistance are to blame in most of the program breaks that occurred. Indeed, a decision on whether a program is appropriately ambitious and properly sequenced requires a considerable use of judgment. The same applies to the question of the adequacy of technical assistance, which will vary with the country situation. In any case, the needed reform in ESAF countries cannot be expected to materialize over a short period. Thus, program design should focus on policy credibility rather than speed. This also underscores the need for extra caution in forecasting the macroeconomic consequences of policy moves.

Regarding fiscal policy goals, the priority for expenditure containment is clearly well-placed. Indeed, such a focus is critical for tangible progress of structural reforms in especially the civil service and the public enterprises. At the same time, it is essential that the trend of spending restraint at the cost of capital spending be reversed. Furthermore, the stress on revenue growth must also be maintained especially in view of the priority for spending on education and health. In this regard, I can also appreciate the case for protection of such expenditures through inclusion in "core budgets." However, it is important to remember that such initiatives have to remain consistent with the overriding priority of a program's macroeconomic objectives.

I fully endorse the staff's suggestion that broad-based structural measures are critical for the strength of an economy's response to forceful macroeconomic adjustments. In this connection, the importance especially of secure property rights and a well-functioning legal and institutional framework for dispute settlements cannot be overstated.

I can sympathize with the staff's position on the inadequate quality and availability of information on public enterprise reform. However, it is important to remember that this is mainly a responsibility of the World Bank. Fund involvement should therefore be limited to the macroeconomic aspects of the issue. The same caveat applies to my support for the suggested increase in Fund-Bank collaboration on financial system reforms.

Turning to suggested steps to reduce breaks in program implementation, I have no difficulty in principle to endorse the suggested increase in the frequency of monitoring. However, let me add that it will be important to achieve the increased monitoring primarily through a more effective use of the resident representatives. This would imply savings in the manning and frequency of missions for this purpose. I will appreciate staff comments on prospects for such savings.

Finally, on the issue of selectivity, it is always important to use our limited resources wherever they will likely provide the most help. As before, the past track record and informed judgment on prospective developments are relevant considerations in this regard.

That takes me to the staff's concluding query soliciting suggestions for the way in which reviews of this kind should be conducted in the future. Let me first note that the widespread shortfalls in reaching program goals are above all a reminder that the problems confronting the ESAF-eligible countries are more long-term in nature. It is thus fortunate that the present extensive review and the coming evaluation by the external panel would remain for some years to come a satisfactory basis for appreciation of the issues. I therefore foresee no need for further review of this kind in the near future. Also, given the extensive coverage of the present exercise, I hope any future review will focus more on particular issues. That being said, let me thank the staff again for the very considerable effort behind this comprehensive and insightful set of papers.

Ms. Lissakers made the following statement:

I would first like to thank the staff for the very thorough effort they made in compiling the summary paper and the background papers. I am sure that we will be drawing on these documents in future Board sessions. Given outside interest in the design of ESAF programs, I would also urge the staff and management to consider publication of these documents.

I would also like to voice continued U.S. support of the ESAF. My authorities view ESAF as a critical instrument for the Fund to promote sustainable growth in its poorest member countries. However, taken together, these papers paint a very sobering picture and strongly suggest we need to take a hard look at how ESAF programs are designed and implemented by the Fund and program countries, and how their results are interpreted by this Board.

ESAF has had some success in achieving macroeconomic objectives. Per capita GDP growth shifted from -1.5 percent to a positive 1 percent over the review period. High levels of inflation have been significantly reduced, and external viability has improved in a number of cases. Prices and exchange systems have been liberalized, and social sector indicators are generally on the rise. In sum, progress has been made on the macroeconomics necessary to support sustained growth, higher living standards, and external viability.

This has not been sufficient by itself to accomplish the higher performance that we would have hoped for, however, despite multiple programs in almost all cases. Growth seems below potential, and it appears that ESAF countries have fared worse than other developing economies in raising per capita income. Indeed, the figures on pages 36 and 37 do not paint an encouraging picture. We share Mr. Shaalan's view that something is amiss here.

These papers bring out clearly the need for: (1) putting greater emphasis on structural reforms, which in turn will require much closer interaction with the World Bank; (2) a more aggressive approach to our traditional macroeconomic conditionality; (3) greater selectivity under ESAF, i.e., a lower tolerance for failure; and (4) critical adjustments in the structure of ESAF itself, particularly with regard to monitoring and the sequencing of conditionality.

On key structural reforms, the staff offers a number of arguments for strengthened policies on the macro side, and we will address these in turn. We firmly believe, however, that greater emphasis needs to be placed on structural reforms that will increase the influence of market forces and competition by opening these economies to trade and investment, as well as deregulating domestic business. Although some progress has been made in these areas, far more should be done.

The staff outlines four areas for greater emphasis on structural reform: trade liberalization, public enterprise reform, bank restructuring, and strengthened property rights. We strongly support a tighter focus on these areas. Trade and investment liberalization are clearly key, as evidenced by Figure 19 which demonstrates the relationship between export-led growth and external viability. Given that the staff is now preparing a paper on trade liberalization in Fund programs, however, we will focus now on the other three areas. I should note to staff, however, that we will want to return to this issue as soon as they have finished their report.

Public enterprise reform has consistently lagged in ESAF countries. The staff raises a key point regarding the lack of comprehensive data on public enterprise accounts, and we will turn to this in the context of fiscal transparency. Another critical issue, however, is the current approach to public enterprise reform. The case studies suggest that attempts at restructuring large public firms have not delivered the desired results. Performance contracts have been ineffective in changing management, and budgetary transfers have often been replaced by quasi-fiscal assistance. This bolsters the case for a more aggressive approach—outright privatization or liquidation—and we should pursue tighter conditionality in this regard. The question remains, however, as to whether the Bank and the Fund can see eye-to-eye on this issue. In any case, we share the view expressed by Mr. Kaeser regarding the crucial role of front-loaded structural reforms of the state sector for the achievement of fiscal sustainability, and echo his support for more frequent use of structural conditionality and prior actions in this area.

Bank restructuring is closely related to public enterprise reform, and certainly this seems to be an area where many ESAF recipients are stuck in a vicious circle. Without full disclosure of public enterprise accounts, banks are unable to properly evaluate their portfolios. Further, in the absence of an arms-length relationship between the state and large enterprises, banks remain subject to pressure for directed credit and other nonprudential practices. This in turn leads to poor intermediation, rising nonperforming loans, and misallocation of scarce resources.

Strengthening property rights, and more broadly, enabling the development of a transparent and fair commercial system and an effective legal order generally, is clearly an area where we would like to see more progress. This is part of the Managing Director's "second generation" of reforms. We will have to give more thought to the Fund's role relative to the Bank's, and how to effectively incorporate such elements in Fund programs.

One area of structural reform that should be added to staff's list of priorities is human resource development. The staff's research has demonstrated the importance of human capital accumulation as a determining factor in growth performance. This in turn highlights the need for structural reforms aimed at ensuring adequate investment in human capital through raising health and education standards. This should clearly be a priority in program design. Again, this is not solely the Fund's responsibility, but my general conclusion about the whole structural agenda is that it will require much more intensive interaction with the World Bank and IDA.

Turning to macroeconomic measures, we read with interest the background paper on revenue and expenditure policy under ESAF programs, and generally concur with the staff's suggestion for a more decisive fiscal adjustment. However, the issue goes well beyond the outcome on the primary balance. Given that the primary fiscal balance loses significance in the face of large extra-budgetary transfers or quasi-fiscal activities conducted through the banking system, the focus of Fund programs needs to be qualitative as well as quantitative. Thus, while we share the staff's view about the profile and likely composition of adjustment, there needs to be a much clearer mandate to pursue fiscal transparency as a key objective. Transparency in fiscal data is crucial to exposing the structural weaknesses that the staff has already noted, and we should have no qualms about setting out structural benchmarks in this area. Greater fiscal transparency would also bolster the trend of redirecting military and other unproductive expenditures toward social sector spending and investment in human capital, and support efforts to improve governance.

It comes through clearly from the papers that the emphasis on decisive fiscal consolidation must be supported by a new and more demanding approach to civil service reform. I was not surprised by staff's findings in the background paper on revenue and expenditure policy that reduction of the public wage bill has, as often as not, taken place through reductions in real wages rather than personnel. This is an area of reform that perennially falls behind target, and we should work with the World Bank in an effort to revise our approach—perhaps along the lines of a more transparent medium-term framework as suggested by the staff and bolstered by appropriate conditionality.

We were intrigued by the staff's suggestion of establishing a "core budget" to protect key capital and social sector expenditures. The great many times this Board has cautioned authorities regarding compression of investment and social sector spending to accommodate a budget target seems to support the concept of a core budget. This is especially relevant for African countries, where low-growth is tied to insufficient investment in human capital. However, I wonder about the potential side-effects. Would a core budget exacerbate the problem of extra-budgetary operations? I would be interested to hear any evidence on the effectiveness of a core budget.

The staff has presented interesting arguments for a more aggressive approach to disinflation. The need to reduce high levels of inflation is recognized, and it was gratifying to see that this was one area where ESAF programs were largely successful. Evidence presented in the staff paper also illustrate the costs of intermediate levels of inflation, and we should consider a more proactive approach for ESAF countries where we have let this slide. Given that the relationship between meeting NDA targets and inflation performance appears to be weak, there is also a good case for considering a nominal anchor to reinforce the effort on disinflation. Clearly, however, this is not a panacea. The staff recognizes that prudent fiscal and monetary policies are a prerequisite, and this argues for a case-by-case approach, such as we have now. However, the staff has given us a useful framework to shape future discussions.

I was disappointed at the cursory treatment of exchange rate policy. One would have thought the Fund would pay more attention to the impact of various exchange rate regimes on the success of ESAF programs, particularly when we have the experience of CFA countries to contrast with other exchange regimes. Instead, this issue is included only as an ancillary to the discussion on disinflation—to peg or not to peg. Clearly, we are not looking for a policy for all cases. We need to consider the ability and willingness of governments to implement the complementary macro policies that fit with different exchange rate regimes, and develop exit strategies when these regimes are no longer appropriate. Is there a reason staff did not do more in this area?

In regard to selectivity, a tighter focus on structural reforms and a revised approach on key macroeconomic issues is only half the equation. There must also be a sufficient commitment by the authorities to undertake the necessary reforms. Greater selectivity by this Board in granting access to scarce ESAF resources seems warranted by a number of points raised in the staff paper.

I would draw attention to paragraph 66 of the summary paper which notes that, contrary to what we might expect, the rate of borrowing by ESAF countries was either unchanged or higher during years the program went off-track. Most of the debt accumulation was vis-à-vis official creditors, suggesting a lack of discrimination between poor and good performers. A more tough-minded approach by creditors, including the Fund, is clearly in order. ESAF performance might be improved by an earlier and more decisive cut-off of resources when programs go off-track, followed by a requiring a greater number of prior actions for any resumption.

