May 11, 1998
Approval: 5/18/98

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 97/102

10:00 a.m., October 15, 1997

Contents

Decisions Taken Since Previous Board Meetings

Executive Board Attendance

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

Executive Directors	**Alternate Executive Directors**
	S.M. Al-Turki
M.-A. Autheman	R. Fernandez
	N.R.F. Blancher, Temporary
T.A. Bernes	C.X. O'Loghlin
B. Esdar	W.-D. Donecker
E.R. Grilli	N. Coumbis
D.Z. Guti	J.P. de Morais
D. Kaeser	W. Szczuka
	H. Kaufmann, Temporary
A. Kafka	H. O'Brien
	H. Mori, Temporary
	O.L. Bernal, Temporary
	J. Prader
	J. Jonáš, Temporary
	V. Rigász, Temporary
K. Lissakers	B.S. Newman
	M. Sobel, Temporary
	T. T. Schneider, Temporary
A. Mirakhor	M. Daïri
A.V. Mozhin	A. Vernikov
G. O'Donnell	J. Shields
	M.A. Brooke, Temporary
A.S. Shaalan	
M.R. Sivaraman	H.B. Disanayaka
E. Srejber	B. Andersen
G.F. Taylor	
J.J. Toribio	J. Guzmán-Calafell
	T. Brizuela, Temporary
J. de Beaufort Wijnholds	L.B.J. van Geest, Temporary
K. Yao	A. Barro Chambrier
Y. Yoshimura	H. Ono
Zamani, A.G.	S. Joyosumarto
	M.Z. Maatan, Temporary
	O. Sein, Temporary
	J. Salleh, Temporary
	Han M.
	Qi J., Temporary
A.G. Zoccali	N. Eyzaguirre
	J.A. Costa, Temporary

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

Thailand—Report by Staff
Staff representative: Neiss, APD

Transparency in Government Operations; and Fiscal Policy Rules
Staff representatives: Tanzi, FAD; Kopits, FAD; Burton, PDR

Kuwait—1997 Article IV Consultation
Staff representatives: Jbili, MED; Puckahtikom, PDR

Philippines—Review Under Emergency Financing Procedures
Staff representatives: Hicklin, APD; Nsouli, PDR

Also Present
N. Carter, Middle East and North Africa Regional Office; S. Dhar, East Asia and Pacific Regional Office. African Department: P.A. Acquah, J. Fajgenbaum, G.G. Johnson, E. Sacerdoti. Asia and Pacific Department: H. Neiss, Director; A. Singh, Deputy Director; D. Goldsbrough, J. Hicklin, C.H. Lim, J.H.J. Morsink, R.S. Teja, N.E. Weerasinghe. European I Department: H.M. Flickenschild, R. Moghadam, M.H. Rodlauer, K.A. Swiderski. European II Department: I. Kapur. External Relations Department: S.J. Anjaria, Director; B. Christensen, C. Hellemaa. Fiscal Affairs Department: V. Tanzi, Director; P.S. Heller, Deputy Director; G.T. Abed, N.A. Chalk, K.-Y. Chu, J.D. Craig, L.M. Cubeddu, L.P. Ebrill, R. Hemming, G.F. Kopits, V.P. Summers, S.A. Symansky, H.T. Young. IMF Institute: G.C. Dahl. Legal Department: P. DeBoeck, L.E. Nordgaard, V.T. Thuronyi. Middle Eastern Department: P. Chabrier, Director; M.A. El-Erian, Deputy Director; V. Sundararajan, Deputy Director; P.J. Duran, S.J. Fennell, A.C.A.R. Furtado, A. Jbili, A.P. Kireyev, A.H. Mansur, C. Sassanpour. Monetary and Exchange Affairs Department: C.A. Enoch, H. Mehran, G. Mitchell. Policy Development and Review Department: J.T. Boorman, Director; J. Ferrán, Deputy Director; D. Burton, J. Gold, R.H. Nord, L.E. Psalida, C. Puckahtikom, T. van der Willigen. Research Department: F. Larsen, M.A. Savastano. Secretary's Department: K.S. Friedman. Secretary's Department: S. Soromenho-Ramos. Statistics Department: T.P. McLoughlin. Treasurer's Department: W. E. Holder, Deputy General Counsel. Western Hemisphere Department: T. M. Ter-Minassian, Deputy Director. Office of the Managing Director: O. Evans. Advisors to Executive Directors: W.F. Abdelati, P.A. Akatu, M. Askari-Rankhoui, E. Rodriguez, C.M. Gonzalez, K.M. Heinonen, G.M. Iradian, R. Kannan, M.F. Melhem, S. N'guiamba, H. Ogushi, O. Otazú, Y. Patel. Assistants to Executive Directors: A.S. Alosaimi, J.G. Borpujari, M. Carlens, J. Chelsky, H.W. Cocker, A.L. Coronel, D.A.A. Daco, J.C. Estrella, M.A. Hammoudi, J.K. Honeyfield, K. Kpetigo, T.-M. Kudiwu, Lai K., J.P. Leijdekker, A. Lucenti, A. Lushin, F. Mercusa, W. Merz, L. Palei, L. Pinzani, J.N. Santos, O. Schmalzriedt, U.Y. Tilyayev, M. Vismantas, R.P. Watal, Zubir bin Abdullah.

1. EXECUTIVE DIRECTOR

The Acting Chairman welcomed Mr. Szczuka as Alternate Executive Director for the Azerbaijan Republic, the Kyrgyz Republic, the Republic of Poland, Switzerland, the Republic of Tajikistan, Turkmenistan, and the Republic of Uzbekistan.

2. THAILAND—REPORT BY STAFF

The Director of the Asia and Pacific Department reported that Thailand's minister of finance had announced previously that the government would work intensively to finalize the financial sector reform strategy by October 15, 1997; meeting that deadline had been regarded as important in eliminating a major element of uncertainty in the Thai program—namely, how 58 suspended finance companies would reach settlement with their creditors. A technical assistance team from the World Bank and the Fund had traveled to Thailand immediately after the Annual Meetings in Hong Kong to aid the authorities in completing their reform plans. The process had not been easy, as—in addition to the tight deadline—there had initially been some differences of view. However, those views had begun to converge, aided by numerous contacts between Fund management and the authorities.

The authorities had announced the reform strategy on the previous day, the Director said. It was not perfect, but it included the main principles to which the Thai authorities had committed themselves in their letter of intent. Accordingly, the authorities' announcement had been welcomed by the Managing Director in a press release issued the previous day, and it had also been welcomed in a press release issued by the World Bank. At the same time, market reactions had been a bit cautious; there had been little change in the exchange rate, and the stock market had gone down the previous day and up again on the present day.

At the end of the week, five pieces of legislation were scheduled to be issued, the Director continued. Those were the decrees on the establishment of a financial sector restructuring agency, on the establishment of an asset management corporation, on an amendment of the Banking Act that would give the central bank greater power in the event of weakness in a financial institution, and on an amendment of the Finance Companies Act that would have the same effect and a cabinet resolution on an amendment of the guarantee through the Financial Development Fund—an arm of the central bank—to provide liquidity to institutions.

The strategy focused on the 58 suspended finance companies, but the remaining institutions—both finance companies and commercial banks—would be affected, the Director stated. The strategy included tighter banking standards and supervision, recapitalization, and liberalized rules on foreign investment in the banking sector, the Director stated. The details would be made public once they had been fully developed. The first necessary action was the establishment and organization of the financial restructuring agency; in that connection, it was important that professional and impartial officials be found to staff it, so that the agency would have full credibility in overseeing the restructuring process.

Mr. Kafka remarked that he had been under the impression that the legislation would be issued as cabinet resolutions rather than as emergency decrees. He wondered whether the staff could explain the differences between the two and the authorities' reasons for choosing to issue emergency decrees.

The Director of the Asia and Pacific Department replied that the difference between the two types of legislation was that a cabinet resolution went into force immediately after it was issued, whereas an emergency decree had to be, first, issued as a cabinet resolution, then submitted to both houses of parliament for approval, and then signed by the King, after which it became an act. Of the five pieces of draft legislation, the one on guarantees had been considered by the government to be potentially controversial, which might have resulted in a drawn-out parliamentary discussion. In the political judgment of the prime minister and his cabinet, there was even a risk that the parliament would reject the resolution on the guarantee, which would obviously not contribute to the confidence building that the government was attempting to achieve with its financial sector strategy.

Mr. Shaalan said that he understood that once a cabinet resolution was passed, it had the same effect as an emergency decree passed by the parliament.

The Director of the Asia and Pacific Department said that a cabinet resolution was enforceable by the courts and was therefore a law; however, it was a "softer" law than an emergency decree.

Mr. Autheman said that perhaps the staff could explain the potential consequences of the resignation of the chairman of the committee dealing with the Fund, as well as the significance of the appointment as head of the economic team of a minister who had been a major shareholder in some of the closed financial institutions.

Mr. Esdar observed that there had been different interpretations in the press on the effects of the reduced limitation on foreign direct investment in Thai companies. The authorities had stated that there would be no limitation on foreign ownership for a 10-year period; he wondered what would happen at the end of that period. For example, would there be a subsequent redistribution or buyout option? He found it odd to allow foreign ownership for only a limited period and wondered whether such a position was consistent with market liberalization.

The Director of the Asia and Pacific Department responded that the 10-year provision had resulted from an earlier proposal that would have allowed foreign investors to have majority ownership for 10 years, after which they would have been required to reduce their holdings to a minority holding. The 10-year provision had been retained, probably for political reasons. The provision was now being interpreted to mean that foreign investors could retain an equity share of any size over the 10-year period, but they could not acquire additional equity after that period. He did not believe that the provision would be a deterrent to foreign investment, because much could change in 10 years.

The Acting Chairman noted that the provision was likely based on domestic policy considerations; for example, some economists in Thailand had believed that it was a bad idea to allow majority foreign investment. Also, the provision would serve to indicate to foreign investors that it would be wise to invest in Thailand in the next 10 years while the opportunity was available. As to the government decree, the staff had discussed the matter extensively with the authorities and, in the end, had decided that it must go along with the prime minister's political judgment on the matter. He believed that it was appropriate to note that the teams from the Fund and the World Bank had been in the field for a long time, working at extraordinary intensity and in extremely complicated circumstances, and that the task had been one of the most difficult of those that the staff had been called upon to accomplish. There had been criticism of the speed with which the Thai authorities' strategy had been formulated; however, it should be noted that it had taken nine months to organize the Resolution Trust Corporation to deal with the U.S. savings and loan bailout, whereas the formulation of the Thai strategy had taken only one month. That was a considerable achievement, although the markets did not yet share fully that appraisal. Perhaps they would as the plan began to be executed.

3. TRANSPARENCY IN GOVERNMENT OPERATIONS; AND FISCAL POLICY RULES

The Executive Directors considered a staff paper on transparency in government operations (SM/97/174, 7/2/97; Cor. 1, 7/3/97; and Cor. 2, 10/2/97), together with a staff paper on fiscal policy rules (SM/97/175, 7/2/97; Cor. 1, 7/3/97; and Cor. 2, 10/2/97).

Mr. Shaalan made the following statement:

> Fiscal indicators can be considered as transparent when they are free from distortions in data coverage, recording, and classification. Progress in this regard depends in part on technical capacity of the member countries and on data availability. We would emphasize the benefits of fiscal transparency mainly for promoting responsible and proper fiscal management including in the area of budgetary formulation. I attach less importance to the objective of providing the market with detailed information beyond what is necessary under the Special Data Dissemination Standard (SDDS) or General Data Dissemination System (GDDS) partly on grounds of costs, and I am not sanguine as the staff on the markets' ability to analyze and interpret such information. There is also, of course, the danger of misinterpretation.
>
> Of course, priorities for improving transparency differ among groups of countries as suggested in the paper. While advanced economies would be advised to concentrate on developing more transparent measures of fiscal sustainability, developing and transition countries should focus on promoting transparency in public sector finances. The experience of the six countries discussed in Appendix IV suggests that the main factors that contributed to fiscal transparency include an active legislative and institution-building process, a prudent and open budgetary system, and a high level of competence in the civil service. We fully support this finding and would add that it is specifically in these areas that technical assistance from the Fund or other relevant bodies should be directed.
>
> No one can disagree that the coverage of fiscal accounts should extend to the entire general government, preferably including accrual-based recording, and be supplemented with information on quasi-fiscal activities. In a number of developing and transition countries, encouragement or discouragement of certain economic activities is often not done through the budget but through quasi-fiscal activities, which are outside the budget, replacing the spending-taxing function of the budget. This is particularly evident in countries with a low tax ratio or a low ratio of public spending to GDP. Estimates of the cost of quasi-fiscal activities of state-owned financial institutions and information on

nonfinancial public enterprises are essential for forming a complete picture of the aggregate public finances.

The compilation of fiscal data on accrual basis would address deficiencies of the existing cash basis recording and enable a greater degree of harmonization with other macroeconomic systems. The reliance on the cash basis approach alone, as is the case in many countries, can lead to distorted, or incomplete recording of certain important government transactions. Fiscal data on accrual basis, therefore, makes assessment of the financial position of the government more transparent. In this context, the Fund could work on a strategy that would enable countries to move progressively to compiling an extensive range of accrual information and reconciling data on economic and financial flows and stocks.

There is some merit in producing long-term projections of the actuarial value of net unfunded liabilities of social security programs in order to ascertain whether fiscal policies are sustainable well into the future. While favoring the projection of such identifiable categories, where the margin of error could be small, we have reservations on the value of multiyear projections on all budgetary categories. Fund experience shows that the margins of error of such projections could be very large.

It is not clear to us what is meant by the statement that "the Fund staff would seek, in the context of Article IV discussions, to identify and, if possible, quantify nontransparent institutional arrangements and practices likely to affect economic performance, and suggest specific corrective measures" as noted in paragraph 54 of SM/97/174. It would seem extremely difficult to quantify "opaque budgetary practices." Further staff views on this issue would be appreciated. Also, while we encourage the staff to discuss these issues with the authorities, we have reservations regarding their inclusion in our arsenal of conditionality, particularly when quantification is not technically feasible.

The availability of timely and comprehensive public sector statistics that are recorded on both an accrual and cash basis, would require substantial technical assistance from the Fiscal Affairs and Statistics Departments of the Fund. Nevertheless, we are less sanguine about the merits of preparing a manual of best practices in fiscal transparency. Any attempt to document transparent and nontransparent practices in member countries would be judgmental, and it would be difficult to design a standard of best practices that could be applicable to all member countries. I would appreciate further staff clarification on the feasibility and objectives of preparing a standard of best practices.

Turning to the paper on fiscal policy rules, clarity in public sector measurement and analysis is critical for the formulation and implementation of successful fiscal rules. We support the adoption of fiscal policy rules related to government borrowing and debt. The complete prohibition of borrowing from the banking system to finance fiscal deficits, for example, removes an important source of inflationary pressure, and the adoption of binding limits on such credit contributes to the moderation of inflation. Staff analysis suggests, however, that macroeconomic performance under such a rule, has been mixed. In the absence of sufficiently deep internal financial markets, restrictions on bank financing in several developing and transitional economies were in part accommodated with a substantial buildup in external indebtedness. Also, compliance with fiscal rules has led to distortions in the composition of expenditure or in tax increases in these countries, and in some instances induced a lack of transparency in the budget process including payment arrears, proliferation of creative accounting practices and recourse to one-off measures.

Two critical questions arise with respect to balanced budget rules on fiscal behavior. First, whether they are effective in enforcing fiscal discipline or, instead, whether they can be circumvented by creative accounting. Second, if these rules are effective, what are the benefits in terms of budget discipline versus costs in terms of lost flexibility in managing the economy. I would appreciate the staff's views on these issues.

The experience of European Economic and Monetary Union (EMU) economies over the past few years clearly demonstrates that the reduced flexibility associated with fiscal rules may have been responsible for some of the recent hopefully short term slowdown in growth and increase in unemployment. So far, fiscal rules in the EMU countries have been met to a considerable extent through tax increases, investment cuts, and recourse to one-off measures, rather than through durable structural reform of the public sector.

The current approach to surveillance of fiscal rules, in the context of Article IV consultation discussions and periodic Board papers is satisfactory in our view, and their is no need to explore alternative approaches to assessing and monitoring fiscal rules. We feel that technical assistance on the design and operation of fiscal policy rules are not at present feasible given the limited staff resources. In the context of Article IV discussions, however, the Fund staff could review fiscal rules, raise the awareness of the authorities about the potential downside risks associated with either noncompliance or compliance through one-off measures, and stress that a fiscal rule should be introduced as part of a comprehensive and consistent set of macroeconomic policy initiative—otherwise fiscal rules would turn out to be counterproductive.

I am not convinced by the argument that downplays the demand for additional staff resulting from such heavy new ventures. The staff presents a rather ambivalent and unconvincing position on the potential demand on staff resources. The need for additional staff has to be seen in light of the recent new Fund activities added to our agenda, including: capital account convertibility, implications to the membership of developments in the Southeast Asian economies, governance, and banking soundness. The proposed new tasks would impose a significant additional workload on Fund staff. This should be thoroughly assessed, including, in terms of the kind of expertise expected and the time required to carry such new duties. At present we believe that staff resources are already overstretched even after taking into account the reorientation of Fund activities. I therefore cannot support any new additions to our activities before a realistic assessment of needed staff resources is made.

Mr. Zamani and Mr. Maatan made the following statement:

Let me first congratulate the staff for the comprehensive papers on transparency in government operations and fiscal policy rules. The staff has broadly covered pertinent issues under these two topics and provided a well-balanced analysis and commendable suggestions on the Fund's role.

In general, transparency in government operations would entails greater accountability of the public sector in its functions and activities. Detailed and reliable information regarding policy orientation, public sector accounts and projections should be easily accessible by the public at large, including the financial markets. Thus, an accurate assessment of the government's financial position and the true costs and benefits of government activities, including their present and future economic and social implications, could be made. Imprudent policies and activities of the public sector, particularly when not countered by other macroeconomic policies, may backfire on the government through setback in the financial market and may cause a dent on the government's popularity. Given these implications, it should be in the utmost interest of the government to ensure proper and efficient governance of public resources. It is this fiscal discipline, I believe, that the Fund, through its role on governance issues, should impart among its members.

Given the different stages of economic developments among Fund membership, areas of further improvements in fiscal transparency may differ among group of countries. In this context, I broadly concur with the staff suggestion in paragraph 65 of the paper on transparency in government operations, whereby "Advanced economies could concentrate on developing more transparent measures of fiscal sustain ability, along with an open debate over reform options in the face of aging populations. In the developing economies, emphasis may be placed on promoting transparency in government institutions and dissemination of essential fiscal data and projections. In the economies in transition, adoption of new attitudes may be essential to support the institution-building process."

Issues identified in the staff paper represent, I believe, the most important ones affecting fiscal transparency for cross country comparisons. As they are interrelated with each other, a clear signaling to the market of the public sector conditions could only be achieved through broad enhancement of transparency in all areas identified by the staff. Given the focus on the need to reduce off-budget transactions and quasi-fiscal deficits as accorded in the Interim Committee's Declaration on a Partnership for Sustainable Growth in September 1996, I am of the view that the staff should encourage greater transparency on the budget process and fiscal accounts in their surveillance and program design in member countries. This should encompass information that has not been widely available in the past, such as estimates of the cost of quasi-fiscal activities of public financial institutions and nonfinancial public enterprises. This is with the proviso that all members abide by it. In cases where members are unable to provide certain information due to technical problems, the Fund should be forthcoming with technical assistance when requested by members.

It is noted that the Fund has played a commendable role in promoting fiscal transparency among its members. I broadly concur with the scope for further Fund involvement in this area, on its own or in cooperation with other multilateral institutions in areas outside its technical competence.

I should emphasize, nonetheless, the importance of evenhanded treatment of Fund members. Countries under Fund-supported programs could be subjected to conditionality of the removal of nontransparent practices where required to achieve program objectives. Noncompliance to the conditionality would adversely affect disbursement of Fund financial assistance. Such discipline is not there for nonprogram countries. It rests then on the staff to convince the authorities of the benefits of greater fiscal transparency and the discipline attached to it. In this context, I support the idea of documentation by the staff of transparent and nontransparent fiscal practices in member countries and the extent to which they affect economic performance of these countries. Relevant lessons of these fiscal practices could be conveyed to the authorities to enforce staff encouragement to them of the importance of greater fiscal transparency.

I do not fully share the staff's views that a more focus on transparency in government operations will only reorient staff resources. At the initial stage, the workload would be tremendous as the staff engages further in identifying nontransparent operations of the public sector of member countries and subsequently recommend necessary steps to be taken by the authorities. Therefore, I believe that this implies an additional burden on staff resources. Perhaps prioritization of such work on members according to severity of nontransparency of government operations should be accorded.

Let me now turn to the second paper on fiscal policy rules. In general, such rules provide a clear policy direction of the public sector. Balanced-budget or deficit rules, borrowing rules and debt rules as implemented or considered by some countries, for instance, are commendable and prudent policy steps. While they provide guidance, an established track record of persistent adherence to the rules are more important in ensuring credibility of the government enforcing it.

Fiscal policy rules seem to have advantages over discretionary fiscal policy under a well-functioning and efficient economic system, as well as when there is no large disturbances to the economy, either internally, such as political instability, or externally, for instance large fluctuation in the exchange rates. Structural rigidities or distortions should be removed before any fiscal policy rules could be put in place. Necessary reforms deserve a priority so that fiscal policy rules that will be introduced subsequently would be supported by efficient policy actions, either from the fiscal side or other macroeconomic policies. It would also ensure no constrain or undue burden is imposed on policy actions to meet the specified rule in times of stress. I believe in times of severe strain facing the economy, discretionary fiscal policy would play a better role in producing a speedier economic adjustment than a fiscal policy rules with flexibility clause.

Indeed, fiscal policy rules can contribute to fiscal discipline in accordance with the September 1996 Interim Committee Declaration. In actual practice though, only countries confident enough to comply with the rules should engage it as the downside risk would be a loss of market confidence associated with failure to comply with fiscal policy rules. Furthermore, adherence to fiscal policy rules should be met by lasting structural reform of public finance and not through cuts in investment expenditures, tax increases, and various one-off measures. The features of the rules may vary from one country to the other to fit circumstances prevailing in the economy. Nonetheless, I broadly concur with the staff that the credibility of a rule is likely to be stronger in the case of a simple, transparent, consistent and enforceable rule. Having said that, the implementation of fiscal policy rules need to be supplemented by transparency in government operations as the market could partly serve as a disciplinary body.

It should be up to the authorities to engage fiscal policy rules in macroeconomic management. Prior endorsement from the Fund is not necessary. Nonetheless, Fund staff could assess the compatibility of such rules with respect to medium or long-term policy framework. I believe the current approach to surveillance of fiscal rules, in the context of Article IV consultation discussions and periodic Board papers, is sufficient. Any technical assistance in connection to these rules should be made available upon request from the authorities.

Mr. Sivaraman made the following statement:

It is presumed that the main emphasis of these papers is transparency in a government's fiscal operations for it will be too voluminous and complicated a task to cover the whole of government operations. I will therefore confine my observations only to government fiscal operations. The staff deserves to be complimented for their contribution which has provoked thinking on this vital subject.