The staff points out that program interruptions occurred in 28 out of the 36 countries surveyed. We should be able to do considerably better. We should also take note of the prolonged use of ESAF resources. As illustrated in the charts on pages 83–84, there are some 18 countries that have had five or more annual arrangements under the SAF and ESAF.

The staff makes a strong argument in favor of more frequent monitoring as a means of forestalling slippages. It is illogical to take a more hands-off approach to programs with countries having weaker administrative and institutional capacity, as is generally the case for ESAF-eligible countries. I was also struck by the footnote on page 77, which notes that annual ESAF arrangements have no test date or disbursement at end-year, meaning there is no penalty for poor performance in the second half of each program year. Again we appear to impose less discipline on countries most in need of external monitoring and program support. The solution, I believe, is to redesign ESAF programs to more closely approximate EFFs: go to quarterly performance criteria and quarterly or six-month reviews. More frequent monitoring could have implications for Fund resources in the near term, but repeated program failures are more labor intensive and costly for the Fund and the country over the longer term.

We could also consider a cumulative cap on use of ESAF resources, to augment the program-by-program limits now in place. Finally, staff-monitored programs—where they represent a precursor to a standby or ESAF—should candidly assess a country's administrative capacity so that we might focus technical assistance to enhance implementation of programmed reforms.

As regards Bank-Fund collaboration, as I noted earlier, many of the suggestions in the ESAF papers and the conclusions we have drawn, point to a need for more intense collaboration with the World Bank at the operational level in individual ESAF country programs. I suggest we take up this issue in an informal Board discussion shortly after the Annual Meetings.

Again, I commend the staff for an exhaustive examination of our ESAF programs and I look forward with great interest to the contributions still to come from our independent evaluators.

The staff representative from the Policy Development and Review Department noted that, in hindsight, perhaps the staff had been too optimistic in setting the design and targets for programs, as a number of countries had failed to reach targets in several areas. However, that issue must be considered along with the question of whether the Fund had been sufficiently selective. Nevertheless, the staff had reviewed the experience with program interruptions with a view to identifying aspects of the design and monitoring of programs that could have been changed to reduce the frequency of interruptions. For example, the staff had analyzed whether interruptions had tended to occur more frequently in countries where targets had been set at very ambitious levels and whether technical assistance could have improved the implementation capabilities of countries. Also, the staff had looked carefully at the role of contingency measures and the role of monitoring. The staff had been left with the impression that, except in a small number of countries, changes in the design and monitoring of programs would not have had a major positive effect.

In reviewing the cases of program interruptions, the staff had found that the program targets in those arrangements had not been substantially more ambitious than in arrangements without interruptions, the staff representative continued. In the relatively more ambitious programs that had been interrupted, the staff had considered Fund support would have been warranted had the actual outcomes been set as the initial targets. The staff had concluded that such modified programs would not have merited support under the ESAF. For instance, in 10 of the 13 such cases, there would have been an increase in the fiscal deficit, while in 7 cases, there would have been an increase in external arrears. As a result, the problem of program interruption could not be substantially reduced by adopting less ambitious targets within the range of targets that could be supported under the ESAF.

In response to Mr. Shaalan's question on the need for nominal anchors, although it was possible to reduce inflation without a nominal anchor, a substantial body of evidence indicated that a nominal anchor contributed significantly to the successful reduction of inflation over a specified time frame, the staff representative stated. For example, the staff's earlier review of conditionality had found that, of the 12 or so countries covered in the review that had started with very high inflation, only 1 had succeeded in reducing inflation to an intermediate or low level without a nominal anchor, while 5 of the 7 that had used a nominal anchor had succeeded in that task. In the current review of the ESAF, of the 8 countries that had begun with high inflation, the 2 countries that had used a nominal anchor had reduced inflation to at least an intermediate level; of the 6 that had not used a nominal anchor, only 3 had been able to exit very high inflation.

Responding to a question about why exchange rate issues had not been covered in more depth in the report, the staff representative said that exchange rate issues had been reviewed when they were central to specific areas under examination, especially regarding efforts to reduce inflation. Although exchange rate issues were very important, space constraints dictated that the staff focus on four or five issues; exchange rate matters could be a subject in a future review.

It was not clear at present what the staff resource implications would be of closer monitoring, but it was an important matter for consideration, the staff representative said.

The staff considered that publication of the papers would be useful, especially as an Economic Forum on the ESAF was scheduled for early September 1997, and since there would be a seminar on the ESAF review at the Annual Meetings in Hong Kong, the staff representative noted.

Mr. Mirakhor asked whether, in the event of more frequent monitoring, a single medium-term program could be negotiated, rather than the current annual negotiations. Such a proposal would save resources for the already resource-strained authorities.

The staff representative from the Policy Development and Review Department responded that such a suggestion resembled the elements of the Extended Fund Facility (EFF), although EFFs had half-yearly reviews of quarterly performance criteria. However, there were often informal discussions to reconsider annual targets under EFF-supported programs, so the difference, in practice, between the two instruments might not be as large as first appeared.

Mr. Mirakhor recalled that negotiations for each annual arrangement under an ESAF were lengthy and amounted to practically a new program every year. It might be an attractive proposition to have more frequent monitoring replace annual negotiations. Also, the practice of having quarterly reviews and annual negotiations appeared redundant.

Ms. Lissakers asked why the EFF model was not applicable to the poorest members of the Fund.

The staff representative from the Policy Development and Review Department recalled that the original inspiration for the ESAF—particularly regarding the policy framework paper—had been that those countries had exceptional technical assistance needs that required coordination, and that a structural program needed to be formulated on an annual, rolling basis. Nevertheless, there were important similarities between programs supported by an EFF and an ESAF, and it would be possible, if the Board desired, to incorporate the technical assistance aspects of an ESAF-supported program into an architecture resembling an EFF-supported program.

Mr. Sivaraman said that he believed that consideration should be given to prolonging ESAF-supported programs in countries that faced administrative and human resource capacity constraints; in order to execute the reform programs, adequately trained staff needed to be secured. Also, low income levels of some countries might prevent them from reaching programmed ratios of tax/GDP, and more time might be needed.

Mr. Yao said that some ESAF-supported programs might have been overly ambitious based on the substantial financing needs. Often, there was insufficient external financing available, which forced the authorities to adopt additional contingency measures or reduce the deficit more quickly than was possible.

Another staff representative from the Policy Development and Review Department noted that the staff had analyzed the effects of the variability of inflation on growth. The staff had concluded that the measures of variability had not been significant—perhaps because there had been a high degree of colinearity between the variability and the level of inflation. Indeed, a number of researchers had found that the level of inflation was a good summary measure of the instability of macroeconomic policies in general.

In response to Mr. Bernes's question on whether the poor were disproportionately hurt by the process of reaching low inflation, the staff representative responded that the outcome depended on the composition of the adjustment package, especially the fiscal adjustment measures. In principle, any combination of fiscal measures could be chosen to offset or neutralize the income distribution effects of the overall adjustment efforts. However, the staff had not pursued the matter empirically, in part because the external evaluation of the ESAF would address the social impact of reform measures. The existing literature on income distribution and adjustment had not yet extended to analyzing the overall impact of macro-economic adjustment programs, but had focused on growth and income distribution.

The staff report had highlighted some complementarities in the area of structural reforms, particularly the close link between public enterprise reform and efforts to improve bank soundness, where the failure to make progress in policies in one area had negatively impacted on the ability to make progress in the other, the staff representative explained. Another example was bank soundness and property rights, where the lack of adequate judicial procedures to enforce collateral inhibited loan recovery and hurt progress toward bank soundness. A third example in the staff report was the link between trade liberalization and fiscal reforms, which would be studied more carefully in the forthcoming staff report on trade liberalization in Fund-supported programs. The staff had attempted to identify empirical evidence of such complementarities, but had concluded that, in reviewing the indices on structural reform, the paucity of strong evidence had been due to data weaknesses.

While one could identify, in principle, clear policy implications from how reforms were sequenced, in practice there were many constraints and the authorities decided to implement those measures that were feasible at a given time, the staff representative stated.

In order to respond to Mr Sivaraman's question regarding the frequency with which performance criteria and benchmarks had been modified in response to exogenous shocks, much more investigative work would need to have been done than had been possible for the current staff report, the staff representative noted. However, even if the information had been available, it would have been difficult to draw a clear link between an exogenous shock and the modification or waiver of performance criteria because, as the current staff report had found, many diverse events often occurred simultaneously with exogenous shocks. Indeed, the exogenous shock was often not the most important event under way.

The staff representative from the Fiscal Affairs Department remarked that the concept of a core budget was essentially a mechanism for protecting high-priority government spending—such as basic education, primary health care, and essential infrastructure—from ad hoc reductions that may be undertaken in the face of unforeseen developments. The importance of the concept essentially derived from the common tendency on the part of governments to deal with such external developments by implementing across-the-board, often proportional cuts, irrespective of the social productivity of the various categories of government spending. With regard to Ms. Lissakers's concern that the use of a core budget could exacerbate the problem of extrabudgetary operations, it was important to recall that the core budget itself was not a separate or stand-alone budget. In fact, it was simply a method of identifying, within a normal budget document, those expenditures that were considered as having higher priority than others. Clearly, the heightened attention to priority spending in the context of a core budget did not detract from the indispensable need for effective expenditure controls covering all budgetary operations. Indeed, the thrust of staff conclusions, as well as that of technical assistance by the staff, had been to press for the consolidation of all government operations, including extrabudgetary operations, in the budget, and to institute systems and procedures of expenditure control covering all those operations. Such systems and procedures were, in fact, essential for the effective management of priority spending in the core budget. Related to that point was Mr. Kaeser's remark on the possible use of adjustors to influence the composition of fiscal adjustment. In that regard, to the extent that such adjustments entailed expenditure reductions, the use of adjustors would be consistent with the concept of a core budget.

Mr. Wijnholds made the following statement:

First of all, I would like to commend the staff for producing such excellent, if quite bulky, papers. Not only do they provide a balanced and comprehensive overview of the main achievements under ESAF programs, but they are also candid about what has not worked as intended. The overall impression one gets from the material provided, is that ESAF programs have in general had a positive influence on member countries, but that performance across countries varies significantly. Clearly, the task is far from over, and the input both from this internal evaluation and the external evaluation will be important in order to achieve a higher degree of success. I note in passing that since a number of ESAF programs in European I and II Department countries were only initiated after 1995, they are not part of the data base of this study. The initial results for these programs have generally been quite good, providing further evidence of the staff's impression that ESAF programs have more recently been doing better.

The staff recommendations are generally well taken. I will therefore focus my remarks on the points which appear to me to be the most pertinent as lessons for the future. First, the division of labor with the World Bank clearly deserves further attention. Second, more frequent monitoring and contingency planning could help to keep programs on track. And finally, the studies convinced me that we might have to be somewhat more selective in providing ESAF support.

Let me start with the role of the Fund in relation to that of the World Bank. My impression is that a number of the staff's recommendations, though quite valid, do not so much regard the Fund as they do the Bank. Some topics are simply not in the Fund's domain, while others are a shared responsibility; with the Bank clearly in the driver's seat. Examples are public enterprise reform, civil service reform, social safety nets and public expenditure reviews. Against this background, it will be important to hear what the Bank's views are. A common view of the two institutions is the only way in which we can ensure a full implementation of our recommendations.

Let me cite some specific examples of recommendations which should be addressed across the street. The staff suggests that more attention should be paid to gathering data on social spending. This is clearly an area for the Bank, or even the UN. The same goes for information on public enterprises. Although more adequate information on these enterprises is desirable, I think the focus of the Fund should be limited to the relation between the enterprise and the budget. Another area where the World Bank is and should be in the lead is banking restructuring. If problems in this area seem endemic, the first best solution would be a change in Bank policy. A stronger involvement by Fund staff is not the preferred solution.

As a final note on this topic, I would also be interested in an assessment of cross-conditionality with the World Bank. Especially in countries with limited institutional capacity, the mere number of targets can confound policy makers.

On sustaining programs, one of the conclusions of the study is that performance under ESAF programs has not always been up to par. In particular, I was struck by the lack of success with regard to inflation reduction and bringing down fiscal deficits, both very much part of our core business. It is clearly important therefore to scrutinize our program design.

In this light, I strongly support the idea of contingency planning. Certainly with regard to fiscal policies, even advanced economies need contingencies in order to face unexpected developments. This is a fortiori true for ESAF countries, as these are more vulnerable to shocks, are restructuring their economy with uncertain results and may face more constraints in terms of data and monitoring capabilities. Contingency planning would be appropriate in areas beyond fiscal policies, as well. Even though the inclusion of contingency measures may prolong program negotiations, they could prove invaluable for keeping programs on track. As such, this is an investment that is bound to pay off.

In addition, we should look at changes in the monitoring of ESAF arrangements. I think it would be useful to allow for the possibility of tighter monitoring and disbursements; the present rather inflexible monitoring mechanism inhibits a more tailor-made approach (as opposed to the GRA). While I agree that structural change takes time and that this could argue against frequent reviews, it is a fact that many ESAF programs have suffered from weak implementation of the macro framework. The resource implications from increased monitoring could be contained by applying a tailor-made approach. Moreover, the staff visits to most ESAF countries are already more frequent than the biannual performance dates would suggest. Adding a formal purpose to these visits would amount to a better use of these staff resources. Since I also favor somewhat greater selectivity of programs, to which I will come back in a moment, I do not think more staff would really be needed.

While on the topic of program design, we might also want to look at the role that ESAF financing plays in program performance. Often, countries are not so much interested in the actual ESAF funds but in the donor support, IDA funds or debt restructuring that come with the Fund's seal of approval. In this light, we might want to look at the relative usefulness of ESAF purchases vis-à-vis IDA financing, as well as the possibility of precautionary ESAF arrangements.

Finally, I would like to make some comments on the issue of selectivity. Given the frequency with which ESAF programs have gone off-track, and the limited availability of staff and financial resources, I would favor somewhat greater selectivity in awarding ESAF support. I appreciate the staff's concerns that it is hard to predict ex-ante how committed authorities will be further down the road. But in some cases, one could get a clearer view of the authorities' commitment by requiring more prior actions. In particular, some preliminary work on institution building could benefit implementation capacity and increase the sense of ownership.

The staff study draws an interesting comparison between FSU programs and ESAF programs and concludes that the FSU perform much better in terms of interruptions. Staff suggests that a stronger Fund presence (in terms of visits, quarterly targets and ResReps) may have played a role. This certainly makes sense to me, and it further underlines my earlier remarks on more frequent monitoring. But this might not be the full explanation. One cannot help but wonder whether the Fund has not been stricter in its approach in this region, thereby convincing the authorities that there was no alternative to reform, and thus stimulating a willingness to comply with the program.

Finally, let me reiterate that the staff has made a valuable contribution in conducting this study and add that I strongly support its publication. Most of our authorities have to go to their parliaments to obtain the resources for the interim ESAF. It is important that we can demonstrate the usefulness of ESAF as well as our willingness to review and improve the instrument.

Mrs. Guti made the following statement:

We have a decade of experience with SAF/ESAF arrangements, making it possible to have a comprehensive report as presented by the staff. The evidence validates the basic conclusion of the 1993 study that the ESAF has been an effective instrument for channeling Fund financial assistance to low-income countries in order to facilitate economic reform. That there have been shortcomings should not be a surprise; it would have been had the 68 multi-year programs in 36 countries—each with its own peculiar problems—had proceeded smoothly without any slippages. Indeed, the Fund would have found not only the recipe of good economic management, on which there is some broad consensus, but also the secret of how to make it produce the desired result. The challenge is finding solutions to the shortcomings, which are not all due to the lack of commitment of the countries, while building on the positive experience gained over the years.

Management and staff have done a commendable job in keeping the issue of ESAF as one that deserves international attention. It has been our strong belief that adjustment, especially in low-income countries, must be seen in a longer-term perspective. After all, the paper suggests that one gets a more accurate view of the reform process by stepping back from the program-by-program detail and considering rather the progress that countries make as the process unfolds over an extended period of time. This makes a case for applying performance criteria and conditionality for individual programs with caution and for keeping them in the proper context. The fact that certain performance criteria are not met as scheduled does not necessarily mean that the adjustment process is off track. Hence, cutting off support for a country's adjustment program should be done only after very careful assessment.

Countries using the ESAF have come a long way. Broadly speaking, the earlier years of acute macroeconomic instability, pervasive state intervention in the economy, protectionism, and highly regulated foreign exchange regimes have given way in several adjusting countries to lower budget deficits, deregulation, increased role for the private sector, trade liberalization and improved exchange rate management, among others. It shows that these countries are, at least, establishing the necessary conditions for sustained growth and development. This is progress, and the Fund can take due credit for the constructive role it has played.

Obviously, there is still much work to be done. This calls for inclusiveness rather than greater selectivity. The paper notes that there have been only a few instances of policy reversals, an indication that governments have remained committed to the process of economic reform. The ethic of economic reform seems to be firmly established and there is no compelling reason for what would likely become a policy of requiring longer periods for prior actions as a condition for Fund support in countries where there have been program slippages. In fact, a policy of greater selectivity could be seen as an attempt to improve our achievements by focusing only on those countries that are considered to have the greater potential for success. What would be our criteria for selection? Staff may with to comment.

It is also important with regard to the evolution of ESAF-supported programs that care be taken not to overburden the authorities with complex monitoring procedures. More frequent reviews and test dates have not been shown to have a clear link to better program results in general. Rather than focusing on monitoring procedures, it might be more useful to apply more resources to technical assistance to improve implementation capacity, which has been a major factor for success in the transition economies. Increased use of resident representatives might also be helpful.

Clearly, efforts aimed at promoting saving and investment should be encouraged. This means the continuation of fiscal consolidation, the intensification of efforts aimed at strengthening the financial sector—although questions can be raised about focusing conditionality more directly on operational measures—and advancing the process of public enterprise reform, including privatization.

The paper argues for a significantly bolder approach toward fiscal consolidation than has been common hitherto in order to achieve single-digit inflation. It also makes the point that such an adjustment would provide support for a nominal exchange rate which would add to the program's credibility and may lead to a rapid reduction in inflation. It should be considered that such an exacting adjustment might not be suitable for all cases. Without a clear link between inflation overshooting and deviations from fiscal targets, the temptation is to incorporate a very stringent fiscal stance into the program to ensure the attainment of the goal of very low inflation. This could not only have adverse impact on short-term growth—a matter of great concern in countries where growth is low to start with—but could also affect broad-based support for adjustment. The point is not to suggest that ESAF countries should not aim for low inflation; rather the issue is whether the achievement of this target in the three-year period that sets the boundary of a given program is realistic in the circumstances facing these countries.

The matter of inflation inertia requires an in-depth analysis of many contributing factors. This is an area where the African countries have not done too well. Perhaps, there is need to modify the emphasis placed on the monetary character of inflation, taking into account the observation that there seems to be no systematic link between deviations from net domestic assets targets and monetary growth and inflation. Many African countries face persistent drought, security situations that adversely affect economic activity and other supply constraints. Perhaps, there should be a detailed study on the reasons for persistent high inflation in these and other countries.

An important observation in the report concerns the lagging growth performance of African countries, notwithstanding the narrowing of the gap. This calls for increased investment in economic infrastructure and, more importantly, in human capital over an extended period of time. It is to be noted, however, that during the period under review, capital spending among ESAF users in Africa declined, rather than increasing as intended. This may have something to do with the design of programs that call for an overly ambitious path for fiscal consolidation. There is a floor below which reductions in current expenditure diminish severely the government's administrative capacity as well as its ability to provide minimal social services. In making this observation, it is not to indicate that efforts to reduce the size of bureaucracies should not be given priority. There is the added burden of debt of servicing. Meanwhile, these countries face constraints on revenue imposed by their low level of development. The staff paper notes that there is evidence that the capacity to raise revenue efficiently is related to the level of economic development. The scenario makes cuts in capital spending almost inevitable.

As the report notes, the impact of policies aimed at promoting growth will be felt only gradually. This means that African countries themselves will have to be committed in the longer-term to a reorientation of expenditure toward productive areas. Efforts to ensure an adequate level of expenditure for health, education and basic infrastructure should be encouraged. Meanwhile, adequate assistance form the international community in the form of debt relief and concessional financing is required. Africa also needs to pursue economic diversification, not only to guard against terms of trade shocks but also to become a full partner in the global trading system. To succeed, efforts aimed at diversification in Africa must be supported by improved access to the markets of developed countries. Debt relief, adequate concessional financing and market access together would create a more favorable environment for successful adjustment.

Mr. Donecker made the following statement:

I am impressed by the excellent and thorough work done by the staff, and I would have liked to have a chance to spend more time reading it. In particular, I am pleased to note that the staff has succeeded in compressing such a complex issue into 695 pages, instead of an easily achievable 2000 pages. But now in a more serious vein, again, staff has produced an extensive and refreshingly self-critical review of experience under ESAF supported arrangements. On the whole, the outcome of staff's comprehensive review, which still has to be complemented by the external evaluation, is quite sobering. In any case, the outcome is far from being a "success story." Slippages in the implementation of fiscal policy and in the restructuring and privatization of public enterprises are pivotal for many program difficulties and too many program interruptions. Too often, administrative weaknesses, political difficulties, the lack of sufficient ownership of the ESAF-supported program, or even worse, corruption, have been the main reasons for insufficient program implementation. At the same time, external shocks such as natural disasters or changes in the terms of trade were far less often the main reason for unsatisfactory program results.