I would like to start from the end by wanting to know why the paper has concluded in paragraph 52 "While most member countries have been cooperative—as permitted by their computational capacity and basic data availability—in supplying to the Fund fiscal statistics broadly based on international accounting standards in the conduct of frank policy discussions, many governments have failed to fully disseminate this information to their own legislature and electorate."

This is a major imputation that certain governments while they are willing to share information with the Fund do not do so with their legislature or electorate. I hope whoever prepared this paper has adequate proof to say so. I will leave it at that.

Fiscal policy or the use of government powers to raise resources, to spend money, to achieve redistribution of resources and in general to give a direction to the economy to make it move on a path of sustained growth is more than an exercise in accounting. It involves politico-economic considerations rather than pure economics. Fiscal policy of a government gets translated into accounts through the instruments of the budget and unless a country has got a transparent budgeting system, it would be difficult for any one to identify the elements in the fiscal policy of the government. Staff papers, both on fiscal policy rules and on transparency in government operations have dealt with this aspect of the issue in various paragraphs but not coherently enough to drive home the importance of having a transparent budgetary cycle. While some aspects of the budgeting have been dealt with in the paper on transparency in government operations, it has failed to address the issue as to the consequences of not having a proper budgeting system not only on the transparency of fiscal policy, but also on its effectiveness.

There are different budgetary practices in the world. Many of us are not even aware of the conventions, rules and practices of the U.S. government, EU governments or those in Latin America or African countries. It is not clear whether there are identifiable common features and practices. I had therefore requested earlier that a staff paper on this will be useful as reports on Article IV consultations contain very little on this subject. I regret to note that no information has been furnished so far.

The first prerequisite for having a proper fiscal policy is to put in place a transparent budgeting system based on functions, programs, activities and objects of expenditure of the government.

The question that has been raised is how would the accounts of the parastate organizations controlled by the state or the public sector enterprises, again fully owned by the state, be balanced or how would the operations get reflected in the final government balances. So long as parastate organizations and public enterprises are separate accounting entities having their own balance sheets under prescribed laws and procedures, a system of public accountability, the need for their final balances to get integrated with government balances cease to exist. So is the case with commodity stabilization funds and social insurance if government access to the surpluses and reserves of these entities are denied by law for meeting fiscal deficits. It is also necessary to have quasi government operations distinctly identified in the budget including transfers if any of receipts from state owned enterprises by way of interest profits or repayment of loan or retirement of capital in order to assess the efficiency and effectiveness of the policy. In any parliamentary system, systematic procedures are laid down for the executive to present a budget and get it approved in the parliament. In this system, it is not unusual to find that there is also provision for the government to file separate reports on the quasi government operations and state owned enterprises. These are even subject to scrutiny by separate standing committees of parliament as in India. The second prerequisite of a transparent budget is to have a proper accounting system and finally there should be provision for an independent audit of government receipts and expenditure by a body which does not report to the executive, but only to the parliament. The paper refers to this as a review agency—but this agency is commonly known as Comptroller and Auditor General of Accounts and Audit. Unless these three prerequisites are there, the system can always be found wanting in transparency and efficiency. The Fund staff, therefore, during Article IV consultation, be able to find out whether there are established budgeting practices in vogue in the member countries or whether they would require assistance to set up one.

In a nutshell, a transparent budget process or what I would call a budget cycle works as described in the annex as per constitutional stipulations or a separate budget law.

The budget cycle thus starts with the Executive and ends with it passing through various parliamentary approvals and controls.

Having said this, the question now arises as to whether government should have fiscal policy rules relating to balancing of budget, fiscal deficit, powers to borrow from domestic and foreign sources, governments' ability to set up extrabudgetary funds without accountability to the parliament and penalties, if any, for flouting the rules. Starting with penalties first, it is difficult to imagine a situation where a government could be penalized for violation of the rules laid down within its own system. I am, therefore, somewhat puzzled at the contents of paragraph 46. Penalty, if any, could be levied only on an authority under the government who had violated norms of expenditure, but government as a whole might at best lose its reputation or would have to justify its violation before the parliament. In parliamentary systems, where budget appropriations have been exceeded by the government, there are provisions for parliamentary committees to examine in detail such violations to recommend punishment in the case of officials who have exceeded the appropriations and to recommend to the parliament authorization of any excess over grants which could be justified by the government. Courts, in any case, would not be able to punish a government. It will be only the parliament, which approved the budget, could impose sanction if any and under no circumstances sanction can be imposed collectively on the government but only on the officers who violated the appropriations. Excess over appropriations should not normally take place as there may be provision for a contingency fund with a fixed amount approved by parliament for meeting emergent expenditures that could not be foreseen at the time of the budget. These get incorporated in the budget as supplementary appropriations through separate acts.

Therefore, the first question that arise is how far a fiscal rule can be enforced effectively. They would act only as moral bindings on governments. Governments which have brute majority in the parliament will still be able to violate an existing rule.

There is also the question of promissory estoppel. Can one parliament frame a rule in a manner which bind its successors on a permanent basis. Probably not. This has been recognized that a parliament cannot always bind its successors and any succeeding parliament can change the legislation. The only deciding factor in succeeding parliaments changing a legislation containing fiscal rules would be the efficacy of the rules in guaranteeing the purposes of the government such as enhancing public welfare and growth in a sustained manner. Fiscal rules therefore will have to be looked at from the angle of their being continued after enactment and their potential to act as a moral restraint on succeeding governments not violating them.

A rule, by definition, should not be flexible. If it is, then it has already contained seeds of its violation. Therefore, the set of rules in regard to fiscal policy can be framed in a manner to provide adequate flexibility to the government in its operations without putting it into a straight jacket. The rules could stipulate that government should achieve a balance in regard to its current operations in the short term as it would be indisputable that any government should necessarily borrow to carry on its current operations. To have a balanced budget rule even though may be theoretically an ideal one, it would be impractical given the politico-economic considerations in a democratic system. I would therefore favor a rule which enjoins maintaining a current account balance. Whether a government budget should be fully balanced and whether over the years governments should free themselves of their debt burdens both domestic and external might involve the question of the role of the government in many areas. Even government borrowings have a redistribution effect. Taxes raised by government may be getting transferred in the form of interest payments to holders of government securities or other institutions. While current generation may be paying for these transfers, future generations may have to redeem the debt unless investment provided sufficient receipts for depreciation and debt reduction as well as interest payments which is unlikely in the case of most government investments. This problem is acute in those countries where expenditure on social sectors particularly welfare payments and Medicare expenditure form a sizable portion of government expenditure. Similarly, on the capital side, rules can be laid down for the government to have a borrowing limit related to the GDP both for domestic and external borrowings. In any case, there would be an automatic constraint on the borrowing so long as governments adhere to the general rule of balancing current operations as they would be in no position to have an increasing burden of interest borne on the current account side without impinging on other vital areas of governmental responsibilities. Adherence to both the rules together would necessarily result in a low fiscal deficit.

Compliance with rigid fiscal rules could also lead to distortion in the composition of expenditures or to tax increases and that the implementation of the balanced budget rules may not always be practicable in times of emergencies.

I support the need for every member to formulate fiscal rules. For the rules to be credible and the most important of them have to be at least morally binding on successive governments, for which they have to be part of the constitutional framework that cannot be altered easily. Hence, they have to be minimal, clearly defined without ambiguity, sufficiently flexible for the smooth operations of governments during emergencies but should not be subject to interpretations. Flexibility means the rule itself should define the margin of variation require in any area such as budget deficits and borrowing limit.

In my view, balancing of governments' current account and fixing a debt to GDP ratio should be constitutional and the rest could be part of a budget law or regulation.

The Fund staff missions during their Article IV consultations could examine the existing rules if any, get the reaction of the authorities to enact a few in their absence and provide assistance if authorities are willing to take positive action.

The paper also deals with transparency in tax treatment relating to contracting and public purchases, costs of transparency, timeliness of public disclosure of government policies, division of responsibilities between levels of government and so on in a rather disparate manner. Each one of these is a subject by itself and requires more serious consideration. Division of responsibilities between levels of government depends on the constitutional framework of each country and there cannot be any hard and fast position on this.

In paragraph 29 while dealing with regulations, there appears to be an apparent confusion on the meaning of regulation. Regulation for healthy competition is different from regulation for controls. The latter may undoubtedly involve avoidable costs to society whereas the former tends to prevent costs to society by promoting healthy competition. Any society to function in an orderly manner, regulations are required.

Again, in paragraphs 30 and 31, ideas of accounts relating to quasigovernment operations or enterprises have been brought in. There seems to be an obsession for their integration with government accounts. It clearly indicates a lack of focus on the main issue, namely how, where and in what manner accounts of government owned enterprises are to be reflected. In my view, they should not be reflected in the main budget except to the extent of indicating transfers to and from these quasigovernment organizations. The accounts of these organizations must be prepared as per law/rule governing such organization and even if they are sole monopolies, they should be maintained separately and audited by independent auditors.

As far as accounting practices are concerned, a cash based accounting system with arrears and liabilities of government indicated separately would serve best the interests of transparency and accountability. An accrual based accounting system may tend to exaggerate receipts and expenditure. As budgets are prepared on a periodical basis with appropriation approved by law, a cash based system would be more amenable for control and monitoring. In this system, suitable indications can be given of arrears recoveries, liabilities and payments. They can form a separate set of supplementary accounts open to audit and parliamentary scrutiny.

I support all the five important actions proposed to promote greater fiscal transparency. I would like to sound a note of caution that pursuit of transparency should not lead us into conflict zones as even the most transparent of all governments have necessarily to keep certain secrets in the interest of national security. We should not attempt to uncover them.

As a direct attempt to promote fiscal transparency, the Fund should assist members who do not have, in establishing a proper budget cycle with all its components in place; guide members in identifying quasigovernment operations and set up proper accounting procedures for the same; analyze the accounting and audit practices of state owned financial and nonfinancial enterprises and assist in removal of deficiencies; in coordination with the World Bank (which has done considerable work in this area) assist members to prepare transparent contracting, tendering and purchase procedures; assist members to put in place a proper institutional framework based on laws and rules that govern the entire budget process.

In conclusion, I would like to add that we should not go overboard on transparency of government operations and privatization of government functions, as humanity is not moving toward a stateless society—at least not yet. I would like to quote what is being said about the changes in New Zealand, a pioneer in such reforms.

> They [the revolutionaries] did not care to foresee that the reforms would create a new class of high rolling consultants and business executives for whom greed was good and some of the most attractive features of a pastoral, egalitarian society would be lost for ever. [Mr. Walker in *The Dominion*, August 8, 1997].

> By 1995, after a decade of radical structural change, New Zealand had become a highly unstable and polarized society. Its under skilled, underemployed, low wage, low inflation, high exchange rate export driven economy was totally exposed to international economic forces. The victims of the market were forced to depend upon a shrinking welfare safety net or private charity. What were once basic priorities—collective responsibility, redistribution of resources and power, social stability, democratic participation and the belief that human beings were entitled to live and work in security and dignity—seemed to have been left far behind. [Jane Kelsey in *The New Zealand Experiment: A world model for structural adjustment*, p. 350]

These quotes do not in any way belittle the achievements of New Zealand in pioneering a new order of government responsibilities toward people. There are many lessons to be drawn from the New Zealand experience by all governments. One should not however overlook the fact that a balance has to be maintained in the pursuit of an orderly society which provides an ambience for growth, prosperity and promotes welfare of the largest number of people and this pursuit can meet with success if a government is transparent and acts as per rules.

Mr. O'Donnell made the following statement:

These papers address core issues for policymakers. As the costs of loss of market confidence and inconsistent actions by economic agents become increasingly apparent, governments must be forward looking, clear and open in the way they determine and explain policy. Decision-making needs to be subjected to public scrutiny. Actions need to be transparent. High-quality information has to be freely available.

The Fund has a crucial role in helping governments develop sound procedures for macroeconomic policy. Drawing on theoretical work and the experience of member countries—both good and bad—it has in the past given sound advice on how to specify monetary and fiscal goals, what data are required and how to account for performance. But it has not always codified such advice and (until the development of the SDDS) it concentrated more on the information requirements of governments and the Fund than on markets and the population.

It is now time to move this process forward. The suggestion in the transparency paper that the Fund should develop a code of good practice is timely and relevant. Such a code would provide an important discipline to us—to distill what we have learned so far—and to member countries aiming to improve their processes. It would not bind all countries to the same standards but help them to identify priorities given their current circumstances. On the fiscal policy side, it could usefully also embrace some of the issues addressed in the 'Fiscal Rules' paper: advice on how to formulate and explain economic goals is as important as the display of data and projections.

Such a code could easily be integrated into Article IV procedures. It would also be useful in the design of programmes supported by the Fund where fiscal issues stand in the way of sustainable progress. Resource implications do however need to be carefully considered.

I thought the "transparency" paper was of high quality. The staff has successfully identified the most important aspects of the debate. I fully concur with the statement that the case for fiscal transparency rests on the fundamental principles of public finance: stability, efficiency, and fairness. More specifically, the timely publication of clearly presented and comprehensive fiscal accounts, together with a budget outlining the government's future intentions, are a precondition for the market to be able to evaluate the government's actions and, thereby, to impose a constructive discipline on it. I also agree with the staff that fiscal transparency increases the productivity of public expenditure by limiting the scope for the government to introduce allocative distortions and inequities.

Clearly, in an ideal world, all Fund members would agree to meet broadly the same standards in fiscal transparency. Such actions would greatly facilitate the Fund's and markets' ability to provide meaningful surveillance over members' macroeconomic policies in much the same way that common accounting standards and financial reporting requirements for commercial companies allow shareholders to assess the economic condition and relative performance of the firms in which they have invested. However, given the very different stages of economic development of Fund members and the associated resources and sophistication of their civil servants, it would be unreasonable to expect all members to conform to the same standard over the short term. The different focusses outlined by the staff in paragraphs 43 and 44 therefore seem appropriate.

Reflecting the mandate given to this Board by the Interim Committee to "enhance the transparency of fiscal policy by persevering with efforts to reduce off-budget transactions and quasi-fiscal deficits," I take it as a foregone conclusion that we should be encouraging members to prepare and disclose more information than they have published in the past. The United Kingdom is continuing to move in this direction. Directors may be interested to note that the U.K. government has established clear fiscal objectives (the golden rule and debt limits as outlined below); that the U.K. fiscal deficit figures are now published also on a cyclically adjusted basis; that closer attention is being given to the issue of public sector net wealth data; full information about the government's assets and liabilities will be made available from the fiscal year 1998/99 onwards; that the assumptions underlying the government's budgetary projections of public finances are checked by the National Audit Office, an independent body; and that the government actuary produces estimates of unfunded public pension liabilities.

Monetary policy is also being conducted in a fully transparent way with explicit inflation targets set for the Bank of England; and with the Bank accountable for both performance and actions. Furthermore, as announced at the Annual Meetings in Hong Kong, the United Kingdom will begin to publish full information about the government's net foreign exchange reserves and the scale of official intervention.

Finally, I would like to endorse the proposals put forward in paragraphs 54–58. As the U.K. Chancellor of the Exchequer proposed in his speech to the Interim Committee, the Fund should "develop a code of good practice for promoting openness in fiscal (and monetary) policy." Such a code would be invaluable in helping the staff to fulfill their requirements under the new Fund guidance in the area of good governance. I also see many advantages in documenting existing practices of member countries. Such a review would serve as a useful benchmark to assess the extent of progress made under the Fund's new transparency initiative.

The staff paper on fiscal policy rules helpfully explains the main rationale for fiscal rules. However, I would have preferred a more thorough discussion of theoretical case. I suspect that most of us are familiar with the "rules versus discretion" debate more in the context of monetary policy; I would have been interested in a discussion of the extent to which the same considerations apply to fiscal policy, and where the analysis is different from that of monetary policy.

The United Kingdom has been formulating and operating a medium-term approach to fiscal policy since the early 1980s. The new Labor government has formalised this approach so that it is now more clearly a 'rule-based' procedure. In particular, the government has announced two new principles for fiscal policy. First, the golden rule: over the economic cycle the government will only borrow to invest and not to fund current expenditure; and second, public debt as a proportion of national income will be held over the economic cycle at a stable and prudent level.

One key consideration for the U.K. government in adopting the golden rule was that of "intergenerational fairness." This factor was not adequately developed in Section II of the staff paper. By stipulating that the government will only borrow to fund investment, and that current spending must be met from taxation and other current receipts, the golden rule recognizes that it is unfair to expect future generations to pay the cost of consumption by the current generation, and equally unfair that the current generation pay for the cost of public investments that will provide benefits to future generations.

Although Section III of the paper sets out a comprehensive and fair assessment of the economic effects of fiscal rules, I felt that the paper's overall evaluation of fiscal rules was less balanced and rather lukewarm. The conclusion in paragraph 16 that "the superiority of discretionary fiscal policy rules has not always been corroborated in practice" is something of understatement; it is also difficult to reconcile with paragraph 11, which notes the global trend toward deteriorating fiscal balances in the 1970s and 1980s at a time when the norm was for fiscal policy to be guided by short-term stabilisation goals. By the same token, the paper was less voluble than the staff and management often have been in its praise of the fiscal consolidation achieved in the runup to EMU, where the setting of specific rules in the form of convergence criteria has played an important role.

Of course, this one instance does not prove the superiority of rules over discretion in the conduct of fiscal policy in all circumstances. The paper does a good job of explaining the drawbacks of fiscal rules, and of setting out the criteria for deciding what makes a good fiscal rule.

Should the Fund endorse the adoption of fiscal rules? The answer is, as usual, "it all depends." If we can be reasonably sure that a particular fiscal rule is the best way of meeting the overriding objective of fiscal sustainability, we should endorse that fiscal rule. But obviously a fiscal rule is only part of the story, and the best policy prescription will depend on the circumstances of the country.

Evaluation of existing fiscal rules against the criteria set out in this paper, and active consideration of whether the introduction or adaptation of fiscal rules might be advantageous, should clearly be part of the Article IV surveillance process, and should be borne in mind in program negotiations. They might also be a candidate for technical assistance.

The arguments for transparency in government operations also apply to these papers. It would be useful if they could be published as soon as possible. Some updating is however necessary, including, for instance, identification in Table 1 of the fiscal rules paper of the recent rules adopted by the United Kingdom.

Mr. Kaeser made the following statement:

We share the view that greater transparency in government operations is an important element to achieve a sustainable fiscal stance and improve good governance. The staff paper presents a clear and comprehensive overview of the main issues related to this topic.

As the paper points out, transparency in government operations has many aspects and implications. All countries to some extent face a transparency problem. These difficulties differ, however, from country to country as well as the adequate corrective measures needed to alleviate them. It would therefore not be wise to set a single strategy and a single priority that would apply to all member countries. As the staff suggests, the priorities for improving transparency should be designed on a case-by-case basis.

We have underscored at several occasions the need for budget accounts to be as transparent and comprehensive as possible. Only then can the macroeconomic repercussions of a given fiscal policy and its sustainability be properly assessed. We therefore strongly support the proposition that Fund members should be encouraged to include in their general government budget information that has not been widely available in the past, such as estimates of the cost of quasi-fiscal activities of state-owned financial institutions and nonfinancial enterprises. In addition, governments should be encouraged to compile and disclose information on their commitments and contingent liabilities such as guarantees for depositors in financial institutions and estimates of the actuarial value of net unfunded liabilities of social security programs.

We would also be in favor of the staff's suggestion to incorporate medium-term projections in annual budget documents. Long-term scenarios could also be provided in special reports as far as possible and helpful for fiscal policy. Such information would show the future evolution of these spendings, allow an assessment of the sustainability of the current policy and help illustrate the effect of specific reform options.

An important point relates to the temptation to substitute regulation for budgetary spending when governments are under pressure to cut expenditure. Such a switch toward regulation is often perceived as a free lunch. In reality, however, a regulatory framework may have great economic and social effects. It would be important to bring these effects to light through a cost-benefit analysis.

Efforts to improve transparency in fiscal and economic affairs may be a first step toward a more general culture of transparency within a country and must be placed in the larger framework of good governance. Achieving a clear delineation of areas of competence between the public and the private sector is in our view of particular importance. This would contribute to limit the room for ad hoc bargaining and thus enhance government accountability.

In this spirit, we fully support the staff's assessment on the importance of transparent rules and procedures for the planning, execution and reporting of budget items. Transparent and accountable institutions are crucial for fostering confidence in the administration among the population as well as among local and foreign investors. With more transparency and accountability, government actions become more predictable, which in turn gives more confidence to potential private investors. In addition, transparent institutions also give a stronger voice to private decision makers in the formulation of a budget which then better represents the needs and demands of the population.

However, adopting transparency rules for government institutions and behavior, for instance, would be of limited use without the establishment of the needed instruments to enforce them. In this respect, the creation of an independent review agency responsible for conducting performance audits would play an important role.

As the paper mentions, the Fund has already been active in the promotion of greater transparency in government operations through its surveillance, program design, technical assistance and research. Transparency issues could be given a greater importance in all these activities. Decisions to reorient existing capacities to these issues should be made on a case-by-case basis, in view of the other problems a given country is confronted with. We would like to suggest that the Fund consult specialized nongovernmental organizations in its search for relevant information. In addition, we would welcome the preparation of a manual of best practices in fiscal transparency.

When adopting a fiscal rule, caution is warranted. Apart from the drawback of fiscal rules which the staff describes, consisting in the fact that they could impair the short-run stabilization and "tax smoothing" roles of fiscal policy, there are also a number of factors which can significantly reduce the effectiveness of fiscal rules. For example, in fiscal systems in which state and local budgets are determined independently of the central government, the fiscal rules govern only part of total spending and revenue decisions. Decisions made at a local level could thus sabotage a strategy designed at the federal level. Inversely, decisions made at a federal level to reduce transfers to local levels to meet fiscal rules could simply result in an accumulation of arrears at local levels.

A fiscal rule should not be seen as a panacea for a lack of fiscal discipline. As the paper points out, a fiscal rule may not by itself guarantee fiscal discipline or credibility. To be effective, it should be accompanied by a widely shared commitment to fiscal restraint. Without such a commitment, a rule would simply induce the authorities to resort to creative accounting schemes, for instance, in order to circumvent it. In addition, without such a commitment the structural measures needed for the fiscal rule to be implemented in a sustainable way may not be carried through.

The application of a fiscal rule requires also fiscal transparency. Without transparency, a fiscal rule would again lead to circumvention and distortions. The staff reports that often fiscal rules have been met through cuts in investment expenditure or through the accumulation of payment arrears. None of these strategies are sustainable practices. Yet the potential benefit of fiscal rules over discretionary policies stems precisely from the credibility of a lasting commitment to fiscal discipline that the authorities should gain in the eyes of private decision makers by adopting such rules. Any circumvention would therefore undermine the effectiveness of the rule.

In designing a rule, we agree with the staff that flexibility is important. The authorities should keep some freedom to be able to deal with exogenous shocks. An economy that would be managed on the basis of relatively rigid rules governing monetary and fiscal policies would probably face difficulties to cope with shocks beyond the control of the authorities. If we add structural rigidities to the picture, the situation is even worse.

Finally, the concept of simplicity of fiscal rules may be a bit tricky. In Switzerland, we are now considering a rule—the "Schuldenbremse," or "the brake on debt." It may not be realistic to expect that the man in the street will understand what a structural deficit is, and why it is not the same as the actual deficit. However, there is a general feeling among the population that public finances have gotten out of hand, and people find even a seemingly obscure fiscal rule preferable to none at all. After all, the Swiss central bank has been targeting monetary aggregates for years, and the public at large may not have a clear idea about why that helps keep inflation low. But at the end of the day, what is important for credibility is the track record. If a complicated fiscal rule brings deficits down, it will be accepted.

Mr. Bernes made the following statement:

Fiscal consolidation is an integral part of all Fund-supported adjustment programs, and a key focus of surveillance. I welcome the opportunity to discuss the issues related to fiscal policy rules and transparency, and commend the staff for its thorough review and analysis of the issues.

The shared objective of fiscal policy rules, and transparency in fiscal operations is the promotion of fiscal discipline. In this context, the two issues are interrelated. However, it is rather difficult to discuss the two staff papers together as they are based on different analyses, data, and methodologies. I therefore separate my comments into two sections.

The main conclusion one can draw from the staff paper on fiscal policy rules is that despite the loss in fiscal stabilization implied by fiscal rules, they are in general preferable to discretionary fiscal policies as they help improve fiscal discipline and lead to better fiscal outcomes. While I agree with this conclusion in principle, I believe the degree of stringency, and other features of fiscal rules should be adapted to the specific circumstances of countries. For example, in cases where there is a severe lack of fiscal discipline, rules should be comprehensive, covering all fiscal operations, and less flexible in terms of contingencies and escape clauses. On the other hand, in cases where credibility in fiscal management has already been established, more flexible rules can be adopted to allow the authorities to respond to shocks, and engage in intertemporal reallocation of welfare through public investment and saving.

In designing fiscal rules, the following issues should be taken into account. In order for governments to fulfil their mandate effectively and equitably, they have to be afforded some flexibility as to how to allocate taxes and spending among various sectors and over time. Overly restrictive fiscal rules may in fact introduce distortions in the composition of expenditures or tax increases. For example, rigid constraints on the overall budget balance may encourage governments to forgo desirable public investment in favor of transfers and subsides that are more acceptable to the electorate. While fiscal rules in general help increase transparency in government operations, highly restrictive rules may indeed encourage nontransparent practices through creative accounting methods, quasi-fiscal transactions, and unrealistic economic and fiscal projections. In order to prevent undue reliance on tax measures in complying with budget balance rules, the overall constraint should be accompanied by separate constraints on both spending and taxes. Fiscal rules need to be accompanied by enforcement mechanisms and penalties for failing to observe them.

The staff paper may benefit from a review of the recent experience of the Canadian provinces and territories with various forms of fiscal rules. Since 1993, six of Canada's ten provinces, and both of its territories have introduced budget and/or debt-reduction legislation with various degrees of stringencies. Some of the remaining provinces have announced their intention to adopt fiscal rules.

It is yet difficult to establish whether the fiscal rules enacted by the Canadian provinces have been effective. Fiscal performance has improved significantly in the provinces that have adopted fiscal rules as well as in those who have not. It is also not evident whether the market perception of debt riskiness has improved for those provinces with legislated rules compared with those without. For example, in 1996, the average yield spread over 10-year government of Canada benchmark bonds for the provinces with legislated budget constraints was only moderately (about 5 basis points) lower than the average for provinces without restrictions. Moreover, between 1994 and 1996 (most of the rules became law in 1995 and 1996), the decrease in average weekly yield spreads (relative to the government of Canada 10-year bonds) for the provinces with and without constraints has been virtually identical.

The success of the Canadian provinces in reducing their fiscal imbalances can be attributed to two factors other than the adoption of fiscal rules. First, in the early 1990s, the provinces that were perceived to have unsustainable deficit and debt levels experienced a substantial increase in their borrowing costs, forcing them to take the necessary steps to improve their finances. Second, the public has become more receptive to fiscal consolidation, providing the governments with more latitude to undertake tough fiscal measures.

The experience of the Canadian provinces does not provide a definite answer in terms of the effectiveness of fiscal rules. However, we can draw three lessons. First, markets can impose effective constraints on governments, mitigating the need for legislated fiscal rules. Second, as the staff notes, a widespread public acceptance of the need for fiscal consolidation is a prerequisite for achieving fiscal discipline irrespective of the method used. Third, fiscal rules may be more effective in sustaining fiscal discipline and market confidence that have already been obtained through discretionary measures, rather than as an initial response to a fiscal crisis.

Regarding transparency in government operations, I broadly agree with the staff's analysis and recommendations, and propose that this paper (with appropriate revisions to reflect the Executive Board discussion) be published. Transparency in government operations, especially in the fiscal area, is an essential ingredient for a well-functioning market economy. To manage their financial affairs effectively and efficiently, governments need to establish credibility with the public and financial markets. This can only be obtained by setting out clear fiscal objectives, using transparent and widely accepted accounting methods, and providing timely and reliable information to allow a credible assessment of the progress toward the objectives. This does not mean that full transparency at all times and in every case is optimal. As the staff notes, there are cases where the release of certain information has to be carefully timed and managed in order to prevent rent seeking activities.

However, I believe there are core principles in the area of fiscal transparency that all members should be asked to adhere to, and the Fund should take the lead in establishing them as a code of good practice as suggested in Mr. O'Donnell's statement. In the context of Article IV consultations, the Fund could identify divergences from the best practices, and establish if technical assistance is needed to rectify the problems. For example, the Fund should help members to harmonize their public accounting systems, facilitating cross-country comparisons of fiscal situations.

While I agree with the staff that the behavioural aspects of transparency in government operations (listed in paragraph 5) are less amenable to Fund surveillance, their importance in promoting transparency should not be ignored. For example, the Fund does not have the expertise or the mandate to design conflict-of-interest rules, but it should urge the members to establish effective rules consistent with their specific political, economic, and legal institutions.

The rest of the statement will provide specific comments on the staff paper.

The question of credibility is inherently subjective and, the basis for its establishment, as such, requires special consideration. Transparent practices that generate confidence in the reliability of information provided by the government, assurances that important information will not be suppressed, and a public view that government officials and politicians are acting in the public interest are essential for a wide range of public and private economic decisions, including the level and composition of private investment and tax compliance among the public. The Fund should therefore, in assessing the adequacy of government fiscal transparency, be open to "perception-based" measures of credibility and confidence such as Transparency International's "Corruption Perception Index." While such measures may not focus on all aspects of fiscal transparency, and they are by no means definitive, they do provide information about areas in which government credibility is lacking, including in fiscal affairs, and where government efforts need to be strengthened.

The staff argues that ". . . it is necessary to distinguish between deliberate secrecy or misreporting . . . and technical inability to provide certain information." While this distinction clearly is important, it should not be overstated since, to a significant degree, governments determine the priority they assign to data production. A lack of interest in, or commitment to transparency, will, therefore, often lead to inadequate investment in the establishment of data collection systems and a claim of insufficient capacity to be adequately transparent in government operations.

The staff notes that the "arguments in favor of transparency are subject to certain caveats." These caveats are complex and may need to be more clearly constrained than suggested in the staff paper. The decision on whether to make certain information public cannot be determined purely on a case by case basis, in isolation from other such decisions, since credibility cannot be established unless a government has willingly made public information that is not to its strategic advantage to release.

However, as mentioned earlier, there are cases where confidentiality is warranted. But, the need for nontransparency in those cases must be assessed against the ability of the authorities to maintain confidentiality and guard against profit-seeking by "insiders."

In paragraph 24, the staff notes the value of a permanent, independent review agency, "with wide investigative and reporting authority over government operations." I strongly support this method of bolstering external credibility, which has been adopted by many countries.

The staff has quite usefully drawn attention to the importance of intergenerational analysis of fiscal policy and it should encourage such work in all member countries. While not underestimating the challenges this presents, we should not overplay the complexities of such an endeavor. As with all economic analysis, intergenerational analysis can be undertaken with varying degrees of complexity and we should be careful not to discourage even rudimentary consideration of intergenerational impacts, because even this can encourage governments to incorporate these considerations in policy design.

Finally, the paper notes that "taken in total, the tasks proposed could impose a significant additional workload on staff and will need to be thoroughly assessed." This conclusion does not follow. Transparency and its consequent benefits are at the core of the effective exercise of the Fund's mandate. This paper highlights ways that the Fund can better focus its policy advice to members in carrying out its mandate. As such, clearer consideration of transparency is part of the natural evolution of our policy dialogue and should not be seen as an add-on to present practice. It is therefore welcome that the paper also acknowledges that "the tasks outlined would entail a reorientation rather than an additional workload" for the staff. Therefore, the resource implications should be marginal.

Mr. Wijnholds and Mrs. van Geest submitted the following statement:

These are important subjects that deserve adequate attention, both inside and outside the Fund. We would therefore support the publication of the papers after the usual editing, taking into account the Board discussion.

On fiscal policy rules, it is perhaps instructive to elaborate on the Netherlands experience. During the 1960s, fiscal policy was geared to the structural deficit, as mentioned in the paper. Under this approach, the structural deficit was to equal the structural excess of private savings over private investment, thus balancing national savings. Owing to overestimates of trend growth in the 1970s, budget deficits exploded and the rule was abandoned. It was replaced with a policy aimed at (reducing) the actual deficit. This policy succeeded in its aim, but gave rise to continuous shifts in expenditure and revenue policies and led to a rather hectic process of decision making. Subsequently, as a result of the improved budgetary situation, a so-called spending framework was adopted a few years ago. Under this framework, the net-expenses are tested against pre-set targets for three broad categories (central government, social security and health care) and as long as the upper limits are not exceeded spending can remain unchanged. Estimates of expenditures and revenues are based on cautious macroeconomic assumptions, thus minimizing the risk of emergency cutbacks during the budget cycle. Extra tax revenues are used to reduce the deficit or to lower tax rates, but will not lead to higher spending. Key in the Netherlands experience is that the new budgetary system became feasible only after a substantial decline of the deficit, albeit to a level not yet considered satisfactory. Expenditure targeting appears to be advisable only when the deficit reduction process is well under way. Expenditure control is fostered in the Netherlands by an agreement that ministers have to compensate excess spending on any budget items with underspending on others.

We generally endorse the ideas expressed by the staff in the paper on fiscal rules. Fiscal rules can provide an important (but not the only) means to maintain fiscal discipline and foster credibility. We also support the touchstones for the evaluation of specific rules. Regarding the various formats, we agree that it would be most useful to focus on the overall balance. In light of the Netherlands experience, we are somewhat skeptical regarding fiscal policy rules based on structural concepts of the deficit. The cyclically adjusted balance is notoriously difficult to calculate and sensitive to assumptions on potential growth. If one overestimates trend growth, the structural balance can provide a false sense of security and undermine the incentive for fiscal adjustment. This is one example where an academically sound idea can lead to untenable results in the realm of political decision making. On the other hand, we would fully endorse the notion that one should preferably only opt for a fiscal policy rule, following a successful discretionary adjustment.

In terms of the borrowing rules, we note that the staff dwells on the prohibition of or limits on central bank borrowing, but does not discuss the notion of privileged access to financial institutions. Financial market discipline obviously constrains the room for fiscal policy. Prohibition of privileged access will ensure that this discipline will work at full force. This notion was also incorporated in the Maastricht Treaty.

Regarding endorsement, we would expect the staff to operate in the same manner as when it encounters an exchange rate rule. Evaluate the rule and its appropriateness or inappropriateness for the country concerned. We do not see ground for a different approach here.

In terms of the content of the paper on transparency, we have no major difficulties. We would underscore, however, that transparency is a credibility issue. And a reputation of credibility is difficult to attain and easy to lose. This clearly circumscribes, if not eliminates the room to pick and choose when to be completely open and when not. If one chooses to be nontransparent on some topics, it should at least be clear to the public one does not convey information under any circumstances. In addition, one should make sure that those in the know cannot abuse their advance knowledge; severe compliance rules should eliminate any temptation.

While the paper itself provides a useful overview of transparency issues, we think that the main body may not be sufficiently tailored to the role of the Fund. The Fund is in the business of providing macro economic policy advice and fiscal policy advice is one of the staple goods. Transparency in government operations (and fiscal rules) can be an important means to enhance sensible fiscal policies; the present attention for these topics is therefore certainly welcome. However, transparency should not be promoted to a Fund goal in and by itself. In terms of future work, this implies that Fund staff should not go out on a limb to identify nontransparent practices; it is not a special agency mandated to eradicate nontransparency. Nevertheless, if nontransparent practices complicate sound policies or could imply major macroeconomic costs, the staff should raise the matter with the authorities, both during Article IV consultations and program negotiations. Technical assistance could also be considered. All in all, we would call for an eclectic approach, tailored to the needs and capabilities of the country concerned. Now in my impression, the staff has been making good progress in this area over the years—we recall for instance, the staff's advice regarding tax expenditure estimates during the last Article IV visit to the Netherlands and discussions on the costs of aging on various occasions—but there does seem room for improvement.

With regard to a manual for best practices, we are somewhat cautious. One would hope that the present paper already provides a reasonable overview of the best practices to date. The diligent construction of a best practices manual could then very well lead to a lot more detailed knowledge, without any major new insights. It would on the other hand add to the existing claims on staff resources. We would therefore argue for a less ambitious approach. We could work on the basis of the present paper and sensitize authorities and the staff to the issue. Any major new developments will automatically come to the attention of the staff and the Board during the Article IV discussions and in a couple of years time we could then usefully update the present paper.

More generally, the staff notes in the paper that most of the activities could be absorbed through a reorientation of activities. The staff has highlighted possible new activities, but remained silent on the posteriorities. We would therefore be interested to know which activities should be cut back.

Mr. Zoccali and Mr. Costa submitted the following statement:

The economic and political implications of today's discussion on fiscal policy rules and transparency in government operations represents a clear opportunity to give operational content to the concept of good governance. We are grateful to the staff for the thorough analysis provided in the papers. While we broadly share the main conclusions, our comments should be considered preliminary, as the many issues raised are still being considered by our authorities.

First, the staff has rightly highlighted among the reasons for the current interest in fiscal policy rules the widespread deterioration in fiscal performance since the early 1970s, coinciding with the breakdown of the Bretton Woods system which was tantamount to an implicit rule for fiscal discipline and stable debt ratios. The greater policy independence afforded by a flexible exchange rate system facilitated a generally expansive fiscal policy over the cycle. Thus, despite theoretically superior characteristics of discretion over rules, the resulting brand of discretionary fiscal policy generally proved itself insufficient in practice to ensure fiscal discipline. In today's globalized environment, with financial markets increasingly integrated, the importance of fiscal discipline for macroeconomic stability has become even more apparent, suggesting the desirability of moving once again in the direction of fiscal policy rules. Poor fiscal performance predicated on so-called "fiscal illusion" has also been associated with the deficit bias of the political cycle. The difficulties of the electorate to fully understand the intertemporal budgetary trade-offs associated with a politically motivated expansionary fiscal policy have empirically been borne out more than the notion of "Ricardian equivalence." In these circumstances, fiscal rules could provide additional reassurance to financial markets that governments will not be tempted to run unsustainable deficit positions over the cycle, particularly when unfunded contingent liabilities already represent a serious problem in many countries. The "time-consistency" advantage of rule-based policies over discretionary ones is difficult to refute particularly since the necessary condition for fiscal discipline is widespread acceptance of its need and commitment to enforcement on a permanent basis.

Regarding the more general advice offered in paragraph 49 of SM/97/175, that it is best to introduce a fiscal rule only after a successful period of discretionary adjustment, in our view, what counts is the durability of the rule rather than the period of convergence. Moreover, broad popular support for the required structural reforms could well emerge in the aftermath of a major financial crisis when is also most critical to quickly restore policy credibility. Implementation of the necessary set of structural reforms to ensure the sustainability of a fiscal rule could consequently go hand in hand with its introduction.

The transitional fiscal costs of implementing structural reforms, however, deserve more explicit analysis. In this regard, the reduction in revenue caused, for example, by a shift to privately administered fully funded pension schemes, giving rise to temporary budget deficits and additional increases in indebtedness need to be taken into account when assessing convergence. The intertemporal fiscal benefits and contribution of such measures to the deepening of domestic financial markets and domestic savings, deserve greater prominence in the presentation of the fiscal accounts just as unfunded liabilities are usually flagged as a source of potential weakness.

Second, with respect to the major types of fiscal policy rules governing: the deficit, borrowing or debt levels, it is important that they be operationally self-contained, such as the deficit rule. A prohibition on government borrowing from domestic sources, although conducive to monetary discipline, can be made less effective by access to external borrowing. The debt level rule requires a given path for the primary surplus in order to become operationally binding. To the extent that it is not accompanied by a specific timeframe for achieving a given debt to GDP level, it suggests a desirable goal rather than a rule. In this regard, it should come as no surprise that in Appendix III, which analyzes the implications of various rules for the short-term variability of output, the debt target policy simulation represented the closest approximation to the "tax smoothing" function of fiscal policy. Thus, the strong arguments in favor of such a policy rule in paragraph 140 of the paper should be subject to some qualifications given the less than clear long-term debt reduction incentive.

Third, on the nature of fiscal policy rules, the staff notes that specialized rules that could be imposed on certain categories of government expenditure or revenue were deliberately left out of the scope of the present paper. Nevertheless, such rules could constitute useful supplements to address structural issues, including the "right" mix between expenditure reduction and revenue-enhancing components and, as importantly, the efficiency and effectiveness of public expenditure programs. Further work on the part of the Fund on best practices in these areas with clear micro- as well as macroeconomic implications, is deemed necessary.

An important additional issue raised in the analysis of fiscal policy rules is their degree of rigidity. Should the budget be, for example, balanced each fiscal year, as proposed by some for the United States, or should balance be pursued over the course of the economic cycle? Precluding a short-run stabilization role for fiscal policy, by not allowing for the operation of automatic stabilizers would unnecessarily constrain policy making. We thus share the staff's conclusion on the desirability of a more flexible fiscal rule allowing for a moderate counter cyclical role.

Also worth highlighting is the relationship between fiscal rules and economic growth. The evidence provided clearly suggests that when fiscal adjustment is credible, perceived as permanent, and is accompanied by structural reform measures it can favorably impact on growth, through declines in future interest rates and tax rates thereby encouraging present investment and consumption while mitigating the negative initial withdrawal of demand. What is important, in our view, is that the commitment to fiscal discipline be buttressed not just by rules but also by mutually reinforcing structural policies, to install an environment of favorable expectations.

Regarding institutional aspects, paragraph 95 of the staff paper notes that an independent fiscal supervisory body may be desirable to ensure adherence to rules. We do not consider the introduction of a new institutional layer to monitor implementation of fiscal rules either a necessary or a sufficient condition for fiscal discipline. Existing agencies within the government could well be entrusted with that responsibility. At the same time, the staff points out that compliance with fiscal rules may lead to distortions in the composition of expenditure through an undesirable reduction of public investment, an excessive reliance on tax increases, recourse to payment arrears, and one-off measures. Resorting to such policies to meet fiscal rules is without doubt counterproductive and justifies the call for greater transparency to counteract those tendencies while enhancing accountability. The case for greater transparency, however, goes beyond that of satisfying fiscal policy rules in a nondistortionary manner. To the extent that governments are required, for example, to preannounce their fiscal strategies and objectives and are held accountable for delivering results, the superiority of fiscal rules over discretion would not be of significance.

The paper on transparency in government operations, SM/97/174, rightly emphasizes the importance of data coverage, recording and classification for enhancing responsible fiscal management and market discipline. Moving toward greater transparency, however, could entail significant costs both for the Fund as well as for member countries inasmuch as shortcomings in these areas may reflect technical or resource limitations rather than a deliberate intent to hide information. The Fund's role in this regard should be not only to point to the weaknesses but to facilitate their resolution so that greater transparency would in fact translate into improved fiscal discipline, governance and economic performance. More specifically, regarding the suggested issues for Board discussion, we view transparency as a multiphasic and evolving phenomenon which, as a matter of principle, should be of concern to all countries. The Fund, as an institution, should continue to promote greater fiscal transparency through its surveillance, technical assistance and program design keeping in mind, however, the differing stages of development and needs of its member countries. Estimates of the cost of quasi-fiscal activities performed by public institutions as well as of the actuarial value of net unfunded liabilities of social security programs are becoming increasingly important, but so are other aspects including nontransparent tax concessions, subsidies, payment arrears, off-budget spending, and the diversion of resources to finance activities other than those originally intended. Consequently, the questions in paragraph 68 deserve a broader focus.

Finally, we would welcome additional efforts by Fund staff to engage in a systematic documentation of transparent and nontransparent practices in member countries as a basis for preparing a manual of good rather than "best practices" in fiscal transparency. Nonetheless, before embarking on such a task, we deem it appropriate to clarify the internal resource requirements to avoid affecting the provision of technical assistance, in particular by the Fiscal Affairs Department (FAD) and the Statistics Department to members that are reliant on such advice. In sum, greater transparency should be encouraged in the policy dialogue with member country authorities with the view to making its many benefits explicit and to eliciting the necessary support to put in place the incentive structure that will produce greater fiscal discipline instead of merely another dimension of conditionality.

Mr. Al-Turki made the following statement:

The two items before us pose fundamentally different challenges. We can all agree that "transparency in government operations" promotes a reliable first hand information base and is, therefore, desirable. However, the paper on fiscal policy rules has a more ambitious agenda as it projects into the future a particular view that now prevails about causal links between economic facts. Clearly, both have far-reaching implications for the Fund.

Regarding "transparency in government operations," let me first point out that the topic covers a territory well beyond the Fund's mandate. Indeed, the staff recognizes this as the report concentrates exclusively on fiscal transparency. The relevance of the broader title for the report is thus unclear.

Improvements in the economy's information base clearly comprise the substance of fiscal transparency. As the report spells out, fiscal transparency "involves ready access to reliable, comprehensive, timely, understandable, and internationally comparable information about government activities—whether undertaken inside or outside the government sector—so that the electorate and financial markets can accurately assess the government's financial position and the true costs and benefits of government activities, including their present and future economic and social implications."

This is indeed an exceptionally broad agenda well beyond the scope of what the Fund can or should engage in. It also entails many conceptual and institutional complexities that are detailed in the report. Identification of an appropriately narrow subset of issues is therefore critical for effective involvement of the Fund.

As the paper points out, promotion of fiscal transparency has always been an integral part of the Fund's dealings with member countries. The staff makes the case for the Fund's involvement in identifying and suggesting appropriate remedies for instances of nontransparent institutional arrangements and practices that are likely to affect economic performance. However, given the complexity of the task, it is important to keep the issue in the proper perspective. Also, the budgetary implications of the additional work are unclear. The report should have included at least a rough estimate of the likely costs.

Turning to the issues for discussion, I believe that the staff should continue to address fiscal transparency issues on a case by case basis as part of the regular surveillance, consultation, and use of Fund resources exercises. Any such involvement should be limited to issues of macroeconomic significance with remedial action concentrated primarily on cases of deliberate misrepresentation or suppression of information.

Regarding encouragement to countries for additional information that has not been widely available in the past, the criterion should be based on relevance to the Fund's mandate. Also, such requests should be in the context of the country's statistical capabilities and resource constraints, with the Fund standing ready to provide the necessary technical assistance.