This confirms our long-held view that good governance and national ownership are absolutely indispensable prerequisites for adequate program implementation and for the urgently needed strengthening of investor confidence at home and abroad.

The lack of success of many ESAF-supported programs, and now the staff's encouragement of greater Fund involvement in areas that are clearly the domain of the World Bank, also raises the important question of whether there is a sufficient degree of cooperation between the Fund and the Bank in this field. What should be done to strengthen the desirable cooperation? We certainly do not want to promote a duplication of work between the Fund and Bank, but to further a concentration of each of them in its special field of responsibility and expertise. I agree with Messrs. Bernes and Shaalan that we need to take a closer and more critical look at the quality of communication and coordination between ourselves, the World Bank, and perhaps bilateral donors, particularly in the area of banking and public enterprise reform. After these general remarks, I should like to turn now to the proposed issues for discussion, and turn to paragraph 118 of the main paper.

The achievements of countries undertaking programs of adjustment and reform supported by SAF and ESAF have been very uneven, which is no surprise given the high number of countries under review. Regrettably, however, convincing cases, i.e., cases which under ESAF-supported arrangements have actually achieved a viable balance of payments position, are the exception. Many ESAF countries have undergone several structural adjustment arrangements in succession, but even some of these cases of intense and long ESAF support have not been able to make sufficient progress toward a viable external position, and need now additional assistance under the HIPC Initiative.

We are very concerned about this unsatisfactory, disappointing development. I think it is important to recall here that when the ESAF instrument was established some ten years ago, its purpose was, and I quote from the summing up at EBM/171 from December 15, 1987, "to promote, in a balanced manner, both balance of payments viability and growth through mobilization of domestic and external resources, improvements in resource allocation, and the removal of structural impediments. Such programs should involve a substantial effort to strengthen the external payments position in a sustainable manner, and in particular to assure substantial progress during the three-year program period toward an overall position and structure of the balance of payments that is consistent with orderly relations with creditors, and a reduction in restrictions on trade and payments, while permitting the timely servicing of obligations to the Fund." I think it was important to recall what we started out with when we started the ESAF.

These ambitious guidelines on the one hand, and the poor results achieved in too many cases on the other hand, give rise to some fundamental questions. Is it realistic to assume that the objectives envisaged at the creation of the ESAF are achievable? If this is the case, how can it be explained that despite several successive ESAF arrangements some ESAF countries are still in such a poor position that they now require special additional assistance from the HIPC Initiative? Could it be that in too many cases the design and objectives of individual ESAF programs were inappropriate? Have ESAF loans been provided even though some recipients did not meet the necessary minimum preconditions for successful program implementation right from the start? Do ESAF loans in many cases provide nothing else but highly concessional financing for development purposes, with much too little concern for clear and sustainable improvement of the recipients' balance of payments position?

Among the ESAF countries, Asian and CFA countries stand out from non-CFA African countries, particularly with regard to their current account performance. In this context, it would be interesting to analyze what are the main causes for this different development. According to the staff's review, there are some problematic ESAF countries with particularly stubborn difficulties. Could it be that these difficulties, to a considerable extent, may stem from particular structural problems not adequately covered by the conditionality of Fund-supported adjustment programs?

On paragraph 119, we support the staff's demand for bolder structural reforms in the fiscal area. In most ESAF countries, fiscal policy is the main problem area. If much needed reforms in the public sector are implemented only too hesitantly or fragmentarily, negative impacts on the budget, the economy, and balance of payments are inevitable. In this context, the political willingness to undertake urgent but painful reforms within a fairly short period of time plays a crucial part. In those cases where a country shows a good track record of credible reforms and decisive fiscal adjustment, bilateral donors will, in all likelihood, positively recognize this. On paragraph 120, the area of social spending is clearly a matter for the World Bank, and I am grateful for Mr. Wijnholds and Ms. Lissakers to have pointed to this fact. There is no reason to further blur the allocation of responsibilities between the World Bank and the Fund. Therefore, we cannot support the idea to provide technical assistance in this area by the Fund also. The Fund should rely on the expertise of the World Bank and other specialized multilateral agencies in this field. The Fund cannot act like a "jack-of-all-trades," but must respect the agreed division of labor among the multilateral agencies.

On paragraph 121, the achievement of lower inflation rates requires a consistent stability-oriented overall economic strategy: monetary, fiscal, and wage policies, as well as external elements, must be in tune with each other, and have sufficiently broad-based support within the country. Since individual ESAF countries' circumstances differ too much, there is no universally effective patent medicine prescription available on how to achieve this fine-tuning of anti-inflationary policies. But the clear, unambiguous, and unwavering commitment of the authorities to the objective of price stability certainly helps.

I would like to add to what the staff said before about the difficulties of measuring the effects of various adjustment strategies on the poor, but I think it is without doubt, and it is my firm conviction that high rates of inflation, even if it is stable, hurts the poor most.

The response to the question whether there should be a greater use of exchange rate pegs also depends on specific country circumstances. In our view, it is important to realize that strict reliance on a peg per se does not enhance credibility. For the success of a peg, it is crucial to pursue a consistent economic policy mix and to remain aware of political and economic changes in the economy to which one's currency is pegged. In most cases, an exchange rate peg appears to be appropriate only at the very beginning of the reform process to support a credibility-enhancing economic policy. Since in most cases an exchange rate peg can only be seen as a temporary instrument for stabilization, it is also important to choose an ex ante exit procedure on how to switch to a more flexible exchange rate regime when the adjustment policy is successful.

On paragraphs 122–124, trade liberalization property rights, as well as incentives for foreign investors can play a crucial part in achieving a viable balance of payments position. At the same time, restructuring, in particular of the public enterprises and the banking sector are, at least, of the same great importance in this regard. Here, the Fund must continue to rely on the expertise and assistance of the World Bank in resolving these structural problems. Because of this, and to further promote urgently needed structural changes in many ESAF countries, an improved cooperation between the Fund and the World Bank is more important than ever. Particularly so in view of the scarce resources available.

On paragraph 125, quarterly reviews may perhaps contribute to improve the rate of success of ESAF arrangements. However, given the staffing implications related to such a move, we consider "quarterly tests" to be feasible only to a very limited extent. For example, only in those cases where the risk of weak program implementation is particularly high. In all other cases, however, the Fund should do without such quarterly tests in order not to further increase staff's already heavy and costly work load with regard to ESAF programs. But greater use of prior actions, and of appropriate benchmarks, as well as of qualitative and quantitative performance criteria should be made to improve the adherence to the agreed adjustment and structural reform strategy and to support the reform momentum.

Finally, we support the staff's suggestion of greater selectivity in providing Fund support under ESAF arrangements, especially regarding requests for ESAF arrangements from those countries that obviously do not meet the minimum standards, i.e. where there are considerable doubts with regard to their ability and/or political willingness to implement the structural adjustment program. I agree with Mr. Bernes that we also need to be prepared to respond more strongly, and I would add with less delay, to program slippages, particularly in the area of civil service reform, and to respond faster to clear signs of bad economic management, and be less generous in the granting of waivers.

I also agree with him that we should try to enhance the degree to which authorities assume ownership over their reform process. As Mr. Shaalan reminded us only yesterday, in the case of Egypt, national ownership of an adjustment and structural reform strategy is critical for the success of any such strategy.

Mr. Yao made the following statement:

I would like to commend the staff for the comprehensive and well-focused papers on the basis of which we are assessing the strength of past ESAF programs and identifying areas that are critical for improving further the effectiveness of these programs. I share the staff's conclusion that overall the structural programs have contributed to the improvement of economic performance of ESAF-eligible countries during the period in the study. Key macroeconomic indicators have recorded encouraging trends, with in most cases inflation going down, the budget deficit declining, and the export volume increasing. Despite these overall achievements, there are still a few areas of concern where progress has been either slow or limited. For instance, real per capita income has grown marginally, the external viability of a number of countries in the sample have not improved, and several of these countries are still experiencing heavy debt problems.

To bring these countries to a higher growth path, I concur with the staff that increasing domestic saving to accommodate higher private investment is desirable. Given the dominant role of the public sector in economic activity, and since its behavior has a significant impact of the level of domestic savings, emphasis should be put on measures that are likely to contribute to higher saving from that sector. To that end, the role of the central government should be well-defined, and its ability to collect revenue must be enhanced, and its provision of services rationalized and streamlined. In that regard, I share the view that the civil service and the public enterprise reform needs to be accelerated in order to reduce government involvement in productive activities and its consumption in the form of wages and salaries. In the particular case of countries in my constituency, achieving the higher saving have been made difficult by the significant role of the informal sector in the economy. Due partly to this phenomenon, the broadening of the tax base has been difficult to implement in most instances. And increases in tax-to-GDP ratio has been burdensome to the formal sector. It seems, therefore, that reaching the revenue threshold of 20 percent of GDP will be difficult. Under these circumstances, expenditures will have to bear the brunt of the adjustment effort. I, therefore, support the need to pay greater attention to the quality of such expenditure, with more emphasis given to the priority sector. In that context, I see merit in addressing the problem related to the wage bill, as well as the subsidization of state enterprises. However, the short-term social cost associated with the reduction of the government's role in the economy are very high. This is the reason why many governments have been hesitant to embark on this reform. In my view, the addition of this government to such reform will be facilitated through a clear-established burden sharing between the countries and external donors. Here, we are referring to the severance pay and state enterprise liability to the banking system. These burden sharing arrangements should be incorporated in Fund programs.

Before I continue here, I think I need to make a comment about what Mr. Donecker said. He was saying earlier that we should move faster when there are difficulties to implement the civil service reforms. I think there shouldn't be any doubt in my authorities' willingness to undertake this kind of reform. Like I said earlier, it is a question of costs. If we can find donors to share the cost, you can be assured that those measures would be implemented as quickly as possible.

My authorities also support the proposal aimed at putting more emphasis on improving the quality and the availability of information on social spending. They are also of the view that more needs to be done in the critical field of capacity building in Africa. The involvement of the Fund along with the World Bank in this area is desirable. The staff has rightly pointed out that the reform of the public enterprise became an important part of ESAF programs because of the weak financial performance of these enterprises in most ESAF-eligible countries. Not only had these enterprises recorded such substantial financial losses despite the monopolistic position, they were also a drain on the budget and on the domestic banking system. They had also imposed a relatively distortionary burden on the economy. In our view, policy measures to improve the performance of the public enterprise sector should aim at eliminating all factors that have contributed with financial weaknesses. We also agree that failure in hardening budget constraints and imposing management accountability has slowed down progress in the public enterprise reform. To improve the performance of public enterprises, it would probably be more useful to eliminate the monopoly position of the existing enterprises, and allow access to various market participants. This should be done in conjunction with the privatization process. Clearly, the restructuring of the public enterprises should proceed or precede or be undertaken concomitantly with the reform of the financial sector.