Given the resource constraints, I will appreciate staff comments on how additional obligations such as a systematic documentation of transparent and nontransparent practices among member countries are to be absorbed. Also, I share Mr. Shaalan's doubts about the merits of the proposed manual of best practices in fiscal transparency. Clearly, what is the best practice for an individual country in particular circumstances cannot be transposed as the best practice to other countries and circumstances. This is especially the case as the report concedes risks that may justify temporary deviations from transparency.

The rigidity that fiscal rules introduce can at times be a helpful step. As the staff report notes, fiscal target setting for a preannounced period of time has played a major role in many countries with and without Fund programs. Also, fiscal targets can greatly facilitate a move from one economic system to another as in the economies in transition. However, the fiscal rules the report speaks of are intended for application on a permanent basis by successive governments. This raises several issues.

The academic debate over the central question of discretion versus rules in fiscal policy is still open. Indeed, the report notes that discretionary fiscal policy can also be effective. The recourse to fiscal rules is nevertheless being justified as useful to make up for the lack of "a far-sighted electorate or financial market." Here, it should be noted that the discretionary element of fiscal policy varies with the widely differing budgetary processes across countries. The design and implementation of what the staff calls "economically sensible fiscal policy rules" is thus far from an easy challenge.

In addition, the policy rigidity the fiscal rules inject may be overtaken by new ideas and circumstances. Besides, as the report makes clear, the rigidity implicit in the rules may be effectively circumvented by creative accounting and reliance on low-quality one-off measures. Furthermore, the rules can either be ignored or be the subject of litigation regarding whether or not they have been met. Indeed, the few instances the report cites of successes with fiscal rules are accompanied by others that have been ineffective, suspended, or abandoned.

I therefore remain of the opinion that the use of fiscal rules is likely to remain limited primarily to the particular circumstances that the staff cites of, for instance, a federation or a confederation-cum-monetary union. Fund encouragement for adoption and implementation of fiscal policy rules should therefore be determined by specific country circumstances with the focus on prospects for success under a more discretionary approach. I also favor continuation of the current approach to surveillance of fiscal rules in the context of Article IV consultation discussions, and periodic Board papers as in the case of the EMU. While I am for continuation of Fund technical assistance on macroeconomic fiscal issues, extension of the assistance specifically for design and implementation of fiscal policy rules should be offered on a selective basis as needed.

Mr. Taylor made the following statement:

These two papers are a welcome step in raising awareness of what is involved in good fiscal management. One of the Fund's most important roles is to collate and analyze country experiences, and distill from them best practices which can be recommended to other members. In this regard, I particularly welcome the initiatives suggested in the transparency paper.

Like the staff, we see numerous difficulties in the imposition of fiscal rules as such. As the staff has pointed out, fiscal rules may impair the stabilisation and tax-smoothing role of fiscal policy, and can also lead to distortions in the composition of expenditures and taxation. Moreover, if the political will is lacking, costly ways around the rule will likely be found.

In theory, many of these negative features might be reduced or eliminated. We agree with the staff's assessment of the characteristics of a 'model' fiscal rule—and also agree that no one rule can combine all elements of this model, as there are tradeoffs between them. In our view, transparency is an essential element, and should receive a greater weight than other elements. It is thus appropriate for the staff to cite New Zealand's Fiscal Responsibility Act, with its emphasis on transparency, as a model instrument for maintaining fiscal discipline.

The New Zealand, and more recently, Australian, models concentrate on ensuring that fiscal transparency is permanently enhanced by mandating a range of reporting requirements covering, in particular, the fiscal strategy, the economic and fiscal outlooks, and intergenerational and net worth analysis. These reports by the government to the parliament are tightly specified in legislation in terms of extensive content and coverage, accounting conventions and time periods (including, incidentally, the preelection period).

These reports enable extensive scrutiny and analysis of fiscal behaviour by the public, the financial markets and professional commentators (and by political opponents).

It is true that the New Zealand approach goes beyond this in enshrining among the "principles" of responsible fiscal management the maintenance of prudent levels of Crown debt by "ensuring that, on average, over a reasonable period of time, the total operating expenses of the Crown do not exceed its total operating revenues." Departures from this loosely defined balanced budget 'rule' (or from any of the other principles) must be reported to the parliament, together with the means and time period through which the government will return to the principles. Thus, the emphasis is on justification of a discretionary fiscal stance in a highly transparent way.

The recent Australian "Charter of Budget Honesty" requires that governments clearly enunciate their fiscal strategy in a statement to parliament, through medium-term fiscal objectives and targets, and the specification of short-term goals within the medium-term objective. This ensures that there are appropriate benchmarks against which the government's fiscal performance can be measured. In accordance with these provisions, the present government has committed itself to a medium-term fiscal objective of achieving underlying balance, on average, over the course of the economic cycle; with the short-term goal of redressing the significant structural deterioration in the 1990s by entering surplus on an "underlying" basis in 1998–99.

Thus, while the fiscal strategy must be framed to observe specified "principles of sound fiscal management," observance is essentially judgmental in nature.

Regarding the staff proposals for more effective Fund involvement in improving transparency, the staff has grouped transparency issues into those most relevant for each group of countries—developing, transitional and advanced economies. This is a useful first approximation. However, it is easy to find cases of creative budgeting in advanced countries, and examples among developing countries of quite well-developed fiscal management infrastructure. It may be more useful to regard the process of developing effective transparency arrangements as a journey taking some years to complete (no one has finally arrived), accepting that countries at similar stages of economic development are sometimes at quite different stages of developing sound fiscal environments.

There is a degree of concern over resource costs in further work by the Fund. I hope the staff will be in a position to respond to that concern. I think we should also be conscious of the much greater resource costs in member countries. The full flowering of transparency arrangements depends on years of statistical accounting and methodological work (with added costs and speed limits in federal systems). Moreover, such developments are commonly only part of much wider public sector reforms going to issues such as efficiency and management.

Against that background, I would like to support each of the ideas in the paper for further Fund involvement, with the following comments.

The staff proposes, in paragraph 54, that the Fund seek to identify and quantify nontransparent institutional arrangements and practices in the context of Article IV consultations and Fund-supported programs (attention to the fiscal integrity of government pension funds could be added to the list of examples). From what we have observed, the staff already raises these issues in many Article IV consultations, and we consider that it is appropriate for them to continue to do so, on a more thorough-going basis.

In paragraph 55, the staff proposes that the Fund encourage (again, presumably, intensify existing encouragement) members to improve the construction and disclosure of their public sector statistics, including bringing extra budgetary operations into the accounts. In this respect, I propose that all Article IV reports include a concise—say one page—description of the basis on which the government accounts are prepared and an assessment of how accurately these accounts reflect government activity, and how this may have affected the quality of and confidence we can place in the Fund's analysis—in a way that would facilitate comparison between countries, and with any notion of best practice that may be developed.

In paragraph 56, the staff proposes that authorities be encouraged to develop meaningful supplementary measures of fiscal balance, indebtedness and tax expenditures, and to specify methodology, alternative methodologies, assumptions, etc. We agree that these issues are desirable for countries that have already put in place more basic measures to improve transparency, and should be pursued by the staff as an extension of the ideas in paragraph 55.

We support the staff's proposal at paragraph 57 that transparent and nontransparent practices in member countries be systematically documented. Adopting this structured approach would provide a more comprehensive picture than is usually available from the Article IV consultations, and would help the staff and Fund members to compare practices across countries more effectively. It would also facilitate the implementation, by area staff, of the initiatives discussed in the three paragraphs above (and reduce inconsistency of treatment between members); and help FAD staff to better prioritise competing demands for technical assistance.

Finally, we strongly support the staff's proposal (also paragraph 57) that a manual of best practice be developed (in close association with the World Bank and consistent with OECD work, please). The manual should, of course, recognize that there will not always be "one right way" to do everything, but could nonetheless set out, in addition to theoretical elements, corresponding simplified operational examples of transparent practices. This manual may take some time to develop. During this development process, we would recommend that the staff expose its thinking to Executive Directors through one or more seminars to interested Executive Director's and their offices.

Ms. Lissakers and Mr. Sobel submitted the following statement:

The staff papers raise critical issues regarding the conditions for the successful conduct of sound fiscal policy. Nonetheless, the two papers are quite different. On balance, the authors make a persuasive case for the benefits of increased transparency in government operations. The case for fiscal policy rules is less compelling.

The paper on "transparency in government operations" extends our work on transparency to the realm of fiscal policy. As such, it is a welcome complement to our agenda of furthering the role of governance in the Fund's daily life, as well as developing the Special Data Dissemination Standard and Press Information Notices.

This chair's views on the benefits of transparency are well known. Thus, it will come as no surprise to the Board that we share the authors' view that transparency in government operations tends to create conditions for improved accountability, public sector management, fiscal policy performance and economic efficiency. Indeed, in a globalized world economy in which countries are increasingly turning to international capital markets, fiscal transparency has become more important than ever.

We broadly support the staff's analysis of fiscal transparency, but a few points are worth underscoring based on our country experiences.

The general government deficit is the most appropriate measure of fiscal performance and should include public sector enterprise and quasi-fiscal activities. In recent years, we have seen many transition countries where reported budget deficits were small, yet very high inflation told us that fiscal stabilization was far from at hand due to quasi-fiscal activities.

Fiscal positions should be reported on an accrual and cash basis. While cash positions may reflect the absorption of national savings, there have been many instances in which unpaid budgetary commitments gave rise to sequestration and large arrears, which undermined the sustainability of fiscal policy and then needed to be cleared.

We strongly endorse the staff's call for greater transparency in tax systems and tax treatment. Discretionary tax relief, tax exemptions and arbitrary tax administration are among the most nettlesome governance issues that this institution faces. Also, the costs of bank restructuring are weighing increasingly on fiscal positions. Accordingly, we wonder whether the staff is making progress in applying its proposed augmented balance approach.

There are numerous indicators and modes of preparing projections. Complexity in their usage may often be more appropriate, the more advanced the economy. But one wonders whether caution is not needed as the complexity itself can give rise to a lack of transparency. For example, cyclically adjusted balances yield valuable information, but are predicated on forecasts of potential growth and NAIRU which are subject to wide margins of error. The operational balance may be relevant in high inflation cases, yet some countries focus on the operational balance well after inflation comes down.

In terms of the Fund's role in fiscal transparency, we support the staff's proposal to prepare a manual on a set of best practices for fiscal transparency. Further, we urge the Fund to intensify its work on transparency, in conjunction with other institutions, in the areas of surveillance, conditionality and technical assistance. Regarding the latter, the Fund and Bank should strengthen their focus on building Treasury systems as a means of disciplining and increasing the transparency of spending.

The debate over rules versus discretion is an age-old one. Generally speaking, our view has been that good performance depends on the political will to implement sound policies. In contrast, simply promulgating "rules"—without building a consensus to put in place sound policies—is unlikely to achieve desired improvements. Given this general orientation, as well as our fiscal experiences, we are not persuaded that fiscal policy rules will yield better outcomes or enhance credibility.

Turning to our experiences, the United States in the mid-1980s instituted the Gramm-Rudman-Hollings Act, which aimed at eliminating the deficit on a unified basis by establishing a medium-term timetable for moving toward this goal. But given a lack of sufficient political commitment, the desired results were not achieved and this approach was abandoned in the early 1990s. Over the past four years, however, the deficit has been brought down from 4.7 percent of GDP in 1992 to less than 1/2 percent of GDP in 1997. This progress was achieved due to the Administration's actions to cut spending and raise revenues in 1993, a bipartisan consensus on the need to tackle the deficit, and legislative procedures which reinforced discipline (caps on discretionary spending, PAYGO). The staff might have given a little more attention to procedural rules given this experience.

There have been repeated legislative efforts in the United States in recent years to enact an amendment to the Constitution requiring a balanced budget. Critics have argued, however, that such an amendment would subject the economy to unacceptable risks. Foremost, such an amendment could preclude the operation of automatic stabilizers and require procyclical spending cuts/tax increases; thus, it could seriously aggravate economic conditions. Similarly, the amendment might prevent the government from responding promptly to crises—acts of god, financial system runs, unforeseen military hostilities—with additional spending. Furthermore, were the government to realize only late in the year that events might preclude meeting the rule by a significant margin, it would need to act hastily regardless of how steep the costs might be. For these reasons, the Administration does not support a Constitutional balanced budget amendment.

Beyond our experience, there are further considerations which weaken the presumption that fiscal policy rules yield better results. The case for fiscal policy rules may be more tenuous than that for monetary and exchange rate rules. Fiscal policy rules are not easy to define, there is a wide range of possible types of fiscal policy rules, and performance measures (e.g., deficits relative to GDP) are often known only with considerable lags and are subject to wide variation depending on accounting treatment. Indeed, insofar as countries attempting to meet the requirements of a rule might resort to accounting gimmicks, unsustainable one-off measures or arbitrary changes in definitions and procedures, there is a real risk that fiscal policy rules can undermine transparency.

In this spirit, the staff notes several properties of a model fiscal rule, highlighting the role of transparency, definition, simplicity, flexibility, enforceability and efficiency. One wonders whether all of these properties are consistent and attainable. For example, as discussed above, simplicity and transparency might call for a clear and uniform specification of a variable—e.g., the budget should always be in balance. However, such a rule would not be flexible and might prevent automatic stabilizers from working in the case of a downturn. Alternatively, if the rule flexibly specified that deviations could be tolerated in certain cases, simplicity would be lost. In short, the staff's view in paragraph 59 that the principal characteristics of an ideal fiscal rule can be identified does not seem supported by the arguments in paragraph 56 regarding the limited experience with fiscal rules, and the possibility that efforts may be made to meet rules through measures that do not have a lasting impact on public finances.

The staff's recommendation that "a formal rule preferably should be implemented following a successful discretionary adjustment" is in some ways perplexing. If a government demonstrates that it can achieve a successful discretionary fiscal adjustment, then it may not see the need to adopt a fiscal rule. If, however, a government has lost credibility or has a weak track record, then it may perceive that a fiscal policy rule—by tying its hands—could strengthen discipline. Of course, it is in these circumstances that the adoption of a fiscal policy rule is the riskiest—if the political will or conditions are not present for adhering to the rule, the failed adoption of the rule may have extremely damaging and adverse confidence effects.

One must also challenge the argument in paragraph 34 that the most powerful reason for fiscal policy rules is that democratically elected governments have a deficit bias, especially with respect to intergenerational considerations. It is not clear that fiscal policy rules address the issue of intergenerational time consistency—for example, a country might need to run surpluses to meet the requirements of future generations, whereas the rule might specify only fiscal balance or a deficit no larger than some given sum. Could the staff comment on the consistency of the 3 percent Maastricht deficit target and current net unfunded pension liabilities in EU member states? Also, the advanced countries are both democracies and the wealthiest countries in the world. Clearly, if fiscal profligacy were the norm, their performance would not be so good and there would be a price to pay in capital markets, not to say at the ballot box. Finally, historical data simply do not bear out that democracies have a deficit bias.

On balance, there are instances in which fiscal policy rules have been a useful tool for countries to institutionalize better financial policies. Certainly, when members of the Fund are interested in formulating such rules or in incorporating them in program conditionality, we should provide assistance. But much more work and experience is needed with fiscal policy rules before this chair could be convinced that they should be routinely endorsed.

The Director of the Fiscal Affairs Department stated that he believed that the current meeting was long overdue. He had been worried for many years that the treatment of the fiscal situation was not as it should be, with too much attention sometimes being paid to specific figures in country comparisons. In that connection, it needed to be borne in mind that sometimes the figures were not comprehensive enough; sometimes they changed because of policies that the government had followed; and often they were not comparable across countries. In some countries, they covered part of the public sector; in other countries, they covered broader parts. The figures were sometimes adjusted directly for inflation, sometimes indirectly, and sometimes not at all. Sometimes the figures might have been changed—for example, if the government could convince banks to buy government bonds, the cost to the government of having a certain fiscal policy might be lower; sometimes, for example, a fiscal deficit could be met by simply not paying bills. Such problems had always worried the Fiscal Affairs Department, and, partly as a response to that concern, the department had produced a series of papers on fiscal matters, as well as a book on how to measure the fiscal deficit.

An implicit question of particular interest at the current juncture was the comparison of the size of the public sector across countries, the Director considered. Some countries had a very low level of taxation and expenditure; others had a high level of revenue and public spending. Under that criterion, the conclusion would be that the role of the public sector in Sweden was about five times greater than its role in China, which was clearly not the case. The point was that there were alternative tools that could replace spending and taxing in carrying out the government role. Those alternatives encompassed regulations of various kinds, tax expenditures, and quasi-fiscal activities. An important objective of the current debate was to become more aware of such alternatives, and the staff had prepared the two papers for the current discussion with that objective in mind.

Regarding the question posed by Mr. Shaalan, whether it was possible to quantify opaque budgetary practices, the objective of the discussion should not be so much to quantify them as to eliminate them, the Director commented. It needed to be recognized that opaque budgetary practices were inconsistent with increased globalization, in which markets were playing a larger and larger role. Moreover, opaque budgetary practices sometimes confused the policymakers themselves, as well as the markets, and in that regard he doubted whether, in some countries, the ministers themselves understood fully what was going on. For example, some years before, he had been part of a mission to a Group of Seven country, and the mission had pointed out to the authorities that there were some aspects of the budgetary process that were so complicated that only two or three people in the country understood them, and none of those people were the ministers.

If opaque budgetary practices could not be reduced, they should be identified more accurately, the Director considered. That was perhaps the first step, as time would be needed to remove them completely. For example, countries needed to move to identify tax expenditures and quasi-fiscal activities, which were substitutes for fiscal policy; such identification would be helpful in itself not just to the Fund or to the market, but also to the country. After the opaque budgetary practices were identified and quantified, the government would need to decide whether or not to keep them. In that vein, when the concept of tax expenditure was first introduced, few people had understood what it meant, but progressively, the concept became better understood, and it had been quantified in quite a few countries. In particular, the cost, in terms of forgone revenues, of extending a tax incentive to a particular group was calculated. The staff hoped that that would be done with increasing frequency, so that governmental subsidies to a certain activity that were not shown in the budget—by, for example, inducing the banking system to provide loans for certain activities at lower than the going interest rate—would nevertheless appear as a charge against revenues.

The statement in the staff paper to the effect that many governments had failed to fully disseminate information to their own legislatures and electorates would be eliminated in any published version of the paper, the Director emphasized. In that connection, the staff paper had been marked "confidential" in recognition of the fact that some of the information it contained, which had been provided by the members to enable the staff to complete the paper, had not been provided to other parts of the respective governments.

The full identification of all the nontransparent budgetary practices in member countries, the regular reporting of them to the Board, and the provision of technical assistance to enable countries to find alternatives to them or to remove them would be very expensive, the Director acknowledged. However, such a full treatment of the issue was not in view. A less elaborate method would be to create within the Fiscal Affairs Department an electronic mailbox to which information could be sent about nontransparent practices identified in the context of missions for Article IV consultations and the use of Fund resources. A periodic report could be written on the basis of that data, for the information of the Board. That approach would not be very expensive.

The same general observations applied to the question of elaborating a code of fiscal conduct for member countries, the Director considered. To prepare a detailed statement would clearly require many resources, but a general guideline of a few pages would not. He recalled that some Executive Directors had argued forcefully in their statements that the Fund should expand considerably what it did in that area, but others had taken a more cautious position—in view of not only budgetary considerations, but other considerations as well.

There were shades of differences of view among the staff regarding the question of fiscal policy rules, the Director pointed out. His personal view was that, if the fiscal policy were sound, no fiscal policy rule would be needed; and if fiscal policy were unsound, no fiscal policy rule would help. At the same time, his colleagues had pointed out that perhaps most countries were not in the extreme position of having either very good policymakers or very bad policymakers; many countries fell somewhere in between. In that situation, having a fiscal policy rule might help to promote better fiscal policy. He had therefore been persuaded that there might be cases in which fiscal policy would be better with a rule than without one. Of course, that raised the question of what kind of rule, and that was an aspect that the staff paper had not gone into in sufficient depth. If the Fund became interested at some point in promoting a rule, the question of what kind of rule should be promulgated would clearly have to be revisited.

He agreed with Ms. Lissakers that a balanced budget enforced every year was a bad rule, and he suspected that most economists would agree with that, the Director concluded. Having a balanced budget over the medium term might be a good rule, but that depended upon how many games could be played in measuring structural shifts, for example. He had some qualms about the so-called golden rule, and in fact, in the succeeding few days, he would circulate a working paper in which he strongly criticized the golden rule, albeit indirectly. In the context of the discussion of the golden rule, it was always assumed that there was a clear way of distinguishing capital expenditure from current expenditure, whereas—for example—even between the United States and Germany, there were different ways of assessing what was capital expenditure and what was not, depending, inter alia, on the time frame for, and the durability of, the assets. That suggested that many games could be played with respect to the reclassification of expenditures.

The staff representative from the Fiscal Affairs Department stated that the evidence was mixed as to the effectiveness of balanced budget rules in enforcing fiscal discipline. Of course, there was not a very long track record about that, except perhaps for states in the United States, many of which had introduced fiscal rules for the first time in the middle of nineteenth century. At the national level, a number of western European countries and Japan had established the golden rule after the World War II. In most of those countries, the rule had had some effectiveness in contributing to macroeconomic stabilization.

More recently, the use of fiscal rules had been successful in the case of New Zealand where, even before the Fiscal Responsibility Act of 1994, budget surpluses had been generated year after year, the staff representative continued. Fiscal rules had also been successful in a number of the European countries in the period of the runup to EMU, as it could be seen that fiscal consolidation was in place and had had some initial results in terms of falling interest rates. However, that was not to say that the rules were necessarily sustainable without there being further structural reform in those countries. In general, it could be said that budget balance rules, when applied stringently, were relatively successful, as the track record of some states in the United States and, to a lesser extent, in the German länder showed. Although, in the case of developing countries, the track record of fiscal rules was mixed, in the case of Indonesia, for example, the manner in which the rule had been applied had instilled a degree of fiscal discipline that other oil producing countries, and countries at a similar stage of development, had not attained.

Deficit reduction in the medium term, and in the context of the runup to the EMU, had been accompanied by benefits in terms of macroeconomic stabilization and a reduction in interest rates, the staff representative considered. Research indicated that, in general and over time, fiscal consolidation led to increased output, at least in relation to what would have been the case in a counterfactual situation. The picture looked mixed in the short run, with the composition of fiscal consolidation being a key consideration, as illustrated by the cases of Denmark and Ireland in the convergence to EMU. In those countries, the soundness of the fiscal consolidation efforts had prevented a decline in output or other costs in terms of forgone output, whereas in other countries—with a less than optimal composition of fiscal adjustment—there had been cuts in investment and in productive expenditures, and a reliance on tax rate increases that had added a cost in terms of output forgone.

The unemployment record in different countries should also be taken into account, the staff representative considered. In the case of the European Union, there were a number of countries with rather high unemployment rates, and the question was whether that was attributable to the fiscal consolidation. That experience differed from that of the United Kingdom and the United States, which had undertaken fiscal consolidation efforts without an increase in unemployment; in fact, the opposite had happened, with unemployment rates falling. The different experiences could be attributed to the presence of labor market rigidities in some European countries, which, in the light of the fiscal consolidation, seemed to result in an increase in unemployment.