Having said that, I concur with Mr. Sivaraman that in dealing with public enterprises and financial sector issues, the line of respective responsibility between the Fund and the World Bank should be clearly defined. A constructive collaboration between the two institutions in this sector should be aimed without undue conditionality and improve the efficiency and transparency in the management.

Finally, with regard to the question of the program design and implementation, as well as to the prospective need for greater selectivity by the Fund in approving arrangements, the following point could be made.

Program design should take into account the administrative capacity of the country and the effective control of policy instruments, as well as a good statistical base. As Mr. Wijnholds also stated, a high degree of ownership of the program by member countries is crucial. The absence of this key element should not be used as a basis for excluding countries from further arrangements. In these cases, the Fund should increase its technical assistance, including the assignment of a resident representative to ensure the implementation of policy and close monitoring by Fund staff. On this, the approach followed by the Fund in dealing with countries in transition in Eastern Europe has been useful and should be duplicated for other countries.

Mr. Autheman made the following statement:

Please consider my remarks today as being of a preliminary character. I must confess, I have not yet reflected enough on many issues raised by this paper to have come to a final judgment. I would like to start with two general comments.

First, to mention that I have some reservations on the methodology used by the staff. I would take three examples. The Board needs to look at average performance to know if, overall, countries which have been supported under ESAF programs have made significant progress or not. But the Board also needs to analyze the disparity of performance in order to draw precise policy lessons. Whether one looks at the average or the diversity, one can come to very different conclusions. Let us take an example on fiscal policy, in paragraph 22, page 18. On average, the finding of the staff is that revenues fell short of target in roughly two thirds of all programs and that revenues were barely changed from the preprogram level. But the most interesting finding is that overshooting of deficit targets was more typically associated with expenditure overruns. So we have a finding on average that it is extremely difficult to raise revenue, but the most important finding is that slippages are associated to expenditure overruns.

Another example is how to assess performance, meeting the initial targets or meeting more broadly the initial objectives. I think that there is too much emphasis on the strict compliance with targets and not enough on the achievement of the objectives themselves.

I drew these remarks from my experience of the methodology developed by the independent evaluation unit of the World Bank. It is striking to read that there are so few references to interesting findings of the numerous Operations Evaluation Department (OED) studies of the World Bank which are of relevance for our own work. To give an illustration of that remark, I will from time to time comment on a report just issued by this department about adjustment lending in sub-Saharan Africa, which is addressing precisely the question of the performance of ESAF programs from the point of view of IDA.

Another general comment is on the danger of simple conclusions. It would not be too difficult to summarize further the final chapter of the report by saying that the Fund needs more selectivity, more fiscal tightening, more structural reform, and more nominal anchors, but when one looks at each of the four items this conclusion deserves a very serious qualification.

Let me start with the major conclusion, in paragraph 120, "Do Directors consider that more decisive fiscal adjustment is desirable and realistic?" I would like to return the question: what do you mean by that? Do you mean more on average, more everywhere, or more in programs where slippages have been allowed? Is this an evaluation finding or is this a policy recommendation? My sense is that the problem is not that the Fund is not ambitious enough in its fiscal targets. The problem is that too frequently programs fail to achieve the fiscal consolidation which is aimed at. So the issue is not changing the Fund's policy approach, but how to secure better performance in countries which do not meet the agreed objectives.

While I would go along with a conclusion that the Fund must tighten its monitoring in countries which fall short of the fiscal objectives, I do not think that this report makes a convincing case that, overall, the Fund does not aim at sufficient fiscal consolidation. As an aside, I want to point out that I think the assertion that lower deficit means more private saving is quite weak. I was pleased to read that Mr. Hamada intends to address this issue in his external evaluation.

If I remember well the years when I was a student, I was taught that what mattered for private saving was public spending and not precisely fiscal deficit. Indeed, in countries where public spending is not exceptionally high and as long as the public deficit can be safely financed without inflation, I am not convinced that reducing the deficit by all means is the most effective way to increase private savings. Improving investors' confidence in their property rights, in the stable framework for monetary policy, and in the openness of the current account and capital account may be more decisive factors. On the contrary, I have a firm view that in countries where the fiscal deficit leads to recurrent inflation pressures, the burden of fiscal deficits on private savings is unsustainable.

Clearly, we have a serious problem in raising revenues. I must confess that our frequent complaint, when the Board discusses arrangements and reviews that more ambitious revenue objectives should be set, may need to be reconsidered. But here again the Board must be extremely cautious on how to proceed: increasing the tax burden on the formal sector and therefore the disparities in the economy or broadening the tax base and improving the confidence of investors.

Another example where I see a need to be quite nuanced in the formulation of the Fund's fiscal policy advice is the matter of core budget and capital spending. It seems to me that, if the Fund places more emphasis on so-called core budgets, which in my view should include not only health and education but also maintenance of existing infrastructure, this implies that the country has to cut, as a priority, capital spending, which is often related to white elephants. The Fund cannot ignore the fact that the community of donors tends more and more to consider current expenditure in education and health as the most important investment to improve the growth prospects of the economy. So I would be quite unwilling to follow the staff's remark that it is regrettable that capital spending often bears the brunt of the adjustment.

Another set of issues is related to structural policies. I am pleased to see the staff's continued emphasis on the critical importance of structural reform in the area of privatization, trade liberalization, bank restructuring, and property rights. I think that this broadening of the Fund's understanding has marked major progress. Therefore, I would be reluctant to say, "Let IDA do the job." But, on the other hand, I am worried about the deterioration of our channels of cooperation in the World Bank. We had developed in the past what appeared to be an effective instrument with the policy framework papers, so effective that some of us two or three years ago recommended that we should extend this instrument to EFFs. But it is clear that no one pays any anymore attention to policy framework papers. It seems that they are published because they have to be, but it is clear that for the World Bank the important instrument is no longer the policy framework paper but the country assistance strategy. For the Fund, the important instrument is not the policy framework paper but its own agreement. Therefore, the Fund must rethink the instrument which will record its agreement to cooperate with IDA in pursuing common objectives under ESAF arrangements.

Another point I would like to make is that two or three important findings of the World Bank OED's evaluation exercise should be incorporated in the Fund's own work. One is the danger of adding excessive conditionality. An important conclusion of the study I referred to, which is not reflected in this paper, is that "the excessive ambitiousness in the number and complexity of structural measures, not in the toughness of reforms, is a frequent cause of failure." It is clear that the tendency of this Board is to identify toughness in reform and quantity of measures. I do not think that the Board needs to develop so much its own findings as to follow the lessons of IDA findings in this area.

Turning now to the matter of inflation, which I consider extremely important, I welcome the work which has been done by the staff. I must say that it confirms my disappointment. It is clear that the agreement on a Fund program in ESAF countries does not have a decisive influence on expectations. It is not expected that a successful ESAF will lead to low inflation. Therefore, there is a tendency to consider other policy instruments which could help achieve better success. I would join those who think that turning more to nominal anchors such as exchange rate pegs, if it may be a solution in some cases, would often not be an appropriate solution, for the simple reason that the political willingness to abandon the monetary sovereignty which it implies is not there.

On the other hand, I think we should be more straightforward in stating that monetary sovereignty is an illusion for most ESAF countries and that we should address head on the issue of the framework under which monetary policy is conducted. It is clear that in many countries the government can raid the central bank any time. It can decide that, in order to refinance an enterprise or in order to pay for a wage increase, the central bank governor has to bow and print the money. I think one does not address this issue by moving to inflation targeting or an exchange rate peg. One addresses it by moving to a framework where the conduct of monetary policy is withdrawn from government interference. It may be a peg, it may be the independence of a central bank, it may be a currency board, or it may be giving legal tender to foreign currencies. After all, the Fund has told ESAF countries that it was not good for governments to run public enterprises. Maybe it is time to explain to them that, if they want to improve the confidence of the private sector, they should abandon any pretense at monetary sovereignty.

On the critical issue of selectivity, I think it is a much more difficult matter than appears to be implied so far. I would not see it as a yes-or-no approach. Indeed, in paragraph 117 the staff points to the difficult judgment which has to be made. I also find some allusion to the Fund's platonic preference for the good tyranny, as opposed to the danger of democracy. The reference that policy slippage occurs around elections is quite significant.

I would like to make two comments. I think there are two sides to the coin of interruption of programs. One could see it as a problem or as an instrument developed to address the issue of slippages. Slippages occur. They can be addressed through waivers, as is often done in transition countries, or they can be addressed through the interruption of programs. Here I would like to invite my colleagues to reflect on a World Bank finding which is quite interesting since, with great modesty, the World Bank invites itself to follow Fund practices. It says that a new approach to adjustment lending should consider a larger number of small tranches at predetermined intervals. "By this the Fund-like approach, which would require an equally the Fund-style culture which would make cancellations and quick preparation of a revised operation a more routine and less dramatic process, this increased flexibility would combine the advantage of single-tranche disbursement with an approach to adjustment lending that supports reforms in an explicit multiyear framework." So it is quite striking to find that for the World Bank the practice of interrupting programs is considered an effective selectivity instrument, and therefore I would be unwilling to criticize an evolution which in my view has been an indication of progress in the Fund.

Another aspect is that ESAF triggers a very high level of financing. The level of access generated by an ESAF agreement is not influenced by the level of the ESAF agreement itself but by the level of lending that IDA and bilateral donors decide to allocate. Here again, an interesting finding of IDA is that there appears to be no correlation between the level of IDA adjustment lending and the quality of macroeconomic performance under ESAF programs. Part is a responsibility of the Fund. One notices quite frequently that the staff of the Fund, at the same time that it declares a program off track, places pressure on IDA to continue financing to make sure that a country will not run into arrears and that, therefore, when the time will come to restart the program, the country will not have to go through a difficult process of clearing arrears. I have taken these two examples to suggest that the matter of selectivity must be addressed with much greater sophistication than has been done in this report.

I would like to make one final remark on the matter of program monitoring and further studies. On program monitoring, I like Mr. Kaeser's approach: keep half-yearly reviews and consider quarterly performance criteria. I do not believe that the Fund can monitor structural reforms on a quarterly basis. On future studies, I have suggested a few methodological improvements. I would add three remarks. First, I think the Fund must work on the length of the required adjustment. It is clear that the initial assumption that one can achieve external liability in three years is not credible. We know that it requires a longer period of adjustment, as pointed out by Mr. Shaalan. In practice, the Fund has accepted it, but without undertaking a thorough analysis of its consequences.