The variability of output also needed to be considered, the staff representative continued. There had been limited, live tests of actual performance in public finances and output performance for the states of the United States. The output variability that could be attributed to the balanced budget rule did not seem significant in those cases. Therefore, in the staff paper on fiscal rules, the staff had relied on MULTIMOD-based simulations, which indicated that the variability of output would increase with balanced budget rules, but not to a significant degree. Also, work done at the European Commission indicated that, given, inter alia, the GDP elasticities of taxes and unemployment compensation in EU countries, the 3 percent-of-GDP fiscal deficit limit could actually accommodate the operation of the automatic stabilizers for most EU members, provided that those countries aimed to maintain a structural balanced budget.

Regarding the compatibility of the 3 percent-of-GDP deficit limit under EMU with the large unfunded pension liabilities in the social security systems in Europe, he had presented a research paper about a year ago on a related topic—under the title *Are Europe's Social Security Finances Compatible with EMU?*—the staff representative recalled. The conclusion of that paper was that the picture was mixed, and that there were countries that really could not adhere to EMU. Perhaps they could jump into EMU and comply with the Maastricht limits at the very outset, but then there would be much work for them to do in terms of reforms of the social security system to sustain that compliance. There had been a heightened awareness of that problem over the preceding year, in particular. What was happening in Italy was a vivid illustration of the effort to establish compatibility in that area. Also, a staff project was currently under way that would result in a paper on EMU for Board consideration in 1998, and the issue of the compatibility of European social security systems with the EMU fiscal deficit limit would be one of the issues investigated in that paper.

Mr. Wijnholds commented that he was surprised by the Director of the Fiscal Affairs Department's skepticism about fiscal rules. He trusted that, considering that the staff paper on the subject was currently before the Board, Fund management felt more positively about them. As some of his colleagues and the staff representative from the Fiscal Affairs Department had noted, the golden rule had been observed in Netherlands for some time. About 10 years ago, the Netherlands government had had a discussion on budget rules and norms, and the golden rule had come up as one of the alternatives. It had been widely discussed, and while there had been quite a bit of support for it, it had eventually not been adopted. As the Director had indicated, one of the strong arguments put forward against it was the fact that there could be a problem with the definition of investment. He wondered how the United Kingdom was addressing that particular problem.

He found somewhat puzzling the reaction of Ms. Lissakers and Mr Sobel to the staff's recommendation that a formal rule be implemented only following a period of successful discretionary adjustment, Mr. Wijnholds observed, especially as he tended to agree with that recommendation. It would probably not be very helpful to try to implement fiscal policy rules when the budget was way out of line and spending not well controlled. Once the remedial measures were begun in that regard, in order to finish the job, it might be useful, at least in some instances, to have a rule to help maintain the course; that had been the experience in the Netherlands.

He was not sure that he could concur with Mr. Shaalan's view that the experience of the EMU economies clearly demonstrated that the reduced flexibility associated with fiscal rules might have been responsible for some of the slowdown in growth and increase in unemployment, Mr. Wijnholds remarked. In at least two countries that he was aware of—Denmark and the Netherlands—quite a bit of fiscal consolidation had gone hand in hand with increases in employment and satisfactory growth rates.

Mr. Sivaraman stated that, with respect to the operation of a balanced budget rule in a federation, it might be noted that almost all the states in Malaysia had balanced budgets, except on rare occasions. He was not sure, however, whether that was the result of a fiscal rule or some other factor.

Concerning the question whether it was important to balance the budget as a whole, or only the current account, Mr. Sivaraman continued, there was a problem of defining the current account, because certain items of a capital nature could be included in the current account, and certain items of a current nature could be included in the capital account. Whether balance in both the current and capital accounts over a period of time was advisable should be examined further.

Mr. Shaalan, commenting on the distinction between the capital account and current account in the budget, said that capital account items tended to be thought of as productive investments, and from that perspective, that current account items—as opposed to capital account items—could be cut more easily. He would submit that, in many cases, current account expenditures—such as for education and maintenance—could very well be as important as good capital investments, if not superior to them.

Mr. O'Donnell said that a number of universities in the United Kingdom were working on the problems related to the measurement of capital. Keeping the budget deficit within bounds was necessary in the context of sound macroeconomic policies overall. Another consideration was maintaining the budget with a certain profile so as to ensure intergenerational equity, and in that respect, the accurate measurement of capital investment as opposed to current investment became highly relevant. In that connection, what Mr. Shaalan considered a manifestation of current spending—namely, spending on education—he would classify as human capital spending; thus making a distinction that could be universally accepted was not easy. Another example was the classification of certain armament expenditures as current expenditures when actually the items were quite long lived. The problems with measurement should not, however, detract from the importance of getting the economic concept right.

The cyclical deficit versus the structural deficit was clearly another important issue, Mr. O'Donnell continued. While it might be difficult to draw firm distinctions between them on a practical basis, the idea that there was a cyclically adjusted deficit should not be thrown away simply because of an inability to agree on a precise definition of what the cycle was.

It was important that the Fund not become overly preoccupied with defining what constituted a procedural rule and what constituted an objective, as the fact was that the possible approaches represented a spectrum rather than two opposing points, Mr. O'Donnell observed. Even if the U.K. Parliament passed a rule, it could not bind future parliaments to it, and the same situation existed in a number of countries. In his view, the true standing of a rule or objective depended upon the reputational, political, and economic costs that would need to be borne were that rule or objective to be repealed. That applied to the Maastricht rule—and one could regard that as a rule, because it was an international treaty—as well.

Mr. Daïri made the following statement:

I do not see enough evidence that fiscal rules, as defined in the paper, are superior to discretionary fiscal policy. While fiscal rules may be useful in some countries for their particular institutional or political circumstances, the stance of fiscal policy is better assessed against current or projected economic and social developments than in relation to specified rigid rules, such as limits on borrowing or balanced budget targets. The main rules that need to be observed at all times are those related to transparency, discipline, and accountability. The ideal fiscal rule, as described in the paper, seems to be extremely difficult to design and to implement in the real world. Like Mr. Zamani, I believe that the responsibility for adopting fiscal rules should lie with the authorities. The role of the Fund staff's role should be limited to helping member countries in assessing the balance of advantages and risks of these rules and the conditions for their success. The adequacy of fiscal rules is also to be examined with due consideration to the stage of development of the member country and the respective anticyclical roles that fiscal and monetary policies can play.

I concur with Mr. Kaeser that greater transparency in government operations is an important element to achieve a sustainable fiscal stance and good governance. I support the publication of information on quasi-fiscal activities and contingent liabilities that may improve the coverage of government's operations. Availability of a high-quality statistical system and accrual-basis accounting, in addition to a cash-basis accounting would also help achieve greater transparency. I support the staff's proposal for supplementing budget presentation with measures of fiscal balance, indebtedness, and tax expenditure, and for setting the fiscal policy in the context of a medium-term framework.

However, like Messrs. Shaalan and Al-Turki, I do not support the proposal for the Fund to establish a code of good practice in transparency based on best practices. The performance of each country in this respect is to be analyzed in relation to its stage of development and progress made to achieve greater transparency. When considering these factors, many developing countries may be performing better than other more advanced economies. However, I can support Mr. Tanzi's proposal to draft a very short paper on general principles for transparency without reference to best practices or code of conduct.

I agree with Mr. Shaalan that the need for additional resources to meet these new Fund responsibilities may have been downplayed. The issues addressed in the staff paper are complex and very sensitive and require that high quality and experienced staff be available for discussion with the authorities. Like Mr. Shaalan, I cannot support new additions to our activities, unless a realistic assessment of the needed staff resources, including their budgetary implications, is fully identified.

Finally, I would like the staff to indicate why it considers it necessary to single out the Middle East as a region where countries are engaged in nontransparent fiscal practices (see page 64, paragraph 177, of the paper on transparency).

Mr. Fernandez made the following statement:

I would first like to commend the staff for the stimulating papers on fiscal policy rules and the connected issue of transparency in government operations.

The issue of fiscal policy rules is evidently of great interest at a time when several countries are embarking on the process of abiding to such rules, as for instance the United States with the Balanced Budget Act and the members of the European Union with the Maastricht criterion. I am pleased to read that the staff supports the carefully crafted EU approach regarding budget deficit requirements, considered in paragraph 48 as broadly responding to the definition of an ideal fiscal rule.

A critical question is whether the tendency to develop fiscal rules is a historically dated response to the apparent failure of discretionary policies in the past twenty years, characterized by an increase in deficits and debts, or if it reflects the intrinsic superiority of the former on the latter. I see a stronger ground in the first argument than in the second.

Therefore, I share Mr. O'Donnell's view that the rationale for fiscal rules versus discretionary policy could have justified a more thorough theoretical analysis. Developments on the deficit bias, by which governments tend, under political pressure, to redistribute income from future generations to present generations of voters, are interesting: I agree with the staff that the most powerful argument for fiscal rules centers on their political economy aspects, but experience does not tell us much about the conditions required for rules to be effective at forging consensus. I would only point out that the public endorsement of their quasi-constitutional character appears to be an essential feature.

On the whole, I would remain cautious. Like Mrs Lissakers, I was puzzled by the staff comment that a "formal rule preferably should be implemented following a successful discretionary fiscal adjustment." And, as Mr. Kaeser puts it, fiscal rules are not a panacea for a lack of fiscal discipline.

I also support the staff's views that fiscal policy rules should be dealt with very carefully: useful in a certain context and if well designed, they can be disruptive in other circumstances. If appropriate conditions are absent, they should not be put in place. In any case, they ought to be supported by structural measures.

Turning now to the linked issue of transparency in government operations, I agree that it is a condition of good governance. The paper illustrates comprehensively many aspects of demanding discipline for all countries, necessary to sustained macroeconomic policies. The staff is nevertheless right to point that secrecy remains legitimate in certain circumstances in order to allow economic policies to be implemented in an orderly manner.

We have to concentrate on the most important elements of transparency, two points seem of critical importance. First, full and timely disclosure of cash accounts abiding to classical but central features of universality, annuality and unity. Without transparent and accountable budgets, the goal would be missed. Second, comprehensive disclosure of data related to debt and publicly warranted debt. Previous Fund documents have emphasized the importance of setting a transparent institutional structure, centralizing debt management and separating debt management from monetary policy. Of course, further steps such as accrual-based accounts, generational accounting or government balance sheet are interesting, especially because they help to understand implications of current public policies: but they should not distract from the essential compliance with basic essential rules.

I agree that priorities should differ among groups of countries as suggested in paragraph 65. The Fund has played a very useful role in developing and transition economies where a particular attention must be given to the weak fiscal position.

Finally, I broadly support proposals listed in paragraphs 54 to 59, yet with some questions on the opportunity of issuing a so-called manual of best practices. I can support the recommendation to subject to conditionality elimination of nontransparent practices in Fund-supported programs, when these practices have a clear impact on macroeconomic performance and when they can be clearly identified. Could the Policy Development and Review Department confirm my impression that we already do it? But, as others, I wonder what we would be trying to achieve with a manual of best practices. The risks of such an exercise and over-systematization should not be underestimated, while its relevance does not seem obvious given the central role of a case by case analysis. At least, discussions on its precise content and priorities should be necessary before embarking the staff on a time-consuming task in a context of constrained resources.

Mr. Toribio made the following statement:

It was very appropriate, in my opinion, to decide a joint discussion of the two policy papers on "transparency in government operations" and "fiscal policy rules." Both of them deal with government responsibilities and, above all, both are aimed to prevent short-term political pressures from interfering with the longer-term requirements of economic rationality.

The staff's remarkable papers and the statements of my colleagues hardly leave any intellectual territory to be covered by further thinking, but still I would like to contribute some short comments on both issues.

Regarding transparency, it seems to me little justification is needed to support its introduction in public life. I was, therefore, a little surprised by the discussion on the arguments for (there are many) and against (there are few, if any) the need for transparency in fiscal matters, as developed by pages 4 and 5 of the corresponding paper. Openness and clarity in government operations are probably self justified on moral grounds and, of course, they lead to a faster and more accurate judgment on the part of market sentiments about the merits and shortcomings of the policy program being applied. With full transparency, there is, therefore, less room for mistakes and for mischief in economic policy and the results will necessarily show it. The fact that morality and efficiency go in parallel should not be a surprise at this stage, but it is always comforting to find new instances to reassure ethical principles.

Of course, disclosing things at the wrong time could constitute a serious mistake. Untimely expectations may be created, thus impairing the ability of policymakers to effectively implement their economic strategy. But that does not mean that openness and clarity in fiscal matters may be inconvenient. On the contrary, it only comes to proof that transparency, like many other human virtues, has to be applied with intelligence and good judgment. That combination of virtue and intelligence is probably what we call "wisdom," a quality so difficult to find.

But, after these philosophical reflections, let me be a little more concrete in my remaining comments.

Box 2 on page 14 of the staff paper gives a very complete summary of best practices in government accountability. It may constitute a solid starting point for a "manual of good practices in fiscal transparency" which, in my opinion, the staff should prepare and publish, as a reference for both its technical assistance and their future surveillance activities. This Board would, also, find in such a manual more and better criteria to pass a balanced judgment on the appropriateness of supporting some policy packages.

I would also favor the proposal to let the staff engage in a systematic documentation of transparent practices in member countries, should we also compile a list of countries with nontransparent practices as the staff proposes? I would prefer to be very cautious about it. These type of judgments are always better accepted when passed in positive terms and tend to become a source of conflicts, otherwise. Being absent from a table of well-behaved countries may be embarrassing enough. Let's postpone the list of vicious authorities for a later stage.

In any case, I am afraid we will always face important difficulties deriving from the fact that government budgetary systems are conceptually much less developed than private and corporate accounting principles. Very few governments would be able to publish a double-entry balance sheet, or a clear income statement. Government budgets usually mix up expenditures of a very different nature, and more than a few of their accounting practices would be unacceptable for modern corporate auditing standards. Why is it, for instance, that "creative accounting" is so much easier and accepted in government operations than in public traded private companies? In my opinion, the staff of the Fund—perhaps in cooperation with private auditors—could make an important contribution to the advance of public accounting not only as a technique, but also as a conceptual system. Otherwise, it may be very difficult to derive clear and relevant information from a conceptual instrument which has changed so little in the past several decades.

I have also missed in the staff paper a reference to those fiscal practices that so frequently tend to conceal the true burden of taxes from the eyes of taxpayers. Such is the case of tax discounts from the payroll instead of active Income Tax payments, or the inclusion of value-added tax or sales taxes in the final price of a product and service and so on. Governments should, in my opinion, be specially clear and transparent in their collection of taxes, because only informed taxpayers may place an effective limit to the public spending bias of modern democracies.

And that takes us to the second paper about fiscal policy rules. I agree with the staff in its pointing out that whatever theoretical superiority of discretional fiscal programs, policy rules may constitute a second best solution to reduce the politically induced deficit bias of many governments.

Trying to go deeper in the characteristics of ideal fiscal rules would take me—I am afraid—to simply repeat a lot of what the staff describes in its papers and many of my colleagues have so clearly analyzed in their statements. Such characteristics, when applied to the major types of fiscal policy rules listed in Box 1 (page 5) of the staff paper can provide rational elements to judge the relative merits of each one.

I would like, however, to express a partial disagreement with an statement of the staff (page 28) according to which "prohibition or limits on government access to central bank financing can be useful, especially in developing and transition economies for restraining inflationary pressures."

First, prohibition or limits on government access to central bank financing goes, in my opinion, well beyond the field of a simple fiscal policy rule. I think it constitutes, in fact, a clarification of the roles of two important players—governments and central banks—in modern economies, with repercussions not only on the fiscal side but also on the monetary field, as well as on the structure of financial markets. But, above all, with consequences on the institutional architecture of policy making.

In the second place, I do not see why prohibition of government financing by central banks may have a special interest for transitional and/or developing economies. It has been—and it probably still is—as useful for advanced economies, as shown by the case of the European Union, where inflation rates have uniformly declined after the Maastricht Treaty introduced that prohibition.

As for the rest of the suggested fiscal policy rules, I have very little to add at this stage. All of those rules have, in my opinion, to be simple, clear and transparent if they are going to serve any purpose. That's why I said at the beginning of this statement that both issues—rules and transparency—seem to be so obviously interrelated.

In both accounts, the Fund staff have an important role to play and I would appreciate if they keep this Board informed about their goals and activities in the near future.

Mr. Yoshimura commented that he agreed with Mr. Toribio that many governments had old and outdated accounting practices in the government budget, including his own government. However, at the same time, governments needed to find ways to account for activities in which the private sector did not engage, and in that respect, the accounts of a government could not always follow exactly the accounts in the private sector. In particular, the maximization of profits was often a goal of the private sector, but it was not necessarily a goal of the public sector. While the achievement of profits could be quantified, it was more difficult to quantify achievement of the often different objectives of the government sector. Also, governmental activities often were concerned with powerful externalities, and were often implemented with a long-term horizon. For those reasons, it was inappropriate to apply to the activities of government the same yardstick as that applied to the activities of the private sector, including from the perspective of the government's budget and fiscal activities.

Mr. Toribio replied that he concurred with Mr. Yoshimura that the nature of the operations of governments was different from the operations of private corporations. In that vein, he was not suggesting that a government simply adopt the double-entry accounting practices of the private sector. At the same time, it needed to be recognized that the accounting capabilities and innovations of the private sector were much more developed than those of the public sector. In his view, the time had come to give more attention to the conceptual framework of public accounting, to see whether as much progress could be made in it as had been made in private accounting over the preceding century.

Ms. Lissakers commented that she agreed with Mr. Toribio. The Fund was well placed to do additional work in the areas identified by Mr. Toribio.

To the extent that there were trade-offs between work on fiscal policy rules and transparency, and to some extent there was, she would give greater weight at the current juncture to the transparency issue, because it went to the heart of the quality of policy formulation, Ms. Lissakers considered. The trade-off between fiscal rules and transparency was illustrated well by the experience of many of the U.S. state governments, to which the staff had alluded. New York State, for example, was a textbook case of how to follow the fiscal rule and violate all the rules of fiscal transparency. Fiscal transparency raised many serious philosophical and analytic issues, and Mr. Toribio was right in suggesting that a compendium be assembled laying out the best practices, if not a code of conduct. She could understand the reluctance of some of her colleagues to embrace the concept of a code, which would imply that there was a law that would have to be followed. A manual of best practices, which could analyze the experience of many different governments that had dealt with those issues, and the staff's view of which solutions were preferable, would avoid that. Such a listing of best practices would help to move in the direction of greater standardization of government accounting and greater clarity in accounting treatment.

Mr. Sivaraman said that he agreed with Mr. Toribio about the differences between the system of government accounts and the system of private accounts. Company practices had advanced a great deal with the adoption of internationally accepted accounting standards. He recalled that, in the late 1960s or early 1970s, the United Nations had written a budget manual based on the system of national accounts, so that there could be a one-to-one correspondence between the budget operations of a government and the system of national accounts. The United Nations system was very transparent, but it had a number of deficiencies. For example, it tended to be inadequate in years in which the government's share of economic activities was large, and in that case many items of expenditure would be missing from the budget—such as for depreciation and maintenance of government assets.

The budget could be transparent with regard to many items of expenditure; or it could be opaque with respect to some items of expenditure, but the opacity of which—relating, for example, to quasi-fiscal operations—could be removed by some thought, and the drawing of conclusions regarding the material that had been presented; or it could be completely opaque, perhaps clear only to the person who had written the budget, Mr. Sivaraman pointed out. In talking about transparency, he was not sure whether all the items needed to be uncovered, and indeed, he was sure that many countries, quite rightfully, would not like to have uncovered some of the items of expenditure included in the budget. In preparing a manual of fiscal rules or of budget operations, what was really desired, and what governments were really expected to do, should be made clear.

Mr. O'Donnell noted that he agreed with Ms. Lissakers that developing the area of transparency should take priority over developing fiscal rules, if there were a trade-off in terms of staff time. It was clear that many of the problems that had been encountered in Fund surveillance had arisen because of failures of transparency, not because of failures to apply fiscal rules.

Mr. Toribio's point about the analogy between private sector accounts and public sector accounts was important, Mr. O'Donnell considered. Many private companies had, in fact, two sets of accounts: a profit and loss account, and a balance sheet account. Most governments had a profit and loss, but not a balance sheet account. The United Kingdom was only just starting to think about assembling a public sector asset register, and that was perhaps an area in which the Fund could lend its assistance, especially in defining rules and seeing the most sensible way forward.

Mr. Yoshimura said that he shared the view of other speakers about the importance of learning from the private sector's accounting practices. At the same time, it needed to be borne in mind that it was difficult and expensive to do a reliable cost-benefit analysis in respect of many activities of government.

Mr. Yao said that he agreed that priority should be given to working on transparency rather than fiscal policy rules. In discussing transparency, the extent to which the nondisclosure of sensitive information might contribute to the violation of the principle of fiscal transparency needed to be known.

Mr. Sivaraman added that a clear view needed to be had of what constituted the assets and liabilities of the government. In particular, it needed to be clear whether they were assets and liabilities created solely through the budget, or whether such things as natural resources were included. He would be keen to see how the national asset register was prepared in the United Kingdom.

Mr. Esdar made the following statement:

The Fiscal Affairs Department has provided us with two excellent and very comprehensive papers. I can easily endorse most of the findings and conclusions because the analysis is not only convincing but it also reflects our own thinking.

On fiscal transparency, I can be brief, indeed transparency in government operations is a crucial precondition for a reasonably educated fiscal policy, for its sustainability, for good governance and for the overall fiscal rectitude. This is also reflected in the Declaration on a Partnership for Sustainable Global Growth. Transparency has to be established in all its dimensions, i.e., reliable information on the government's intentions and forecasts; detailed data information about operations including quasi-fiscal activities; rules of conduct for officials and for the implementation of policies, as discussed in paragraph 5 of the paper.

Against this background, we welcome and endorse the staff's intention to help countries to improve transparency. In this context, a manual of general rules could provide in our view a good instrument to support countries in their own efforts. However, there are some aspects which should remain in mind.

First of all, such recommendations have to be sufficiently flexible to meet the particular circumstances in each member country. Fiscal policies in member countries are based on different institutional settings and philosophies and sometimes are also based on different accounting rules. Obviously, there can be no one-fits-all solution or recommendation.

Second, while we agree that there should be a comprehensive and broad data information, we have to avoid an overloading of the information system and we have to be aware that there may be trade-offs between information requests and cost considerations.

Finally, there should be a distinction between data which are required to be published in order to meet minimum transparency requirements and those which provide additional and in particular analytical information which might be published voluntarily. In this context, I very much agree with Ms. Lissakers and Mr. Sobel who remind us that cyclically adjusted fiscal figures should be taken and interpreted with caution. Also, Mr. Wijnholds and Ms. van Geest's comments confirm the need to be cautious.

In addition, I have some specific remarks to the staff paper.

In paragraph 10, page 4, it is stated that countries with high fiscal transparency have usually exhibited greater fiscal discipline and more robust economic performance. We would certainly appreciate if such an outcome could be confirmed statistically beyond all doubts. However, it might also be true that a convincing fiscal performance might encourage governments to use increased transparency to disseminate the information of this well-doing and vice versa. At least such a reversal of the logical chain should be kept in mind when interpreting empirical experiences.

In paragraph 17, page 8, the staff discusses potential justifications for a temporary departure from transparency rules or commitments. While I in general would not question the need for such flexibility, I would like to draw attention to the fact that it might prove to be very difficult to define appropriate borderlines.