My second point is the matter of "stocktaking." Until very recently, it was an agreed policy of the Fund that at the end of an ESAF agreement the Fund should have a stocktaking year before considering a new ESAF arrangement. This option has been abandoned partly as a consequence of the HIPC Initiative which implies the continuity of ESAF arrangements. I very well understand the reason why the Fund is reluctant to suspend its support and run the risk of a slippage between two ESAF programs, but there was one dimension in the stocktaking idea, which we should preserve, i.e., that the

Fund would undertake a systematic evaluation of performance under an ESAF program at the end of it—the before, during, and after process proposed by Mr. Kaeser. The third issue which in my view will deserve in-depth study in the future is governance.

Mr. Mirakhor wondered whether Mr. Autheman considered that lessons could be drawn for the ESAF from the recent Fund-Bank cooperative framework under the HIPC Initiative. Also, there had been cases recently when the Fund had approved an ESAF-supported program, but then the Bank had not disbursed its committed financing, forcing some performance criteria to be missed. He encouraged Mr. Autheman, as a Director in both the Fund and the Bank, to work to improve the disbursement practices of the Bank.

Ms. Lissakers commented that Mr. Autheman had made many interesting points, especially regarding Fund-Bank interaction. His comment that the Fund staff occasionally encouraged IDA to maintain its lending to a country where the Fund had interrupted a program might be one explanation of the continuation of the accumulation of external obligations once a program was interrupted, and suggested that the Fund's catalytic role might be less than desirable in some cases.

The increased reliance on trade taxes under Fund-supported programs was a disturbing finding, Ms. Lissakers continued. Increased trade tax was counterproductive to the Fund's efforts to encourage trade liberalization and export-led growth. Increasing trade taxes, while decreasing income and capital gains taxes, suggested that the design of revenue measures in ESAF-supported programs might be less than optimal.

Mr. Han made the following statement:

First of all, let me say that the staff should be commended for their hard work in preparing the voluminous papers on this important issue, for today's discussion.

I am in general agreement with staff assessment on the outcomes of the SAF and

ESAF-supported programs. With the aim to achieve a sustained high growth and improved external viability, these programs have made great contributions toward macroeconomic stability and improvement of the living standards of those programed countries in the past 10 years. It is also understandable from the paper, that progress has been made unevenly among those countries, given their different characteristics and economic conditions. In this connection, I hope the future ESAF programs could be designed in a more country-specific manner.

I can agree with staff that fiscal consolidation, to a large extent, is a vehicle for the success of the program. It is necessary for ESAF countries to press ahead with the fiscal adjustments and increase domestic savings. Nevertheless, caution should be exercised before launching any drastic or ambitious actions by considering the very low level of revenues in these countries. It might be useful to cut fiscal expenditures by reforming the civil service and public enterprises, but the direction and emphasis of these reforms should be well designed by considering various conditions of ESAF countries. Donor assistance in these areas is encouraged and it is hoped to be well coordinated. I see it appropriate to use "core budgets" to protect high-priority expenditures on health and education, and more attention could be paid to improve the quality and availability of information in this regard.

Low inflation target is a key element for the macroeconomic stability in ESAF countries. It is not surprising to see that countries with low inflation have grown faster than those with high inflation. Now that empirical evidence shows countries which use formal nominal anchors achieve better performance in containing inflation, we can support the use of these anchors in the future ESAF programs. In the meantime, precautionary measures should be designed for the countries concerned on a case-by-case basis, together with an exit strategy when the situation is changed.

I fully support the strengthening of structural reform in all programmed areas, including public enterprise reform and bank restructuring. The private sector can play an active role in these areas but we do not think that the privatization could cure the structural problems without well-established market mechanisms. In facilitating the public enterprise reform, we support the Fund's involvement in a close cooperation in this area with the World Bank, to encourage and assist countries in compiling necessary information on the financial position of the public enterprise sector. Since conditions in public enterprises of ESAF countries may differ greatly, we should be cautious in setting conditionality, at least, for arrangements in the near future.

We also support Fund staff to be more actively engaged with the World Bank and national authorities to ensure a full accounting of the financial position of banking systems and the fiscal costs of restructuring. Monitoring and conditionality in future ESAF arrangements could be focused more directly on operational measures, drawing upon best practices and the Basle Committee's "core principles." With the development of financial globalization, the financial risk in one country is not only the risk of the country itself, but also the risk to other countries and international financial system.

As regards the measures to deal with the program interruption caused by policy weaknesses in some ESAF countries, we agree in principle to those suggested by staff. But it seems more appropriate to implement them on a selective basis at this stage, rather than to put them in full scale. Strengthening the mechanism of the programs does not necessarily mean increasing staff. We can agree to greater use of selectivity in providing Fund support in cases where programs are not well implemented, but reasonable and feasible criteria for selectivity should be designed first.

In conclusion, we support the empirical measure staff use in this paper which has both horizontal comparisons among SAF/ESAF countries and historical comparisons of each SAF/ESAF country. On the issue of publication, I can join others in supporting the publication of the summary report and related papers.

Mr. Guzmán-Calafell made the following statement:

I wish to join previous speakers in commending the staff for the excellent set of papers prepared for this meeting.

It is clear, as previous speakers have pointed out, that the implementation of economic programs with the support of SAF and ESAF resources has been instrumental in allowing a strengthening of the economies of many low income developing countries over the last years. It is also true, however, that the progress made so far is not satisfactory yet. The staff papers contain a deep and objective analysis of the accomplishments made under ESAF programs in a number of areas. But perhaps the best way to evaluate the results of these programs is to concentrate on their impact on the two key objectives of ESAF, namely, the achievement of sustained higher rates of economic growth and the restoration of balance of payments viability. The paper leaves mixed feelings in this connection. Even though in contrast with the experience of the eighties average annual growth of per capita income in nontransition ESAF countries has shown positive figures in the nineties, this was insufficient to reach the figures observed in the rest of the developing world during 1991–95, and therefore the gap between both groups of countries continued to widen in this period. The analysis of external viability leaves the reader with a similar impression. The staff concludes that 22 out of 27 countries analyzed appeared to have made some measure of progress in this connection. Nevertheless, a closer look at the disaggregated figures shows that in 16 of the 22 countries in which progress is reported, the debt service to exports ratio falls outside the range deemed as sustainable under the HIPC Initiative. In the case of those countries classified by the staff as with "limited progress toward external viability," the mean for this ratio is more than 40 percent.

The most relevant issue here is of course what must be done to improve this record. I believe the staff has identified a number of the areas that may play a crucial role, and I would like to comment briefly on some of them.

I agree with the notion that the search for more efficient mechanisms to strengthen public finances must be at the heart of a strengthened approach to ESAF programs. The staff concludes that in view of the restrictions faced to raise revenues in many of these countries, the bulk of deficit reduction needs to come from structural reform on the expenditure side, supplemented where feasible by tax reform, and with due regard to priorities such as health, education and capital spending. In addition, the reform of public enterprises is deemed as crucial given the losses they impose on state budgets. It would be difficult to disagree with these conclusions. I would only add that there is a significant degree of overlapping between these objectives and those set at the time of the previous ESAF review. As explained in the paper, one of the central conclusions of that review was the need to achieve more ambitious fiscal adjustments through fundamental reforms of expenditure control and tax systems. A shift from current to capital expenditure was also actively sought, and raising expenditure on health and education was an objective of those programs. Furthermore, it was emphasized then that more forceful efforts were needed to address the lagging reforms of public enterprises. The staff papers include a number of new proposals aimed at supporting a more efficient fiscal adjustment, such as the use of core budgets for high priority spending, or the incorporation of more cautious assumptions regarding the pace of tax reform. But it would be useful if the staff could highlight those elements that in their view will be decisive to achieve a more satisfactory outcome this time.

It was interesting to read in the reports that no systematic link was found between inflation, on the one hand, and NDA targets on the other, or between inflation overshooting and deviations from fiscal targets. Obviously this raises doubts about the sources of inflation in these countries, and points to the need for a deeper understanding of this phenomenon, since it is very difficult to propose solutions to a problem which is not thoroughly understood. This is an area where further work is needed. The staff wonders if fiscal targets were too loose to achieve the inflation objective. I doubt this is a conclusion that derives from the information provided in the report. As explained in the main paper, on average, only about half the targeted reduction in primary budget deficits in ESAF supported programs was achieved during the period analyzed, with almost half of all programs achieving no improvement in the primary balance over three years. Therefore, if a link exists between fiscal deficits and inflation in these countries, the relevant point is not whether aiming at tighter fiscal targets would have been better, since the latter would have not been met anyway.

On the other hand, I fully agree that programs should aim at single digit inflation only if this outcome is reasonably assured. The staff acknowledge that the programs under review did not provide that assurance. In this regard, it is surprising to see in figure 7 in the main report that the setting of inflation targets was not substantially influenced by the degree of initial inflation. Looking at the future, the staff suggest that particularly when inflation is in the intermediate range, it should be expected that inflation will be brought down to single digit levels in the course of three year programs. While this can be a reasonable objective in a number of cases, we cannot generalize. Precisely one of the lessons of the previous experience is that we must be realistic, and analyze each case on its own merits. This comment also applies to the proposal to use nominal anchors in the transition to low inflation. We must be open minded and be ready to support the use of these instruments in those cases where the preconditions are met, and when there are grounds to believe that the merits of this option will outweigh its disadvantages. But, again, this requires a case by case approach.

In the area of structural reform, it is worrisome that the main concerns of the staff in this connection, i.e., the reform of public enterprises and bank restructuring, were also two of the main sources of distress during the 1993 review. Furthermore, these are areas where both the Fund and the Bank have been involved. Evidently, as many other speakers have noted, this raises questions on the margins for an improved coordination of the two institutions in areas of overlapping interest. It is clear that the leading role in dealing with the reform of the banking sector and public firms corresponds to the World Bank. But the elementary nature of the problems identified leaves margins for an important role of the Fund. In fact, it is discouraging to learn that little has been done to press for improving the compilation of adequate financial data on public enterprises, despite the fact that the issue has been highlighted a long time ago. I can go along with the staff's proposals on the restructuring of banking systems, but this seems to be an area where progress is likely to be slow, given its links with public enterprise reform. In addition, it is not clear that the steps suggested by the staff are going to allow great progress in dealing with what was identified as one of the main obstacles to bank reform, namely, the lack of political commitment by the authorities.

Finally, the information that only a quarter of all three- or four-year ESAF arrangements were completed without significant interruption is astonishing. The staff's concludes that most program interruptions have been the result of factors outside the Fund's control. This may well be the case, but after reading the report and listening to other colleagues' interventions, I am left with the impression that the we cannot rule out the existence of problems well within the Fund's reach. In fact, it is clear that a lot can still be done to enhance program design and monitoring, contingency planning, and selectivity in approving arrangements. In this connection, I fully share the views expressed by Mr. Shaalan and Mr. Sivaraman, that the time frame within which ESAF programs are designed may be too short, given the magnitude of the problems affecting these countries and their limited administrative and institutional capabilities.

Mr. Grilli made the following statement:

I commend the staff for an extensive and illuminating piece of work, and for the frank appraisals, opinions, and conclusions that it drew from it. One would have liked to see in it, perhaps, greater attention and greater comparative analysis of reviews of similar experiences, particularly those of the World Bank, with structural adjustments in Africa, for example. Yet the value of the study, I think, can hardly be overemphasized.

We should think about the discussion today and reflect on its conclusions; perhaps we should resume it on particular aspects to make the fullest possible use of the results of this study, both for the firm conclusions that it brings out as well as for the areas where it points out lack of firm conclusions.

I will try to deal with it in this way and ask three broad sets of questions. What lessons can we draw from the experience of ESAF so far? What are the improvements that we can envisage to the strategy adopted so far? But in my opinion there is also a third set of questions that we should try to answer today, that is, what are the repercussions, if any, of the ESAF experience on other initiatives that the Fund is taking or is about to take in order to broaden and possibly strengthen its development reach? There is no question in my mind that a main challenge to the Fund will continue to be the structural adjustment of low income countries in the years to come.

The first question is: how do we consider the ESAF experience so far? Do we consider it satisfactory, less than satisfactory, or about what we expected? Let me say that, given the multiplicity of the situations that we have encountered, the heterogeneity of the countries that we have considered, the differences in their initial conditions, economic and social, the differences of the problems faced during the program periods, particularly the effect of the external environments, including the political and sometimes the military environments, one is forced to apply "Malcolm's Razor" principle in order to draw some conclusions.

Bearing this in mind, my conclusion is that the results of the ESAF experience so far are at best rather mixed. Here I agree very much with Mr. Donecker. This was not an unexpected result, but still I found that the variance in the results is large and very important. This increases the difficulty in doing justice with the results of the study, because there is variance in almost all of the main areas.

In terms of macroeconomic stabilization, progress in reducing inflation and in bringing government budgets on a more sustainable path was achieved. But in a majority of cases, improvements fell short of program expectations. Inflation was reduced, especially in those countries where it was particularly high, but reaching low, single digit inflation was much more difficult and results were much less satisfactory in many countries.

The fiscal consolidation achievement was insufficient in terms of both size and, particularly, quality of the adjustment made in most countries. It is, indeed, disappointing that the brunt of the fiscal adjustment, in my view, was borne in general by capital expenditure. Here I am not as confident as some of my knowledgeable colleagues in saying that perhaps the brunt having been borne by capital expenditure is not such a bad thing. I tend to believe that when capital expenditure is cut over time, and the cut continues, we put at risk the possibility of the country to develop, particularly to relax supply constraints. In these low income countries, supply constraints are obviously important. The containment of current expenditure? Generally under shorter targets. Also, in many cases, the performance in tax administration and collection was broadly unsatisfactory. Fiscal revenues remain, at best, broadly constant in terms of GDP. In terms of growth, improvement in savings and investment was, on average, modest.

There were, however, some important differences between country groups. While in Asia and in the Western Hemisphere we saw measurable improvements in per capita incomes, African countries lagged behind. Different demographic trends were perhaps part of the explanation. Yet, the first two groups of countries were more successful in creating the conditions, both macroeconomic and structural, that were conducive to the spurring of national savings, of domestic investments and, hence, of economic growth. Figure 16 of the review paper brings that out.

These developments were accompanied by a narrowing in current account deficits, but especially again here in the Western Hemisphere countries, where in the Asian countries external disequilibria were small and remain such. By an increase in the stock of official reserves, both these elements indicate a meaningful reduction in these countries' vulnerabilities to external shocks.

When one looks at the results, again one is struck by their diversity. In African countries, national savings remain broadly constant as a share to GDP, where investments—always measured in terms of GDP—showed an upward trend, especially in non-CFA countries, driven by the availability of external savings. However, per capita income continued to fall, despite the increase in investments in relation to GDP and, thus, reasonable doubts arise about the effective productivity of these investments.

Here, I think the lack of improvements in factor productivity is a key issue that emerges most clearly from the experience of many African countries that benefited from ESAF programs or had access to ESAF programs. Answers to these questions are needed, and we should attempt to provide them.

In the case of non-CFA countries, these developments were exacerbated by a progressive worsening in the current account deficits, in part for endogenous reasons and in part for exogenous reasons. Here again, there is an important issue of the external environment, again not only the economic environment but the political and military.

Structural reforms were implemented, but much remains ahead in reforming the role of the state in many of these economies, especially in Africa, and in equipping them with efficient, sufficient, and stable financial systems. While the reform of public enterprises constantly remains a top priority in the economic agenda of ESAF countries, the development and reform of the financial sector is a component of the overall strategy that, in our view, should have received more attention.

A sound and efficient financial sector, which sometimes has been depicted as the brain and sometimes as the lungs of the economy, is crucial to foster domestic savings, to allocate scarce investment resources, and to do so in the most productive way possible. In this regard, I think the main problem concerns the development of the appropriate institutions, the availability of the appropriate instruments. As for the former issue, the institution, I would like to point out that the emphasis should not be exclusively placed on the banking system. Again, the discussion today, and perhaps also in the paper, is focused on the banking system. The stability of the banking system is certainly a valuable objective that has to be pursued, and pursued with perseverance. Therefore, I cannot but agree with the staff in underscoring the need for enhancing administrative capacities and propagating best practices. However, strong consideration should also be given, in our view, to the development of alternative financial intermediaries conducive to improve mobilization and allocation of investment resources at the micro level. Finally it is my strong view, and it is a view which is backed by both theory, beginning with Schumpeter and now the new growth theory, but also from empirical evidence, that the most important function of the financial system is that of investment sorting that potentially and actually improves the potential for growth.

Given the mixed record or the varied record in front of us, it is natural to ask whether these results were the consequence of fundamental faults or important faults in the strategies adopted. This does not seem to be the case. Design problems were apparently much less important than implementation shortcomings, although in making this statement, one must be fully aware that the two sides are often interconnected; you could have implementation shortcomings because the design is less than optimal. However, it seems that the second was more important, the second problem was more important than the first.

Clearly, I find it unacceptable that only 10 of the 40 expired SAF/ESAF arrangements were completed without significant discontinuities or significant deviations. This is something on which we should reflect again as thoroughly as possible. It is possible, moreover, to observe that the countries that implemented the appropriate policies consistently over time succeeded in achieving better results, such as rate of growth in per capita income more than three times higher than the one recorded by other groups of countries, or a level of investments over GDP 1½ times higher. Implementation seems to have been a key problem in most cases. But again, one must be aware of the relationship between design and implementation. Here again, the experience of the World Bank and the experience of OED in evaluating structural adjustment in Africa would be very important to incorporate more fully in our thinking and in our analysis.

As for the content of the programs, in general the analysis of the staff confirms that prudent financial policies, good governance in the sense of adequate institutional capacity in implementation of macroeconomic policies and structural reforms, and removal of restrictions to international competitions are the main pillar of a successful growth strategy, provided that this strategy is implemented consistently over time; no disagreement with that at all.

As for the characteristics of the implementation problems, most of the interruptions in the SAF/ESAF-supported programs were related either to serious deviation from past policy commitments and, to a much lesser extent, to disagreements between the staff and authorities on the future course of policies. Since the evidence seems to support the notion that policy targets were not too ambitious, time consistency difficulties such as those observed raise three sets of issues—how to enhance program targeting, how to strengthen the incentives to policy commitment, how to improve monitoring. Here, I think that despite today's discussion, I am struck by the need to reflect further on these issues perhaps in a separate Board seminar focused on them.

How can we improve the design of ESAF programs? The staff rightly focuses on two aspects—fiscal policy and inflation. Given the limited development of the financial system in most of the countries considered, the two issues are strongly intertwined. They are also, and obviously, the right ones. Prudent fiscal policy is a cornerstone of good performance everywhere. While improving the tax structure and tax administration remains a crucial factor in ESAF countries, there is a compelling need, in our view, for enhancing the quality of public expenditure in them—I believe Mr. Yao has made a good point on this—while containing its rate below that of output.

I can concur with the staff view that public spending in health and education is instrumental to spurring human and capital accumulation. Human and capital accumulation enhance economic growth. However, I am not so sure that one can go the core budget route to obtain better results in this area. While in theory such procedure could protect high priority expenditure, the risk is that it may produce even further ground for rent-seeking practices and may take additional routes to the propensities which already exist for perpetuating inefficiencies and waste. Just to give you an example, you protect expenditure for primary education. Are you protecting overall expenditure or are you protecting teacher salaries? Do you do that because teachers' unions are very important in these countries? There are issues of this nature that core budgets raise, and I am rather skeptical of the notion. I believe it would be important to make expenditure allocation and expenditure appropriation more transparent and subject to periodic quality review. Expenditure reviews perhaps should be included among the structural performance criteria of most ESAF-supported programs. I think that here is another area where further cooperation with the World Bank will be essential, but perhaps we could ourselves use expenditure reviews as structural performance criteria in our programs more often.

As far as the possible use of nominal anchor to control inflation, the conclusions that one can reach are not clear-cut, in our view. If, for example, we consider the experience of countries at the start of their transition process toward a market economy, exchange rate stabilization programs have broadly outperformed those based on targeting monetary aggregates, although the evidence, as in most of these things, is not definitive.

As far as ESAF countries are concerned, while the alternative of using inflation targeting seems to us quite heroic in most cases, the staff points out in its analysis the pros and cons associated with either pegging exchange rates or setting ceilings for money supply. Our bias is that, given the deep and pervasive structural changes usually envisaged in the programs, the approach should remain eclectic. The targeting of monetary aggregates should be supported with the presence of exit conditions explicitly, but also a sufficiently flexible exchange rate policy is important. One should not aim at targeting the real exchange rates, but should aim at using nominal anchors but in a flexible, shifting way when necessary.

Another important area is how to strengthen incentive to policy commitment. Here, I cannot even attempt to do justice to the argument. I would like to recall that the rationale behind multilateral lending is the exercise of conditionality, but that conditionality needs to be exercised with care. If we consider that 51 significant interruptions of SAF and ESAF supported programs have occurred since the mid-1980s, affecting 28 of the 36 countries under review, and if we consider all the waivers that have been granted, we should ask ourselves—Board, management, and the staff—if we are setting too many conditions in our programs and if we are waiving away the nonperformance too easily because of that.