Let me now turn to the paper on fiscal policy rules. Also here I can be very brief because I concur to a large degree with the staff's considerations.

Indeed, fiscal policy rules can strengthen fiscal credibility, they can help to stabilize expectations and in so far strengthen the base for economic stability, low interest rates and eventually economic growth. However, it is also clear that fiscal policy rules are by no means panaceas. Also a rule-based system has to provide sufficient flexibility for the proper working of automatic stabilizers and to provide room for structural reforms. It also increases the pressure on the government to justify such requests for changes which, by the way, should be seen as an advantage, also in light of the first topic of our discussion.

Fiscal rules have a special importance in the framework of monetary unions like EMU. Under a monetary union, destabilizing fiscal policies of one member can pose risks to the overall stability of the whole system with negative effects on the policy mix and on interest and capital market rates. This could also pose a threat to the external value of the common currency. Also, the acceptance of unsustainable fiscal imbalances of member states might generate bailout expectations and negatively affect the sustainability of the overall system.

The Stability and Growth Pact is the European response to these interactions. This pact is described in detail in the paper. While it provides a clear and transparent framework for fiscal policy, it also provides sufficient flexibility for automatic stabilizers to work. With the different elements of the Stability and Growth Pact including its sanction mechanism and its exemption rules it provides a framework which is transparent and fully predictable for every member state.

In this context, I would like to make one comment on paragraph 78, page 33, of the staff paper. The last sentence gives the impression that failure to observe the reference value on debt would not be subject to financial penalty. The excessive deficit procedure of Art. 104c of the Maastricht Treaty foresees also financial penalties in case of nonobservance of the debt criterion.

But also besides the EMU context, there are other fiscal rules which are worthwhile to be further discussed. For example, in Germany, the so-called "golden rule" restricts public borrowing to the amount of public investments in order to limit public deficits and especially to unduly carry forward fiscal burdens to coming generations. We noted with interest that this rule has also found acceptance by our British friends.

There can also be no doubt that the so-called convergence criteria has a significant impact on fiscal performance in Europe. Since 1994, EU deficits have been cut in half and are expected to go down further in 1998.

Therefore, I concur with the suggestion to further look into this topic and further discuss advantages and disadvantages of fiscal rules. This would certainly strengthen our knowledge and broaden the base for program negotiations as well as our consultation process. It might be worth considering whether the staff, in the long run and based on its experiences in the consultation process, could elaborate on a kind of textbook for different sets of fiscal rules discussing the pros and cons of each particular system.

Mr. Bernal made the following statement:

We are grateful to the staff for its very useful set of documents. The paper on transparency in government operations identifies clearly the most important issues. We believe that the main area in which the Fund should encourage greater transparency is the production of fiscal accounts. Adequate fiscal information means to have adequate coverage—including quasi-fiscal activities—to produce very timely data and to use the proper methodologies which would permit adequate comparison among countries. The externalities of good information are many. It improves the understanding of the economy, it permits the development of accurate projections, and, additionally, it provides the basic input for designing better and sounder economic programs.

With respect to disclosure of information, we think it is important by itself, and perhaps also, a way to face corruption problems. However, there are circumstances when a temporary departure from disclosing information is justified; in consequence, the timing of public disclosure requires very good judgment.

The Fund staff should be more active in promoting transparency in government operations, as suggested in paragraphs 54–58 of the paper on transparency, with strong emphasis on the fiscal accounts production, including coverage, proper timing, and publication of the information. Perhaps in order to attach more importance to fiscal data, it would be necessary to revisit the issues of fiscal data on the SDDS. Similarly, it would be advisable that the staff accelerate its efforts to publish and encourage the use of the new fiscal accounts manual.

When analyzing the validity of fiscal policy rules in comparison with the use of a judicious mix of discretionary fiscal and monetary policies, economic theory gives the latter option the higher likelihood to be successful in attaining price stability and sustained growth, provided that it allows for the needed flexibility in economic policy management. Nevertheless, evidence shows that this approach has not always been effective, and that wide swings in fiscal performance have resulted in higher than expected costs during the adjustment process. In these circumstances, the initiative of governments of adopting fiscal policy rules, as a second-best solution, merits consideration—and in some cases probably support—by the Fund.

In a context of transparency, fiscal policy rules can be a helpful tool for governments which are committed to fiscal discipline. While fiscal policy rules, per se, cannot be effective without the willingness to adhere to them, they could certainly be helpful in promoting fiscal action, particularly in cases where political factors explain the lack of fiscal consolidation. In that sense, we agree with the staff that the most powerful argument for fiscal policy rules centers on the political economy aspects.

Thus, the use of fiscal policy rules can induce more fiscal discipline. In that context, we accept them as a tool for macroeconomic coordination. However, since fiscal outcomes are not only the result of fiscal policy actions, it is important to have some degree of flexibility to accommodate external or internal shocks. It is clear that the decision of adopting fiscal policy rules should be a privilege of member countries. The staff should explore approaches to assessing and monitoring fiscal rules, as suggested in the paper.

Finally, the staff might wish to comment on the effect that a more active involvement in the activities being discussed today, would have on the demand for staff resources. Would additional staff be needed or is it a matter of reorientation of activities?

Mr. Yoshimura made the following statement:

I appreciate the staff's efforts in providing us with readable, well-documented papers on transparency in government operations and fiscal policy rules. Both topics are important for improved macroeconomic management, and I appreciate the opportunity to discuss them at the Board today.

I share the staff's view that enhancing transparency in government operations—in particular, in the area of the public finances—will contribute to strengthening fiscal discipline and have a favorable effect on macroeconomic performance. Moreover, the authorities of member countries, as participants in the financial markets, are faced with an increasing demand for transparent fiscal and reporting systems, as they have more chances to access today's highly globalized international capital markets. In this context, I think it is desirable that the Fund play an active role in promoting transparency in government operations.

The approach that the staff paper uses to examine fiscal transparency—namely, to focus on institutions, public accounts, and indicators—is an appropriate one. The Fund's involvement in the efforts to enhance transparency through surveillance, technical assistance, and program design should be considered based on this approach. The staff paper suggests the idea of introducing a manual of best practices to guide the Fund's work in this area. This chair supports this idea. What we have to keep in mind, however, is that the development stages of fiscal and accounting systems differ from one country to another, and an oversimplified approach might not be appropriate. In this regard, the staff paper presents the sensible idea of having a different emphasis for different country groups, and stresses the need for enhanced provision of information in the advanced economies, and the need for institutional reform—such as improving transparency in quasi-fiscal activities—in the developing economies.

When considering the Fund's work on the transparency issue, we should also take into consideration the resource constraints that the Fund is faced with. In this respect, in my view, we should give priority to addressing the difficulties of the countries facing the basic problems of improving fiscal transparency, by helping them to make their fiscal structure more transparent and, from a broader perspective, improving their governance. More specifically, I think it is desirable for the Fund to pay more attention to whether there are proper systems in place to secure appropriate execution of a country's budget. Although this might possibly fall outside of the field for which the Fund is responsible—namely, the aggregate side of macroeconomic policies—it is important for the Fund to provide necessary policy advice when problems in the execution of the budget are of such a magnitude as to have a severe negative impact on macroeconomic performance.

We have seen several instances in recent years when fiscal policy rules have been employed with a view to securing disciplined fiscal policy management. While I note with interest the staff's observation that economic performance under fiscal policy rules has so far been mixed, I also share the view stated in the paper that discretionary fiscal policy tends to give in to the built-in bias toward deficits, and to undermine fiscal discipline. I am thus of the view that fiscal policy rules can play an important role in strengthening fiscal discipline, and I think our discussion today is quite useful.

In order for fiscal rules to be effective, they have to be designed carefully. The staff paper lists several important features of well-designed fiscal rules, such as good definition and transparency. They are all very important features. In my view, however, the characteristic of transparency is of utmost importance. Fiscal measures to achieve certain fiscal rules should not be temporary or one-off in nature. Rather, they should be structural. This is critical if the fiscal rules and measures are to gain credibility.

In order for fiscal rules to be effective, it is also important for them to be supported by various elements outside the rules themselves. As the staff paper argues, the effectiveness and credibility of fiscal rules depend critically upon how widely the rules are shared and supported by the nation as a whole. The introduction of fiscal rules has to be backed by the strong support and understanding of the people as well as the government. For instance, Japan used to maintain the principle of a balanced budget until 1965, and it also followed until 1975 the fiscal rule, stipulated by law, that allows the government to issue government bonds solely for the purpose of financing social infrastructure development. These fiscal rules helped prevent a large fiscal deficit during the postwar reconstruction period, and had the widespread

> support of the people. However, with the introduction of an active stance in fiscal policy in response to the economic slowdown in the 1970s, special legislation has been passed each year to override the original law that provides legal grounds for these fiscal rules, even while the original law still exists. This shows that not only the existence of the rules, but also the widely held support and commitment of the people, is critical. Thus, it is important for the Fund to keep in mind that, in the course of its future work in assisting member countries to establish fiscal rules through surveillance, technical assistance, and program formulations, proper considerations to support the fiscal rules are imperative if the rules are to be effective, and that situations surrounding fiscal rules will differ from country to country. It is important to tailor fiscal rules to each country's economic conditions, as well as to its capacity to carry out economic policies. In Japan, the government will submit the bill for reforming the fiscal structure to the Diet this week. The target of a fiscal deficit reduction to 3 percent of GDP by the year 2003 is included in this proposed bill. We now have the broad support of public opinion for fiscal consolidation in our country, and I therefore think that this new rule will be supported as well.

Mr. Esdar commented that, with respect to Mr. Yoshimura's suggestion that it might be appropriate to tailor rules on fiscal transparency to the circumstances of individual members or groups of members, he would be a bit reluctant to accept the idea of developing different standards for different countries. Rather, in developing rules, the fact that there could be different systematic approaches to fiscal policy needed to be borne very much in mind. Otherwise, the same approach that had been taken in the context of the provision of data would be followed, and two different standards, one more highly developed than the other, would emerge, which would be unfortunate. The stage of development of a country should have no bearing on the requirement of budgetary transparency, in his view.

Mr. Grilli stated that Mr. Esdar had touched on an important issue, especially if the Fund were to develop a manual of good practices. In that connection, what would be the minimum requirements for transparency in all cases, which could be applied to all, would have to be decided, along with what was desirable, but which might not necessarily be applicable to all, at least not in the beginning. It might be costly for some countries, under certain circumstances, to achieve all at once the high standards of transparency in all areas that was the objective, and that needed to be borne in mind. Any manual of good practices needed to guard against creating a situation in which the best became the enemy of the good.

It also needed to be borne in mind that the purposes of promoting transparency could go far beyond the mandate of the Fund, and in that respect, the Fund would need to define its mandate in that area with great care, Mr. Grilli considered. While it would be desirable to have the highest standards, both moral and fiscal, those standards could not be forged in the abstract and applied without regard to the circumstances of individual countries. The Fund's mandate in the area of transparency should be limited to those elements of transparency that had an impact on macroeconomic performance.

Mr. Sivaraman said that most of what he had wanted to say had been said by Mr. Grilli. He wondered whether, in measuring the fiscal deficit, quasi-fiscal operations and the operations of state-owned enterprises should be included. That and similar questions would need to be taken into account in deciding on the kind of transparency in budgetary operations that the Board was seeking. It could be understood that the universal rules regarding transparency would be applied uniformly to all countries, as Mr. Esdar had said. For example, any transfer of funds between state-owned enterprises and the government should be properly reflected in the budget. However, certain practical problems in respect of certain countries needed to be recognized. A country might view the operations of its state-owned enterprises entirely differently because they were governed by a different set of laws, and were subject to a different kind of accountability.

Mr. Yoshimura said that he also took Mr. Esdar's point about not differentiating between groups of countries. At the same time, the different requirements for advanced and developing countries in respect of transparency should be taken into account. In that sense, he supported the argument of Mr. Grilli to set some minimum requirements, and some additional requirements perhaps for the advanced economies.

Mr. Yao considered that at each stage of development there was a need for transparency of a different kind. For example, most countries in his constituency were not in a position to implement the best practices with regard to indicators and projections. He agreed with Messrs. Grilli and Yoshimura on the need for some differentiation of standards in that regard.

Mr. Taylor stated that the distinctions between classes of countries or stages of economic development could be overdrawn. In several of the countries in his constituency, infrastructural deterioration, caused to some extent by following Fund advice about bringing the budget under control, was under way. Some investments with an unclear economic rate of return were being financed in those countries by relatively cheap borrowing from international institutions. Those experiences illustrated the importance of drawing to the attention of all countries, not just the more advanced countries, the concepts of net worth and intergenerational transfer. The limitations as to the statistical base and the other issues that Mr. Yao had pointed to were realities, but the need to keep an eye on the quality of the stock of government assets was even more pressing for smaller, less wealthy countries.

Mr. Daïri stated that he saw a major difference between the issue of best practices for statistical information and the issue of transparency and governance. Issues of transparency were at the core of the political system of any country, and from that perspective, the Fund needed to guard against making value judgments or deciding that one system was superior to another. That was not within the Fund's mandate under the Articles of Agreement. The Fund should define clearly what it expected to achieve in pursuing transparency.

Mr. O'Donnell said that he agreed with Mr. Daïri that sometimes transparency issues and governance were closely related, and in that respect, the World Bank should be doing something on that issue as well. There might be room for some useful coordination there between the Fund and the Bank.

He agreed with Mr. Esdar about the need to pursue the good at the expense of the best, Mr. O'Donnell continued. There should be some minimum standards. He agreed strongly with Mr. Taylor that the issue of the definition of capital spending and current spending should be look at carefully. That was at the heart of the problem of lending by international institutions with no direct financial interest in the rate of return from particular projects.

Having a code of best fiscal practices would be superior to having a manual, Mr. O'Donnell considered. Semantically, a manual suggested to him a compilation of detailed answers to problems, and of course the Fund would never be able to come up with that. A code would suggest a short set of guidelines, which was closer to what could in fact be achieved.

Mr. Grilli commented that he agreed with Mr. Taylor about the importance of the definition of transparency. In his view, Mr. Taylor's illustration pointed to the need for sound governmental decision making, which was a step above transparency. Transparency was perhaps a necessary, but not sufficient, condition for good decision making. Governments needed to preserve infrastructure, and cost-benefit analyses needed to be done for allocating resources in that direction.

Mr. Andersen made the following statement:

> I join others in welcoming this interesting set of papers providing a balanced and wide-angled overview concerning fiscal rules and fiscal transparency issues, and I support the publication of the papers after appropriate editing. While it is difficult to add anything to the views already put forward in the numerous statements, I would like to offer some remarks for emphasis on both subjects.
>
> Starting with transparency, I agree that transparency in government operations is important to achieve a sustainable fiscal stance and to ensure overall good governance, and that the Fund should be more active in promoting increased transparency in public operations on a macro level through its surveillance activities, technical assistance and program design. There is no doubt that fiscal transparency facilitates the Fund's as well as the market's ability to provide meaningful surveillance over members' macroeconomic policies, as noted by Mr. O'Donnell. Moreover, it seems obvious that fiscal transparency should be promoted in all economies, and that there is a long way to go in its implementation in many countries.
>
> I agree that the issues covered in the paper on transparency are important, especially those concerning the areas where the progress has been modest in many countries, such as transparency over the general government, including estimates of quasi-fiscal operations, hidden subsidies and taxes, and actuarial values of unfunded liabilities like pension liabilities, health entitlements, education and other areas creating future liabilities. Also, I agree that accrual-based accounting should be used more widely, in conformity with internationally accepted accounting standards. Transparency is not just an issue of correct accounting but also of understandable disclosure of policy and policy goals. Disclosure of the policy intent is important as it allows involvement of a wider audience in the debate over the policy. In this context, fiscal projections must be well grounded and supported by realistic, policy consistent and clear assumptions.
>
> As already alluded to, I agree that a stronger involvement of the Fund in promoting greater transparency in government operations would seem appropriate to the extent that the Fund doesn't get involved in micromanagement, but rather promotes transparent policies on a macro level, and gives more specific advice only when the lack of transparency has a

significant macroeconomic effect. The Fund's role in the area should primarily be catalytic and not lead to a demand for significant increases in staff resources. Accordingly, at this stage I would be somewhat cautious in recommending that the Fund staff should devote significant resources to prepare a comprehensive Fund manual of best transparency practices in government operations. We must at least weigh this activity against the other activities the staff will not be able to undertake if we launch this project on a too ambitious level and time frame, and be careful not to overstretch our mandate. Here I very much agree with the remarks just made by Mr. Grilli. Like Mr. Wijnholds and Ms. van Geest, I could see some merits in a less ambitious approach, and I find it important, as noted by Mr. Taylor, that any work in this area should be done in close association with the World Bank and consistent with OECD work. Like Ms. Lissakers, I wonder whether the staff maybe could enlighten us on what other international organizations have done in this area? Another, or perhaps additional, route worth exploring could be whether the SDDS, which was a significant step toward more transparency on economic data in general, perhaps could be broadened to include a few additional categories on public operations. The staff may wish to comment on the possible merits and drawbacks of such an approach.

Turning then to the issue of fiscal rules, there are well known arguments pro and contra in the literature on rules versus discretion and in public choice. It is evident that fiscal rules may lead to better public finances if accompanied by a strong commitment to macroeconomic balance in general and to fiscal discipline in particular. Clearly, they must be formulated in such a way and established in such an environment that they are effective. Thus the causality is not always that straightforward—if it goes from rules to stronger commitment or from commitment to well functioning rules. Here again, of course, transparency appears to be essential for the successful operation of any fiscal rule.

Fiscal rules have an advantage over discretionary rules in time consistency and in making the policy framework more transparent. It should, however, also be kept in mind that there have been cases where rules have been ineffective or abandoned. Obviously, the loss of flexibility which creates confidence in the pursued policies, is also a disadvantage as the possibility to perform an active counter cyclical fiscal policy within the rule might be very limited. This might, however, be outweighed by the positive effects of fiscal rules as easily understood guideposts or pedagogical devices in keeping the fiscal situation healthy. The support in fiscal discipline could be enhanced by clear rules if they are transparent and well explained. In this context, further thought about how to formulate rules that include the effect of today's fiscal undertakings on the future generations might be of value. In some countries, as the staff papers show, such intergenerational transfers have reached dangerously high levels.

This chair agrees with the staff that fiscal rules should not be implemented immediately after the period of a fiscal down slide. The post-crisis correction will, in most cases, require more flexibility, and a rule would not be credible. However, fiscal rules could serve well to sustain the gains of such discretionary correction when fiscal discipline has been reestablished.

Thus, in some cases, the Fund could endorse implementation of fiscal rules with the features mentioned above, and provide technical assistance, for example, in cases where there has recently been a fiscal crisis which was corrected and the gains must be sustained; in cases where there are too many distortions in the intergenerational accounts, or otherwise, the crisis is being postponed to later generations; and in cases where constantly changing political climate brings wide swings in the discretionary fiscal policies. However, the recent proliferation of fiscal rules is no reason for the Fund to change its basic approach to technical assistance and surveillance of fiscal policies. A case by case evaluation of the best road forward for the Fund to recommend with due regard to the individual economic and political circumstances in each country, as well as to other juridical obligations which the member state may have, will continue to be necessary as economic and political circumstances will vary.

Mr. Yao made the following statement:

The set of papers prepared by the staff on "transparency in government operations" and "fiscal policy rules," provide very useful background information for today's discussion.

I share the view that fiscal transparency contributes to macroeconomic stability, mainly because it enhances the accountability of the government in its operations. In that regard, I support the disclosure of policy intentions, budgetary process and public sector accounts. Such a disclosure should aim largely at promoting good governance.

Given the cost of providing detailed information to the market, I feel, like Mr. Shaalan, that the SDDS and GDDS should be the primary means through which member countries provide information to the market.

The staff provided summary of best practices in institutional, accounting as well as indicators and projection. I do agree that a clear delineation between public and private sectors and distinction between general government and state owned non financial enterprises could contribute to transparency in government operations. However, we find the best practices too detailed to be useful as operational guidelines.

It would, therefore, be helpful in the development of the guidelines for transparency to take account of the institutional capacity of countries. At this stage, very few countries in my constituency are in a position to implement the best practices in Transparency of Indicators and Projection. Therefore, Mr. Tanzi's recommendation this morning on simple principles in transparency is welcome. Like Mr. Esdar, we favor "good" instead of "best" practices.

This chair agrees that Fund members should be encouraged to disclose information that has not been widely available in the past, with emphasis on information that could have a destabilizing impact on economic activity, i.e., quasi-fiscal activities. It is however, important to note that many countries may be reluctant to provide detailed information on transactions related to national security. To what extent the non disclosure of sensitive information contribute to a violation of the principle of fiscal transparency.

As regards the involvement of Fund staff in countries' efforts to promote fiscal transparency, I believe that Fund technical assistance would be useful. The achievement of good practices in all areas of transparency will require strong institution and human capital not yet available in most developing countries. It would, therefore, be more advisable to focus on institutional building and human capital development during the technical assistance and Article IV consultations. Having said that, I hope that transparency will not constitute a conditionality in Fund supported programs.

On fiscal rules, the staff seems to indicate that the existence of fiscal rules is not a panacea for a sound fiscal policy, because compliance with these rules have led to distortion in the composition of expenditures or tax increases. I, therefore, believe that in the absence of fiscal transparency, fiscal rules alone cannot enhance fiscal discipline. Fiscal rules could be useful for countries at their early stage of development due to a lack of competent civil servants and weak institutions.

Concerning other advantages of fiscal policy rules, I agree with the staff that they can confer credibility gains. In the case of CFA franc zone countries, the limit on government borrowing has been effective in keeping the rate of inflation low. It has also increased business confidence and attracted foreign investment during a prolonged period.

On the choice of fiscal rules, I note that the staff has cited the main characteristics of what could be considered an "ideal fiscal rule." Among other things, I note that the fiscal rule should be highly transparent and adequate with respect to specified goal. If one accepts the proposition that the main goal of fiscal policy is, together with monetary policy, to contribute to the achievement of stronger economic growth in a stable macroeconomic environment, I wonder whether there is a specific ranking of fiscal policy rules that corresponds to each country's level of economic development.

Finally, I would like to reiterate my support to Ms. Lissakers' proposal to give priority to transparency in government operations.

Mr. Toribio observed that Mr. Yao considered that, in those countries without an independent central bank, limits on central bank financing to the government should be considered a fiscal rule. In his view, the best approach would instead be to provide for the independence of the central bank.

Mr. Prader made the following statement:

Like others, we welcome the long-overdue and many times postponed discussions on fiscal policy rules and transparency in government operations.

These discussions should take us far toward developing the standards of openness in fiscal policy that were promulgated in the Hong Kong Interim Committee communique. We find it particularly useful that the background papers describe practical experience and practices used by various countries in devising fiscal rules and achieving fiscal transparency. The papers reflect the operational expertise that the Fund has accumulated over many years, notably by the Fiscal Affairs Department, and we should try to make full use of this treasure.