Also, we must ask ourselves whether we do not remain too wedded to our own prior ideas, even in the light of evidence to the contrary. Even in today's discussion, some Directors emphasized the positive correlation between progress toward external viability and economic performance, and suggested in their statements that even greater efforts are needed to provide debt relief to ESAF countries. But the staff tells us in EBS/97/112, Supplement 1, page 135, that it is difficult to find strong evidence of debt-servicing difficulties affecting growth after controlling for the effects of policies and exogenous shocks. I think that this is a challenge that I often raise, but it was not most often acknowledged, i.e., were we justified in this reliance on debt relief and debt restructuring efforts and operations.

On monitoring, if we aim at enhancing program implementation, we need above all a continuous dialogue between the staff and the authorities on the quality of the policies, successes, and the difficulties. We should enhance our ability to make changes in the programs. I think that if monitoring contributes to that, monitoring should be improved. But, when we do that, we also have to be realistic about the costs of monitoring and the limits.

I support the publication of the summary report, and perhaps the background papers also, but after careful review. This is complex, extensive work, and the findings have to be reviewed for consistency, readability, and clarity. I think this is going to be an important publication read by many different categories of readers, and one must think carefully of ways in which this publication can be best implemented. There are benefits in the publication of work of this type, but there are also risks. I think that both should be considered.

Mr. Yao said that Mr. Grilli's comment that the problems of most developing countries were not due to the debt problems, but to lack of implementation of appropriate policies was interesting. However, with the HIPC Initiative, the debt of countries that have undertaken appropriate policies for a number of years would be reduced.

Mr. Kiekens made the following statement:

I join my colleagues in praising the professionalism of the papers the staff has prepared for today's discussion. Mr. Grilli observed that it was difficult to do them justice. The best way of doing so would be to consider them as an important reference guide for our daily work in the years to come. It would be unacceptable that, as happened with our previous review four years ago, some of their major conclusions would be largely ignored.

Though ESAF programs have resulted, on average, in stronger economies, they have also often fallen short of their macroeconomic and structural objectives, and have not enabled countries to reach their full growth potential. The report's candid conclusions serve notice that ESAF programs must be improved to help the poorest countries bring their living standards closer to those in the other developing countries. Today's review identifies specific areas where programs should be improved. I expect that the upcoming evaluation by external experts will be equally useful. Let me start with a few general remarks.

It is argued that ESAF programs are perceived as falling short of their targets because it takes so long for structural reforms to produce results. The fact that many ESAF countries performed better in 1996, admittedly in a more auspicious global environment, supports this view. The staff reviewed the performances of five regional country groups. It could have been interesting to have also included in the comparison a sixth group of countries with a succession of ESAF programs, such as Bolivia, Bangladesh, the Gambia, Uganda, Togo, Senegal, Mozambique. Such a comparison could have verified whether their performance differs significantly from the others.

Poor statistical data is a chronic problem in ESAF countries. One of the tables in the report shows that in the years 1991–95, an increasing share of growth had to be attributed to unexplained factors. I therefore think that GDDS initiative is timely, or even overdue. The Fund should allocate sufficient resources to ensure that this initiative produces early results. It is difficult to implement good policies without good statistics.

The problems of ESAF countries are deeply rooted and closely intertwined. Addressing them one at a time is ineffective, as is confirmed by the review of the shortcomings in the reform of public sector enterprises and of the banking sector, and by the discussion of how governance needs to be improved. This comprehensive approach should include the so-called "second generation reforms" which lie at the heart of sound social and economic development. Reducing population growth, speeding the accumulation of human capital, opening the economy to international trade, downsizing the government, and improving governance—are the areas where ESAF country policies have fallen short and the gap with other developing countries have widened. More attention must be paid to human resource development and to improving the civil service, the legal system, and the protection of property rights.

The first step toward a more effective ESAF program is an inventory of all the distortions and obstacles to growth. Once the problems have been identified, strategies to address them can be developed. This procedure is already used in establishing policy framework papers, but about which Mr. Autheman observed that they seem no longer to receive primary attention. Finding comprehensive solutions to the entrenched, interconnected problems of ESAF countries will require a joint effort by the Fund and World Bank, since neither alone possesses the requisite expertise and manpower. Today's review will be worthwhile if it improves the cooperation between the Fund and World Bank.

There should also be changes in the way reviews are conducted. In the past, the focus was predominantly on performance and program implementation during the six months preceding the review. It would be useful to add more forward-looking surveys of what remains to be done to achieve the program targets. ESAF programs must be monitored closely, almost on a daily basis. I therefore support having all ESAF countries assisted by a resident representative of the Fund in their daily program implementation. The role of the resident representative should be clarified during our upcoming review of the resident representative program. The comprehensive approach also calls for integrating the Fund's technical assistance into the program to detect incipient slippages and improve program implementation.

Let me now come to the issues proposed for today's discussion.

The staff rightly stresses the need for the poorest countries to finance higher private investment with increased domestic savings. The most useful way is more vigorous fiscal consolidation complemented by the creation of an environment that gives confidence to savers and investors that their deposits and investments are protected. Some ESAF countries have very low revenue-to-GDP ratios. This is due to poor tax collection, an inadequate tax base, and ineffectual tax and customs administration. I agree with the four key proposals for strengthening tax systems, as shown in Box 5 of page 57 of the summary paper.

For most of the poorest countries, the major problems are on the expenditure side: a swollen civil service, high debt service, subsidies, and all kinds of unproductive spending. These countries not only have to reduce their expenditures, but also to improve the composition of their spending. Because expenditures for health and education must be protected, most of the savings must come both from reforming the civil service and the public enterprises, and from reducing unproductive expenditures.

A good way to do this is through core budgets that protect high priority spending. Better functional classification of expenditures would be helpful for improving the design and monitoring of programs. The Fund should lend its expertise to improving the transparency of the budget process and the public accounts. Off-budget items and quasi-fiscal measures should be integrated into the budget process. The World Bank is best qualified to assess the adequacy and effectiveness of social spending. This is one of the many examples that demonstrate the need for effective Bank\Fund collaboration.

The report identifies lack of fiscal discipline and half-hearted fiscal consolidation as the main causes of failure to reduce inflation and catch up with the faster-growing countries with low inflation. Where fiscal and wage policies are appropriately supportive, the review calls for ESAF programs to make greater use of such nominal anchors as exchange rate pegs, money supply ceilings, and announced inflation targets. This is generally good advice, but I would warn against designing monetary policies that are too complex to be used by countries at this stage of development. Another finding, reported in Staff Study No. VII on progress toward external viability, is that the ESAF countries that have achieved higher growth have also recorded higher current account deficits. This confirms the growing out of debt strategy, and highlights the association between strong growth and progress toward external viability. It also underlines the urgency of further trade liberalization. Finally, it makes a strong case for pushing export diversification, which is still low in many poor countries and makes them very sensitive to external shocks.

There is no doubt that promoting private investment and entrepreneurship will brings a faster and stronger supply response. This is where many ESAF program fail. The reform of public enterprises and the restructuring of banks in particular are hampered by political intrusion. Attempts to restructure enterprises that are under public management have not been successful. In these cases, full privatization is needed to improve performance durably.

Privatization is complex in developing countries with low savings, poor bank intermediation, and reluctant foreign investors. These handicaps are aggravated by poor transparency and the unreliability of information on the financial position of enterprises. The Fund and World Bank must demand and get better information on the financial position of the public enterprise sector. The Bank and Fund should pay more attention to the public enterprises that burden the budget. Improved budget procedures, better expenditure composition, and faster public enterprise reform contribute to good governance and the elimination of corruption. They are also included among the eleven recommendations of the Declaration on Partnership for Sustainable Global Growth.

Banking sector reform can have high fiscal costs. ESAF program should be designed to minimize these costs and get them out of the way early so they will not impede the reform process. Banking reform must be part of an overall reform strategy, so that it will not be undermined by delays, for example, in the reform of public enterprises.

I can agree that the costs of banking reform should be shared among shareholders and major creditors to reduce moral hazard. But small depositors should not be asked to share these costs: their responsibilities and access to information differ from those of shareholders and creditors. Moreover, depositors have to have confidence in the national banking sector. Making them pay for the mistakes of others is not the best way of earning this trust.

ESAF programs have frequently been interrupted because policymakers were unable or unwilling to maintain the effort. Most slippages are ultimately due to failures to control government spending. Before granting financial assistance, the Fund should have strong assurances that the authorities will carry out their policy commitments. This calls for come more selectivity in agreeing with programs, although a right balance must be achieved in order to keep the policy dialog with countries going. Special caution is needed during pre-election periods, when it is uncertain who are the future authorities and whether pre-election promises will be kept. Extra assurances should be sought from countries wishing to renew Fund support after policy slippages, perhaps in the form of prior actions to recover most of the losses due to past slippages and to ensure that the authorities accept the program's political costs at the outset. The latter is also a good way of promoting program ownership.

In conclusion, the effectiveness of ESAF, one of the strongest instruments at the Fund's disposal, would be greatly increased by taking a more comprehensive approach to macroeconomic stabilization and structural reforms. ESAF countries must thus make more vigorous and more sustained efforts to reform. The international financial institutions, especially the Fund and World Bank, must cooperate more effectively with one another and with the international donor community. This review will hopefully be of assistance to that end. I look forward to the report of the external evaluators. I also urge the Fund to follow closely the recently launched "structural adjustment participatory review initiative—SAPRI" of the World Bank. Several conclusions of this review will certainly be relevant to the Fund's own work. I would invite the staff to report to the Board on the main results of the World Bank's SAPRI initiative.

**DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING**

The following decisions were adopted by the Executive Board without meeting in the period between EBM/97/73 (7/16/97) and EBM/97/74 (7/18/97).

**5. AUDIT REPORT, 1997—TRANSMITTAL TO BOARD OF GOVERNORS**

The Executive Board approves the proposed letter set forth in EBAP/97/61 (7/3/97) transmitting, for consideration by the Board of Governors, the Report of the External Audit Committee for the financial year ended April 30, 1997.

Adopted July 17, 1997

**6. WORLD BANK—TRANSMITTAL OF FUND DOCUMENTS RELATING TO INITIATIVE FOR HEAVILY INDEBTED POOR COUNTRIES**

The Executive Board approves the proposal relating to the transmittal to the World Bank of Fund documents relating to the Initiative for Heavily Indebted Poor Countries, as set forth in EBD/97/80 (7/9/97).

Adopted July 16, 1997

## 7. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/97/118 (7/16/97), by Advisors to Executive Directors as set forth in EBAM/97/118 (7/16/97), and by an Assistant to Executive Director as set forth in EBAM/97/116 (7/14/97) is approved.

APPROVAL: April 24, 1998

REINHARD H. MUNZBERG
Secretary