First, before commenting on transparency and fiscal rules, I would like to make one principal point which takes the form of a caveat: Concepts related to transparency can work only if the various systems of public finance accounting used by national governments are reformed to make them comparable between countries. Mr. Sivaraman has also touched on the diversity of fiscal arrangements among Fund members. Any efforts at making fiscal policy transparent has to confront deeply entrenched cameralistic traditions and attitudes in public finance and fiscal bureaucracies. a sequencing of reforms which attempts to start with transparency existing fiscal systems while leaving the various accounting systems unchanged and not comparable with one another could lead to new forms of obfuscation and confusion. In other words, we would need to look at the many different accounting systems and their underlying economic ideas, and standardize and harmonize countries' accounting systems, before we can begin introducing standards of transparency. It follows from this, that I share Mr. Taylor's realistic view that it will take some years before we complete the process of developing effective transparency arrangements. In any event, we certainly should not introduce different standards of transparency for different countries.

Second, I especially wish to underline the staff paper's observation that fiscal rules, no matter how well meant, which are not supported by fiscal transparency, have a tendency to encourage creative accounting and shadow accounting if things get difficult for governments. To be effective, fiscal rules require transparency.

Third, a number of countries have found fiscal rules themselves to be an effective fiscal policy tool leading to more prudent fiscal policies. Indeed, fiscal rules may actually be superior to a discretionary fiscal policy in dealing with the political-economical problems described by Buchanan and others—namely, the tendency of parliaments to ignore intertemporal problems—or the short-term decision-making processes of many governments. And last but not least, fiscal rules have helped to concentrate the minds of European governments during the run-up to EMU, and in this way have proven very effective. As outlined in the staff paper, European governments have experimented with and implemented practically all major types of fiscal policy rules and will even work toward a balanced budget under the Growth and Stability Pact. The markets have been very attentive to this type of European surveillance through borrowing limits and debt rules, and this attentiveness and response has actually helped to reinforce and strengthen the effectiveness of those fiscal rules.

At the same time, we should not turn a blind eye to the fact that fiscal rules have limitations. Obviously, fiscal rules cannot be recommended for each case and each country. As seen in at least one major country, political agreement on such rules may be very costly and may actually result in additional discretionary spending. The lesson of the European experience is that fiscal rules should not be regarded as an end in themselves, and should not be driven by accidental specific conditions of even large countries at a given moment. Fiscal rules need to be based on economic criteria such as sustainability. Basing them on starting points that are arbitrary, economically unjustified, and of short-term validity can backfire and discredit the otherwise useful concept of fiscal rules. Fiscal rules should also embody, to a greater extent, the principles of intergenerational accounting.

Fourth, while accepting as much fiscal transparency as possible for the sake of efficiency, fairness, and stability of fiscal policy, we must recognize that transparency should not be carried to extremes. As recognized in the staff paper, there are actually situations where too much transparency too soon could endanger the efforts and aims of prudent policymakers by mobilizing the resistance of interests affected by budgetary measures. These qualifications notwithstanding, we believe that transparency is a necessary condition for an informed debate on public policy by the electorate and the markets.

Fifth, subject to the need to achieve comparability of national budget accounting systems—mentioned at the beginning of my statement—we can support the proposed extension of the Fund's involvement in member countries in the form of the suggested five additional steps for increasing fiscal transparency in Fund surveillance and Fund programs. For the industrial countries, the emphasis should be on laying open the cost of net unfunded liabilities of social security programs. I think that this should significantly increase the relevance of Fund surveillance for its members.

However, it is only fair to ask that the Fund's proposed new initiatives on transparency in fiscal and monetary policies should themselves be exposed to the same standards of transparency, particularly as regards the staff resources that will be required to establish this new initiative in its member countries. "Best or good practices" should apply to the Fund as well.

Mr. Vernikov made the following statement:

Although in different forms and with different degrees of urgency, the problem of fiscal consolidation is present actually in all country cases being considered by the Board. In turn, fiscal transparency, as well as an appropriate usage of fiscal rules, are important preconditions for successful management of government finances. In this respect, both staff papers are timely and topical, as they provide comprehensive analysis of the problems involved and reasonable suggestions for their treatment by the Fund.

Regarding fiscal transparency, the priorities for improving it will differ considerably across different countries. Moreover, in my view, these priorities should be so country-specific that it would be hardly possible to formulate them with regard to largely aggregated country groups—that is, advanced, developing, and transition economies. The staff's proposals formulated in paragraphs 43, 44, and 65, are correct as basic guidelines, but they are too general for specific conclusions to be drawn when addressing the needs of a particular country.

In principle, the preparation and disclosure of any additional information contributing to the improvement of fiscal transparency is welcome. However, the fact that this information (such as the cost of quasi-fiscal activities of public institutions and enterprises) has not been widely available in the past may to a large extent be the result of a technical inability to produce such kinds of data rather than deliberate secrecy. Should this really be the case, by encouraging a member country to provide additional, nontrivial, fiscal data, the staff should be aware that this may entail considerable problems for the government, both in terms of costs and the required efforts. As for quasi-fiscal operations per se, I agree with Mr. Sivaraman that the main focus should be placed not on the ultimate necessity to integrate them with government accounts, but rather on establishing clear-cut accounting principles for the quasi-government organizations and including in the main budget only transfers to and from such units. For countries that still have large government sectors, such an approach is, to my mind, superior to the orthodox idea of the overall consolidation of accounts for all institutions with government involvement.

It is difficult to disagree with the staff that in most member countries there is ample scope for further progress with regard to improving transparency in government operations. In this context, the proposals of the staff for further involvement in this process, as they are put in paragraphs 54–58, are generally welcome. Especially commendable is the intention to promote construction and disclosure of public sector statistics, recorded on both an accruals and a cash basis. However, I share the doubts of Mr. Shaalan on the merits of preparing a manual on best practices in fiscal transparency, as well as on the possibility of designing a standard of best practices that could be applied to all member countries.

On fiscal policy rules, I think that the staff is right in emphasizing that fiscal policy rules have an advantage over discretionary policies mainly when there is a clear bias of consecutive governments of a country toward running budget deficits. In this case, the "time consistency" advantage of a permanent fiscal rule over loose discretionary policies is especially pronounced. This benefit of a fiscal rule is quite visible in the case of some economies in transition, where the elected government may have little capacity to pursue sound discretionary fiscal policies under pressures from different lobbies. In this case, a legislatively approved fiscal rule, like a prohibition to borrow from the central bank, could play a decisive role in fighting inflation and in attaining general macroeconomic stability. However, imposing a fiscal rule could appear to be only a second-best solution, as, at least in some of the CIS countries, it has been met through a buildup of budget arrears and various one-off measures.

In my view, the comparison among different types of fiscal policy rules (deficit, borrowing, or debt rules) could be most fruitful when undertaken in the context of a specific country. However, if general judgment is needed, I think that on the basis of existing experience and also theoretical considerations, the golden rule, or balance between current government revenue and expenditure, seems to have more merit over other rules to contain budget deficits. I recognize the methodological difficulty in current and capital government expenditure, which has been noted by many previous speakers. Also, I share Mr. Sivaraman's point that some primary rules, like current budget balance and fixing the debt-to-GDP ratio, should be firmly established on a constitutional basis, while the rest could be a part of regulations to allow for an adequate flexibility of fiscal policy.

The principal characteristics of an ideal fiscal rule are summarized by the staff in paragraph 59 of the paper. Although none of these characteristics could be questioned, taken together they seem to be of limited utility for practical decision-making because of their overly general nature. The main features of rules that are likely to maximize the contribution to fiscal discipline should be considered primarily on a case-by-case basis.

As for surveillance of fiscal policy rules, I think that the current approach in the context of Article IV consultations, the World Economic Outlook, etc., and periodic Board papers seems sufficient, while an alternative approach to assessing fiscal rules will incur additional costs that may not be justified. I agree with Mr. Andersen that the Fund's role must be mainly catalytic. At the same time, further technical assistance on fiscal rules issues looks reasonable and should be made available to countries showing interest in adopting them.

Mr. Han made the following statement:

At the outset, I thank the staff for its informative papers for today's discussion.

I would like first to make a brief comment on the formulation of a policy or rule of the Fund. I welcome the staff's initiative and endorse in principle our support for this idea which, is supposed to ensure the healthy, stable and sustained development of the economy of all Fund members, and is also good for the stability of the international monetary system.

In the paper "transparency in government operations," the staff listed many facets which to my mind covers the issues that may affect all the aspects of government operations. It well reflects that the Fund should focus on what it has the advantage and expertise on this subject rather than its involvement in every aspect of transparency. The staff is also in the right direction in making the priority tasks for the groups of developed, developing and transitional countries. I think it would be better if more attention has been given to the difference even among the same group. For instance, in view of the different backgrounds of culture, history, development stages of the vast number of developing countries, it won't be a simple task to primarily focus on institutional reforms and the compilation and dissemination of essential fiscal data and projections. So are the cases for both advanced and transitional economies.

For many developing countries, in my judgment it is not their intentions not to enhance the fiscal transparency. There are some other reasons, including the institutional capability, take my own country as an example. In the Board discussion on China's Article IV, many Directors pointed out that China needed to make more effort to strengthen its fiscal discipline. We also recognized that there were some urgent issues to be addressed in China including the fiscal ones, and my authorities right now are trying hard to put the economy on a healthy track and correct factors of economic imbalances, including the increase in tax revenues as the share to GDP, the incorporation of the offbudget activities into the budget as early as possible. Concerning the specific issue of the relations between the policy lending and the budget deficit in China, which was raised in the staff paper, I would seek more clarification from the staff on a bilateral basis. We all know more transparent government operations will serve us better but it takes time to reach the target. In this connection, we are happy to see that the technical assistance offered by the Fund helps us a lot. The Fund's technical assistance can in a sense provide a shortcut for developing countries to more transparent government operations but undoubtedly the demand on the technical assistance at this stage is on the high side. How to meet the high demand with the limited resources in this regard seems important.

Enhancing fiscal transparency is not only the task of the developing countries, as the staff shows in the paper, but the task of all member countries. It will be crucial for the Fund to establish its credibility in facilitating the fiscal transparency in member countries in an evenhanded way. The developing countries should not be unfairly treated just because they are relatively backward in fiscal operations.

Turning to the "fiscal policy rules," the staff has envisaged the ideal fiscal rule, well defined, and highly transparent. Nobody will challenge that, these rules are good for the enhancement of transparency in government operations. Furthermore, we have to think what else these rules will bring to us. They may bring the budget to balance and bring down the inflation rate and interest rates. We do not have any doubts on this. But they may also lead to some short-term and one-off measures which might do harm rather than good to the economy in a longer term. So fiscal policy rules which have been successfully conducted seem to be formulated according to characteristics of individual countries and therefore be feasibly implemented by all the members. Be that as it may, we should not establish rules just because there are such rules elsewhere.

Simply following the rule guidelines to some extent could save the authorities much more energy and shield them from pressures. But this in the meanwhile loses the beauty of the discretionary measures. To my mind, the successful formulation and implementation of the fiscal policy requires the combination of the scientific methodology and practical judgments. I should say the staff is right in pointing out that in general it is preferable to follow a gradual convergence—through a multiyear fiscal adjustment—prior to adopting a fiscal rule.

a final word on the documentation of the fiscal transparency. I can endorse the preparation by the staff of a manual of good practices. At this point I can support Mr. Esdar's suggestion of such a change. And I would like to emphasize that member countries are at different stages of development and have different conditions, the manual is a reference to be followed by the member countries in a gradual and flexible way, otherwise the outcome of the implementations might fall short of our expectations.

Mrs. Guti made the following statement:

The paper on transparency in government operations brings together important issues concerning which there has already been much discussion and some action by the Fund. We are in agreement with the need for the Fund to assist the membership to move more quickly toward greater transparency in government operations. a major concern, however, is about the extensive scope of the terrain and the need, in the context of structural reform efforts, to identify priorities given the obvious resource limitations that some Directors have already referred to.

Indeed, the paper mentions some of the up-front costs of creating the technical and institutional capacities that are required—an issue that poses a considerable challenge in many developing countries. In this regard, while some effort was made in the paper to identify priorities for the various categories of the membership, the agenda of items suggested for developing countries and countries in transition is extensive. We would therefore like to stress the need for realism in reaching a judgment as to what a country could achieve under a given medium-term reform program.

Regarding the suggestions that have been made for strengthening the role of the Fund in promoting fiscal transparency, it seems to me that it would be useful to begin by looking for areas of overlap between any new initiative and implicit commitments arising in the context of both the Special as well as the General Data Dissemination Standards, and then to streamline them. I endorse the suggestion to coordinate efforts with the World Bank and other international institutions, with a view to avoiding unnecessary duplication of effort.

On the specific proposals that have been made for future Fund involvement, it is proposed in the context of Article IV discussions that the staff identify and, if possible, quantify nontransparent institutional arrangements and practices likely to affect economic performance, and suggest specific corrective measures. The staff also suggests that the elimination of nontransparent practices could be subject to conditionality, where required, to achieve program objectives. While the thrust of this suggestion would be a useful addition to Article IV consultations with the membership, I share the view of those Directors who have expressed concerns about the use of conditionality for the purpose of promoting transparency. I also believe that the proposed use of conditionality raises the issue of uniformity of treatment. We could have a situation in which nontransparent practices in some countries attract sanctions in the context of programs, while similar practices with possible systemic implications in some other countries, escape the Fund's discipline.

The second proposal, which is to encourage authorities to construct and disclose quality public sector statistics in a timely manner, is welcome. However, we agree with the staff that many countries will continue to have difficulty in extending the coverage of such data to include general government activity and showing transactions on an accrual basis.

Regarding the proposal to prepare a manual of best practices in fiscal transparency, we share the concerns already raised by other Directors, and believe this would need to be very carefully considered, taking into account the relevant cost implications. The second proposal in this regard—on the documentation of transparent and nontransparent practices—we do not consider as necessary, especially if a manual of best practices is prepared. These issues would already be taken into account in the manual. I can endorse the proposal for the Fiscal Affairs and Statistics Departments to contribute to technical assistance forecasts on transparency issues. This effort has proved to be useful to many countries, and further progress to improve fiscal transparency depends in large part on such assistance.

On fiscal policy rules, the staff has provided a useful analysis of key issues of interest. It has indicated the circumstances under which the application of such rules could enhance fiscal discipline and contribute to long-term sustainability and improved economic performance. From the analysis, a rules-based approach to fiscal policy seems most likely to be effective when the basic conditions for fiscal discipline already prevail, as other Directors have already indicated.

The major advantage that fiscal policy rules appear to have over a discretionary approach is that they may help to reduce the influence of short-term political expediency in the budget formulation and implementation process. On the one hand, to the extent that such political pressures tend to lead to a bias toward deficits over the cycle, fiscal rules, if firmly implemented, could in principle contribute to long-term fiscal sustainability. On the other hand, as pointed out in the paper, it may be difficult in practice to realize the potential advantages of fiscal rules in the absence of a sufficiently widespread perception of the need for enforcing fiscal discipline.

The experience with fiscal rules is not altogether encouraging, as is evident from the staff paper. While some positive results have been achieved in some instances, distortions have also been created, depending on the nature of adjustment undertaken by the countries that adopted fiscal rules. Although the deficit rule adopted by the European Union has proved beneficial to member countries, it seems to me that it is helpful to distinguish the case of fiscal policy rules adopted in the context of a monetary union, in which there seems to be no obvious alternatives as long as members of the union retain fiscal autonomy, from other cases, in which I believe the use of fiscal rules must be conceived as a component of a longer-term structural reform process. This seems clear from the list of what the staff considers to be the principal characteristics of an ideal fiscal rule. Among these are highly transparent government operations encompassing accounting, forecasting and institutional arrangements, and the need to implement efficient policies rather than one-off measures.

The Fund's approach to fiscal rules should continue to be that of providing advice and technical assistance support to those countries that choose to adopt such rules. However, having regard to the limitation of resources, I believe that the Fund should accord higher priority to providing technical assistance support for countries making efforts to strengthen fiscal transparency. Such transparency, as the staff correctly points out, is a necessary condition for the effective use of fiscal policy rules.

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

Mr. Grilli made the following statement:

The nature of the choice between rules versus discretion in the fiscal area is largely, if not entirely, political. In principle, the adoption of fiscal rules can be helpful because they reduce government bias toward excessive fiscal imbalances and toward the underestimation of burdens for future generations. There is always the need for retaining, at the same time, some degree of flexibility, so as to be able to react to shocks. However, contingent rules run risks. The risks are that, if they are complete, they are cumbersome; if they are not simple, they can be very easily manipulated and interpreted.

As for the applicability of rules versus discretion, one important dimension is the credibility of the government when it makes the choice; credibility influences the choice, and so it should. If the government enjoys credibility when it adopts a rule, it should be able to adopt a flexible rule. In the fiscal area, a structural deficit rule is more appealing, in our view, from a macroeconomic stabilization perspective, as it allows for the working of automatic stabilizers. However, if a government does not have credibility, it is bound to adopt a simpler rule that is easy to understand, but its commitment to the rule must be clear. The government can maximize the credibility gains that derive from it. Finally, if we have to make a choice between a rule in the fiscal area—and I say "if"—we believe that a deficit rule tends to be superior to a debt rule.

I enjoyed reading the paper on transparency in government operations. Taking into account the difficulty of the subject matter, the staff has done a remarkable job. At the same time, the paper illustrates many of the dangers implicit in the area of transparency. Two of them are very important, in my view, and they should be reflected upon. One is the risk of overdefining transparency—making it too comprehensive, too ambitious, and therefore too impractical an objective. The other is the risk of overselling its effect, overselling its usefulness, overselling what we can get out of major transparency in the fiscal area.

The paper defines fiscal transparency as openness to the public at large, including the market, as regards government structure and functions. In the fiscal area, that concerns fiscal policy intentions, public sector accounts, and projections. That may be an acceptable definition in theory, but an examination of the components of that definition will reveal that it leads to a very ambitious target in practice. If this is so, the question of focusing on the essential part of it becomes very important. The first important area of transparency on which we should focus is the intelligibility, understandability, and truthfulness of the public sector accounts, and the extent to which they succeed in painting an honest picture of reality for parliaments and the markets.

Including fiscal policy intentions and projections is to raise the objective even higher; extending the objective of transparency to government structure and functions becomes even riskier. For example, Appendix I of the staff paper deals with transparency in institutions and institutional practices and behaviour. The paper makes several points regarding budget practices. It says that in Italy, a unique case of legislative nontransparency was the fact that until 1988 the budget could be voted upon in secret. This, to me, is an example of the risk of going too far. The Fund is not in a position to decide and comment on parliamentary voting procedures. Similarly, on page 31, there is a discussion of the importance of a clear linkage between targets and policy measures. The paper goes on to say that in Italy, the central bank publishes a relatively more transparent annual assessment of fiscal developments than the government. This may be true, but I wonder whether such an observation is really relevant.

The risks of overselling the benefits of transparency are quite real, especially if the view is taken—as the staff paper does—that transparency in government operations is an important precondition for macroeconomic fiscal sustainability. The case can be made that transparency in government operations is essential for good governance and for overall fiscal rectitude, but to say that it is a necessary condition for fiscal sustainability is much harder to see. Transparency has to do with intelligibility of the fiscal stance, the public's awareness of it, and the market's perception of it; but whether it improves or impedes fiscal sustainability is a question of the quality of the choices made. These choices in any country have to do with ideology, social preferences, and the political economy. Unless one can make the case that these determinants of the choice can be changed by greater transparency, establishing a link between transparency and fiscal sustainability becomes very difficult. Similarly, the analysis of the drawbacks and advantages tends to establish relationships that may be correlations, but which certainly does not establish the direction of causation. For example, to say that the cross-country study suggested a positive relationship between broadly defined transparent budget practices and fiscal discipline might suggest the existence of a simple correlation, but there could be an alternative explanation as well—that transparent budget practices are part of the demand for transparency that occurs when certain standards are reached by governments. In that sense, the direction of causation should not be lost.

In looking at transparency, a distinction must be made between misreporting, deliberate secrecy, and a technical inability to provide information. The proposals that the staff makes on the role of the Fund are sensible proposals, and we have no difficulty with the continued practice of the Fund staff, in the context of Article IV consultation discussions, of identifying and quantifying, if necessary, nontransparent institutional arrangements and practices. However, the focus in that regard must be on those elements that are most likely to affect macroeconomic performance. The Fund should not try to become an inspector of good practices in general.

We support the encouragement to authorities to construct and disclose statistics, particularly in the areas in which statistics are most often found wanting. The staff should urge the authorities, especially in advanced countries, to develop meaningful supplementary measures, such as an analysis of the intergenerational effects of measures. An important aspect of our activities should be the supply of technical assistance to the countries that need it in order to improve transparency; sometimes it is a question of demand, but sometimes it is also a question of limited supply.

We would support the proposal to have a manual of good practices in fiscal transparency, provided that we define satisfactorily what we mean by fiscal transparency, and provided that we go to the minimum requirements applicable to all countries, to start with. We have made some important advances in this area, and in defining and conceptualizing it and in looking at our role. But we ought to be modest, and proceed progressively over time. We also ought to look very carefully at the cost implications, not only for the Fund, but for the membership at large.

Mr. Esdar commented that he recalled that Mr. Prader had said that a precondition for the establishment of transparency standards should be the adoption of a standard, uniform accounting system worldwide. There had been failed attempts to do just that for 50 years. He was thus reluctant to postpone deriving transparency standards until uniform accounting standards were agreed, as that might imply waiting another 50 years. The Fund's transparency guidelines should be flexible enough to adapt to different institutional frameworks in different countries, as Mr. Grilli had also suggested. He was skeptical of the likelihood that a uniform accounting system could be adopted worldwide.

Mr. Taylor considered that the Fund should look at transparency from the operational perspective and seek pragmatic solutions to transparency problems. He agreed with the Director of the Fiscal Affairs Department's remarks about the unease he often felt in trying to interpret data on the budgetary accounts. For example, the degree of confidence that could reasonably be placed in data on the budget and fiscal accounts in staff reports for Article IV consultations was often unclear. It was almost always unclear what level of confidence the staff had in the data that it was working on. That was why he believed that, in the context of Article IV consultations, the staff should present a brief standardized set of information, so as to inform the discussion about how much credence could be given to the data. In that vein, it would be recognized that Fund members were at very different stages of the development of statistical systems, accounting frameworks, and methodological issues, and that developing those elements took a long time. Countries like Australia and New Zealand had been working at them for more than a decade. The real costs lay not in the Fund, but in developing the systems needed for adequate transparency in the countries themselves.

The level of interest in Article IV consultations in Australia and New Zealand was not very great, Mr. Taylor pointed out. In fact, the New Zealand authorities would be content with less frequent consultations. However, what would interest the authorities in both countries would be if the Fund could challenge their thinking at the frontier of an issue like that of fiscal transparency, along with an analysis of the best international understandings and practices.

The Fund need not work very much on tax reform, as much research was being done in that area by the OECD, in which a major committee had been established for that purpose under the chairmanship of the United States and the United Kingdom, Mr. Taylor considered. There was certainly a need to identify a division of labor. He would hope that the Fund could have an appropriate share of the action.

The Fund was already withdrawing somewhat from the smaller island countries, some of which were in his constituency, Mr. Taylor observed. He understood the reason for that, which was that there were greater needs elsewhere. Nevertheless, that was of some concern to him, as there were few competent, knowledgeable, and experienced staff in those countries. Such staff as there were led an isolated life, not just geographically, but also professionally. For those staff, some code or manual would be very useful.

In the slightly artificial but nevertheless reasonably important debate about transparency versus rules, he would side with those who wished to emphasize the need to place whatever resources were available into transparency, Mr. Taylor concluded. The question still remained, however, as to transparency for what, and in what context. There would need to be, at a minimum, some kind of strategy or policy articulated in sufficient detail to be transparent about. Transparency was important, but it had to operate in a meaningful context.

Mr. O'Donnell said that there was a strong case for Fund coordination with the OECD in the area of fiscal transparency, and in fact, because of the universality of Fund membership, there were good reasons for the Fund to take the lead role. Both of the staff papers prepared for the current discussion merited being published, in his view, while amending or removing some of the references to specific countries that Messrs. Grilli and Sivaraman had called attention to. In that connection, some of the information in those papers on the United Kingdom was now out of date.

The Director of the Fiscal Affairs Department stated that there appeared to be a general agreement that transparency was a necessary, but not sufficient, condition for good policy. In many cases, the fiscal accounts were so confused that the policymakers who made decisions were confused about what was going on, so transparency was clearly a necessary condition. Regarding the question of a fiscal rule, if a country had very good policymakers and controls over what they wanted to do, rules were not needed; however, if a country did not have very good policymakers, or if they did not have control over what they did, no rule would help. He was aware of many countries in which there were rules, that had been bypassed or ignored. At the same time, most countries fell somewhere in between those two poles. In the case of the EU in the period of convergence toward monetary and economic union, it could be said that without the Maastricht fiscal deficit criterion, some of the improvements that had been seen in fiscal deficit reduction would probably not have taken place. At the same time, it could also be said that the experience in the runup to monetary union showed that having a rule without the necessary transparency could lead to game-playing, so that the rule was met without having to meet the more fundamental underlying requirements. That was why transparency was very important.

To say that transparency would beget good policy was to jump to a conclusion, the Director considered, but with transparency, at least whether or not the policy was bad or good would be revealed, in his view. Without transparency, it was sometimes hard to judge the results of policies. It was clear that the same standard of transparency could not be applied to everyone, and that, inter alia, the level of economic development had to be taken into account, but ideally, the goal should be to have everyone on the same level.

He often wondered why developing countries had a very low level of taxation and spending, and the industrial countries had a much higher level of spending, the Director mused. The reason was not the objectives of policymakers, as he believed that those objectives tended to be the same all over the world. Rather, the reason was that one group of countries was unable to raise taxes to the same level as another group of countries, and they then tried to reach their objectives through other means, such as regulation—which became quasi-fiscal regulation, which meant a lack of transparency. It was difficult to go to a relatively unsophisticated country and ask the authorities to abandon all their nontransparent practices immediately. In that context, he was reminded of the former head of the Research Department of the Fund, Mr. Bernstein, who had once written a paper arguing strongly for a multiple exchange rate, because a multiple exchange rate provided access by the government to revenues that it could not have achieved otherwise. The argument was that, if government expenditure was useful, then revenues for it should be secured, even if they had to be secured in the wrong way. While times had changed, the issue remained. It would be very difficult in many developing countries, and especially in the poorer developing countries, to attain the same objectives as the industrial countries through taxation.

Also, it needed to be borne in mind that some data that were available in industrial countries were not available in developing countries. For example, the Fund's advice had been to measure fiscal accounts that applied to the general government, but in many developing countries, the necessary local government data were received only after two or three years. In *Government Finance Statistics*, only a few developing countries reported data for the general government. There were institutional and practical problems that sometimes prevented developing countries from achieving the same standards of transparency as the industrial countries.

That was not to suggest that the standards should be abandoned, the Director stressed. Rather, the Fund should slowly, gently, and continuously push member countries to move in that direction, to produce the data, and to make the changes, including more explicit presentation—or preferably, elimination—of quasi-fiscal activities. However, that would take some time, and the Fund should be aware of that from the beginning. Otherwise, it would be too ambitious, as several speakers had said. The same applied to fiscal rules. If they were used, they should be adjusted to the level of economic development. For example, it would be difficult to get the data to support a fiscal rule based on a structural deficit balance for developing countries, as the concept of full employment did not have the same meaning, and there were other difficulties. The same was true of a limitation on debt, as relatively few developing countries reported data on debt. Rules that might be useful and applicable to industrial countries might not be applicable to other countries.

Regarding accounting methods, the forthcoming Fund manual on government finance statistics would introduce accrual accounting, which would bring it much closer to the UN approach, the Director related. His department had been a bit concerned about that in the beginning, because it had been felt that it would be difficult to apply accrual accounting all the time; for example, that might be difficult in the case of accounting for the Russian tax arrears. Accrual accounting in that situation would imply that while, in theory, the unpaid taxes should be counted as revenue on a current basis, in practice there was no knowledge of what would be actually paid. Nevertheless, the staff saw accrual accounting as a step in the right direction, as it would eliminate one of the practices applied in many countries of replacing cash expenditure with arrears in order to meet a target.

Regarding the golden rule, while there was clearly the issue of statistical definitions, there was also a conceptual question of how to account for human capital expenditures, such as education, the Director went on. If education were included in the golden rule, it would be accounted for as consumption rather than investment. At some point, the golden rule would confront a significant problem, which led him to be skeptical about it. It also needed to be borne in mind that much corruption occurred in the context of public investment.

Much work remained to be done before a manual or code of conduct would be finalized, the Director observed. The question also needed to be raised as to which body should be responsible for the work. While it was true that the OECD had already made a large contribution to it, the Fund staff did not want to be completely excluded. He was not aware that the World Bank was doing much in this area. He would prefer the final product to be a guideline of a few pages that stated in broad terms what the government should aim at. That would also be the least expensive alternative. In the meantime, the staff would continue to accumulate information from what it learned from its member countries. He agreed with Mr. Grilli that it might be appropriate for the Fund to be modest in its anticipation of how far it would go into the fiscal details of member countries. For example, some countries did not tax government bonds, and therefore paid a lower interest rate, or they gave special treatment to government bonds. Perhaps the Fund should not advise all countries to tax government bonds in the same way. If the aim was total transparency, then important issues such as that would have to be confronted.

The goal of common accounting standards for the whole world was clearly very far away, the Director concluded, but it should nevertheless be considered as a legitimate goal. For example, only a few countries had attempted to wrestle with the concept of the net worth of the public sector, a concept that had only appeared over the preceding decade. That concept was a very useful one, in his view. The point was to become aware of the problems, to respond to them and learn as much as possible from them, and to move progressively in the direction of the goal, even though, perhaps, that goal might never be achieved fully.

The staff representative from the Fiscal Affairs Department stated that there was no body of statistical data to prove the causality between transparency, fiscal discipline, and good economic performance. To compensate for the lack of data, the staff had analyzed a few selected countries from around the world from each major region, as an illustration of that possible relationship. In that connection, the former Soviet Union before 1991 was certainly one of the most nontransparent economic systems, and that had been the reason then-Chairman Gorbachev had launched his "Glasnost" initiative, which translated into greater transparency. At that time, each of the approximately 60 Soviet ministries had its own budget, which had led to total confusion. The authorities themselves did not know at the time what the reality was.

The relationship between transparency and sustainability was not a tenuous one, the staff representative considered. A good illustration of the importance of transparency for sustainability was the case of social security institutions, such as in the United States, where Congress required the social security trustees to show, year after year, long-term scenarios for each of the trust funds—the Disability Fund, the Medicare Trust Fund, and the Pension Fund. The authors of that, and the trustees, had to appear in Congress and face questions at hearings. That was an excellent vehicle to promote the necessary reforms in order to bring about fiscal sustainability in the social security accounts.

A number of Executive Directors had expressed views as to the desirability—or not—of having the public sector adopt some of the private commercial accounting practices, the staff representative recalled. A number of countries were going in that direction, such as New Zealand and the United States. There was an effort in Australia and Canada to follow more specifically the Generally Accepted Accounting Practices (GAAP), although not in every respect. There were certainly a number of areas in which the public sector could usefully adopt private accounting practices.

The OECD was taking the lead in moving toward more transparent practices in the budgeting area and in promulgating accrual accounting principles, the staff representative confirmed. There was scope for complementarity with the work of the Fund. In the World Bank, emphasis had been placed on governance, although it had also done much work in advocating open public procurement and budgetary practices.

The SDDS and the GDDS were major breakthroughs in transparency, the staff representative commented. While they were subject to modifications, it would be difficult to modify the rules after 60 countries had already subscribed to them, or to try to explain that the reporting requirements to which they had initially agreed were about to change. Those matters would have to be weighed in due course. Furthermore, the SDDS presented fiscal data in a highly aggregated form, and there was little coverage of transparency issues in either the SDDS or the GDDS.

He did not believe that anyone, even within the Fiscal Affairs Department, had had in mind advocating the application in any mechanical form of rules, the staff representative emphasized. That was certainly the case with respect to inflation targeting and monetary aggregate targeting, and it was even more applicable with respect to fiscal rules. He found particularly relevant in that regard Mr. Wijnholds's comparison of fiscal rules to exchange rate rules, and his expectation was that the staff would operate in the same manner with regard to fiscal rules as with regard to exchange rate rules—that is, the staff would evaluate the rule and its appropriateness or inappropriateness for the country concerned. Regarding the questions raised on whether convergence was a prior condition for the adoption of a rule, if conditions permitted, it would be preferable to have convergence, as in the case of EMU, or the Swiss constitutional amendments that were currently being considered. However, in situations of crisis—such as that of Argentina in the 1980s, when a currency board was introduced, or of Indonesia in the 1960s, when the prohibition on domestic financing of budget deficits was adopted—convergence might not be a realistic prerequisite.

The staff did not have in mind endorsing the balanced budget amendment in the United States, the staff representative pointed out. The amendment's one virtue might be simplicity; but for the rest, it would be an extremely rigid arrangement. The Balanced Budget Act and the Budget Enforcement Act of 1990 would not have taken place without the experience learned from the Gramm-Rudman-Hollings Act, however, and that should be borne in mind. By the same token, he could not help but wonder what would happen after the Balanced Budget Act. There were projections indicating that after the endpoint of the medium-term consolidation, there could be a considerable deterioration in the U.S. public finances. Regarding the intergenerational aspect referred to by Ms. Lissakers, there was a potential inconsistency between a fiscal rule and the Balanced Budget Act: namely, the social security rule, which called for the accumulation of considerable reserves that were counted as part of the medium-term fiscal adjustment.

Mr. Prader said that he would like to have more ambition and less modesty with respect to the goal that should be set for greater transparency in governmental budgetary systems. He recognized the inadequacies of accounting in the public sector. While the Fund needed to be realistic about what could be achieved under the transparency initiative, and that only limited transparency might be attained, nevertheless the Fund needed to be ambitious in its goals at the starting point.

Ms. Lissakers commented that, with respect to the balanced budget bill in the United States, it was true that the bill was not the end of the story, as the staff representative from the Fiscal Affairs Department had mused, but that was precisely the point. Both political parties recognized that several important steps would have to follow if long-term budget balance and a solution to social security and Medicare costs were to be secured. There was a strong bipartisan commitment, which would presumably outlast the current administration, to deal with those problems on a long-term basis. The fact that there was not a rule to follow on the current balanced budget plan did not mean that there was not a more lasting budget balancing commitment.

The Acting Chairman made the following summing up:

> Directors welcomed the opportunity to discuss transparency in government operations and fiscal policy rules, given that fiscal policy was an integral part of Fund-supported adjustment programs, and a key focus of Fund surveillance.
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> Directors agreed that transparency in government operations was conducive to fiscal discipline, sound public sector management, good governance, and improved macroeconomic performance. Moreover, in a globalized economy, where the costs of loss of market confidence have become increasingly clear, fiscal transparency should help to instill confidence in a government's economic policies. Fiscal transparency entailed setting out clear fiscal objectives, building clear institutional arrangements (including a proper budgetary process), using transparent and widely accepted accounting methods, and providing timely and reliable information.
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> Directors agreed that the Fund should continue to help its members achieve greater fiscal transparency through surveillance, technical assistance, and program design. They observed that improving fiscal transparency was a

multiyear endeavor, and that the priorities for improving transparency might differ among countries. Therefore, due regard should be paid to the specific circumstances of individual countries. Some Directors stressed that the Fund's involvement in fiscal transparency should be focused on issues of macroeconomic significance, and the need for an evenhanded approach was noted.

Directors supported increased emphasis on promoting transparency in government operations. Many Directors supported a proposal for the staff to prepare a brief manual of good practices for fiscal transparency. Some Directors expressed reservations about establishing "best practices." Some other Directors noted that the present paper already provided a reasonable starting point, and the staff could gradually accumulate an inventory of transparent practices in the context of Article IV consultations. Directors also saw a need for close cooperation with other institutions in their area of competence. Many Directors observed that the resource implications of any such initiative should be taken into account. There was support for provision of technical assistance that would be oriented toward the improvement of fiscal transparency.

Directors noted the importance of timely and comprehensive reporting of public sector accounts. To that end, the coverage of fiscal accounts should be extended to the general government, and should include information on off-budget operations and the cost of quasi-fiscal activities. Also, cash-based recording could be supplemented with accrual-based recording of transactions. It would also be desirable, where possible, to publish information on guarantees and unfunded public sector liabilities. Some Directors noted experience with the use of independently audited accounts and legislative public accounts committees, and suggested that those and similar practices could help in a government's efforts to achieve fiscal transparency. Directors also stressed the need for transparent and stable tax systems, and the need to include estimates of tax expenditures as part of the budget process. They noted that discretionary tax relief, tax exemptions, and arbitrary tax administration were among the most important problems affecting fiscal performance in many countries.

Some Directors suggested that the development and publication, in periodic budget documents, of indicators of the fiscal stance and sustainability, as well as of consistent budgetary forecasts and policy intentions, would be useful.

On fiscal policy rules, many Directors recognized the potential usefulness of fiscal policy rules in strengthening or restoring policy credibility in specific circumstances. Some Directors also noted the usefulness of fiscal rules and limits in the context of common currency areas. In that respect, they pointed to the benefits for fiscal convergence in the European Union that had accrued from the fiscal reference values under the Maastricht treaty.

At the same time, Directors cautioned that fiscal rules were not a panacea. It was observed that good economic performance depended on the political will to implement sound policies, and that simply promulgating rules without building the political consensus to put in place the implied sound policies was unlikely to yield the desired results. The view was also expressed that it might be difficult in practice for fiscal policy rules to embody all the properties of a model rule as described in the staff paper. Moreover, attempts at complying with a fiscal rule through excessive reliance on tax rate increases and unsustainable or cosmetic expenditure cuts, or one-off measures, might tend to be counterproductive.

Directors emphasized that successful adoption and maintenance of fiscal rules required that they be underpinned by a comprehensive structural reform strategy. Directors generally agreed that for a fiscal policy rule to be credible, it must be sufficiently flexible to accommodate exogenous shocks and cyclical fluctuations in activity. Most important, the nature and application of the rule would have to be transparent.

Commenting on alternative fiscal rules, several Directors noted that balanced-budget rules could have merit because of their simplicity, but only if they met key criteria of transparency and flexibility, for instance, they need not be required to hold exactly year-by-year. Limits on public debt as a ratio to GDP could also be useful. a few Directors suggested a "golden rule" which would require current account balance only, which would have the merit of promoting intergenerational equity. However, the difficulty of distinguishing between current and capital spending was noted.

Directors indicated that there were circumstances in which fiscal rules could prove useful for countries to institutionalize better macroeconomic policies. Where members were interested in formulating such rules, or incorporating them in the design of adjustment programs, the Fund should be prepared to provide policy advice and technical assistance.

Directors felt that the papers on transparency in government operations and fiscal rules should be widely disseminated and, therefore, supported their publication after revision to take account of Directors' comments.

Mr. Yao commented that he recalled that several speakers had said that fiscal transparency should not become a tool of conditionality in the context of Fund-supported programs.

Mr. Esdar stated that it was his understanding that the Fund rejected requests for Fund-supported programs, or required further adjustment efforts in the area on the part of countries, if it were not convinced that there was adequate transparency in certain areas of the fiscal accounts. Therefore, fiscal transparency was already a desideratum of Fund support, and part of Fund policy.

The staff representative from the Policy Development and Review Department confirmed that conditionality had already been applied, and quite widely, to transparency issues in cases in which they were deemed to be of macroeconomic importance and important to the achievement of the objectives of programs. There had been a number of cases in which performance criteria had been attached to the incorporation of off-budgetary accounts into the budget, and cases in which audits of public enterprises had been required as part of conditionality. It was already a widespread practice where improvements in transparency were seen as important for the achievement of the macroeconomic goals of the program.

The Director of the Fiscal Affairs Department, replying to a question from Mr. Taylor, said that the Fiscal Affairs Department would, as a first step for future work, accumulate information on the budgetary practices of member countries, with a view to identifying those that seemed to be more damaging to macroeconomic policy. The department would keep other departments alert to such problems. The department would then progress to the drafting of guidelines, which could be reviewed by the Board at some stage.

The Acting Chairman added that the Fiscal Affairs Department would be requested to go into more detail about the idea of developing a code or manual of fiscal accounting best practices.

Mr. Taylor commented that it would be useful to have an inventory of good practices from which a manual could be drawn, in consultation with the Board, and a report on what the OECD was doing in that regard and how the Fund's work would complement that.

The Acting Chairman agreed with Mr. Taylor.

Mr. O'Donnell stated that he wished to receive confirmation that the staff papers would be published. With respect to Article IV consultations, he agreed with Mr. Taylor that it might be useful, in the context of staff reports for Article IV consultations, to have on a routine basis the staff's assessment of the reliability of the data in the report on which the economic analysis was based. He also agreed with the Director of the Fiscal Affairs Department's idea to begin assembling a database on fiscal transparency issues from the information gathered in the context of Fund missions.

4. KUWAIT—1997 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1997 Article IV consultation with Kuwait (SM/97/237, 9/22/97; Cor. 1, 10/9/97; and Cor. 2, 10/14/97). They also had before them a statistical appendix (SM/97/246, 9/26/97; and Cor. 1, 10/9/97).

The staff representative from the Middle Eastern Department said that information provided by the authorities indicated that the implementation of the Debt Collection Program was continuing as planned. As of September, 7.77 percent of the payments due under the third installment had been made, and the authorities expected the rate of repayment to reach 90 percent after the grace period expired at the end of the year. Furthermore, in an effort to liberalize foreign investment regulations, the cabinet had established a committee to draft a foreign investment law. Also, as recommended by the World Bank, the ministry of finance had recently established a privatization office to assist the authorities with technical preparations for the privatization of public utilities.

Mr. Shaalan made the following statement:

> Following the impressive recovery from the negative impact of the occupation, the Kuwaiti economy continues to forge ahead with remarkable speed and effectiveness. The authorities have successfully restored a strong

budgetary and balance of payments position in a much shorter time than had been anticipated. The fiscal deficit has already been transformed into a surplus, well ahead of the target date of 1999/2000, and the current account surplus is expected to reach 25 percent of GDP this year. Apart from the impact of higher oil revenues, the containment of budgetary expenditures also contributed to this outcome. These gains are being reflected in the steady growth of foreign assets, including under the Fund for Future Generations.

Having dealt successfully with reconstruction and the rehabilitation of financial health, the government views this turnaround as an opportunity to renew its emphasis on structural reforms aimed at enhancing the prospects for self-sustaining private sector growth over the medium term. The authorities' policy stance, as described in the five-year plan being discussed in the National Assembly, emphasizes the real sector—specifically, enhancing growth prospects through diversifying the economy, ensuring a strong enabling environment for the private sector, and, in turn, generating employment opportunities for the increasing number of Kuwaitis joining the labor force. The plan also emphasizes the strengthening of the budget structure consistent with the goal of disengaging the government from commercial activity and improving allocative efficiency.

Kuwait is pursuing two main avenues of economic diversification. One avenue is the development of the non-oil sector, mainly petrochemical production and financial services. The other is through the investment of part of the oil income abroad. Both strategies have served Kuwait well in the past. In 1996, the non-oil real growth rate was twice that in the oil sector, spurred by petrochemical industry development and sustained activity in the services sector. The recent coming on stream of the large "Equate" petrochemical project will also contribute to non-oil growth which is expected to remain the main source of growth in 1997 and beyond. The policy of diversification through acquisition of assets in other countries has also helped to reduce the country's dependence on oil and has been an important factor in improving the structure of the budget and overall balance of payments, as well as in the replenishment of the Fund for Future Generations.

The swift implementation of the privatization program adopted in 1994 has resulted in a significant disengagement of the government from commercial activity. In the past two years, nearly half of the share holdings of the Kuwait Investment Authority have been divested through public subscription and auctions. The remaining holdings of shares, now estimated at KD 1 billion, are to be divested by 1998. Sale proceeds from the divestiture program amounted to 9 percent of GDP by end-1996, nearly twice the initial valuation as most public offers were largely oversubscribed. As part of the next phase of privatization, and consistent with their deregulation efforts aimed at encouraging the private sector, the authorities are considering increasing foreign participation in a number of sectors, including transport and telecommunications, and in foreign portfolio investment through mutual funds. A draft privatization bill that is before the National Assembly would facilitate divestiture of government shares in utilities (water and electricity) and services (transport and telecommunications). In view of the monopolistic nature of many of the utilities to be privatized, the bill addresses the regulatory and pricing regime and competition-related issues following privatization. The government also plans to transfer the management of some public utilities, ports, and health services to the private sector. In order to further promote private sector development, a national investment fund was recently established to support small-and medium-sized businesses.

In the fiscal area, the authorities have reestablished their tradition of accumulating sizable financial assets for future generations. The fiscal position has been transformed from a deficit of 18 percent in 1993/94 to an expected surplus of 9 percent in 1996/97, compared to a budgeted deficit of 6 percent. It is noteworthy that in spite of sizable increases in oil revenues, and Kuwait's very comfortable foreign asset position, total spending was kept within the budgeted amounts. Moreover, the budget's vulnerability to adverse movements in international oil prices was further reduced on account of the strengthened built-in stabilizer role played by investment income. As seen in the staff's illustrative medium-term scenario, the share of investment income is expected to grow from 19 percent of total revenues in 1997 to 22 percent in 2001. Additionally, the structure of the budget is projected to improve following the amortization in 1996 of the jumbo loan contracted for purposes of reconstruction, as well as redemption of part of the Debt Collection Program (DCP) bond. Accordingly, interest payments have dropped sharply starting with the current fiscal year.

Monetary management continues to be prudent. Particular progress has been achieved in strengthening financial institutions and the central bank's effective monitoring of the banking system. In this environment, bank profits have improved substantially. The difficult bank debt problem is being effectively resolved within the framework of the DCP, where 80 percent of installment payments have been made on time and delinquent debtors were subjected to legal actions. Improved prudential regulations and bank supervision—notably increases in capital adequacy requirements to 12 percent and the tightening of regulations governing conflict of interest—have further enhanced the strength of the financial system. The authorities are also considering opening the banking sector to majority foreign participation thereby promoting greater competition. The confidence in the financial system, in combination with the divestiture of government shares, has been reflected in higher capital inflows and a surge of activity on the Kuwait stock exchange. Stock market regulations permit non-Kuwaitis to participate in certain mutual funds and allow cross-listing and settlements of Kuwaiti shares on the Cairo and Beirut stock exchange systems.

The authorities' plan to improve employment opportunities for Kuwaiti nationals outside the public sector focuses on improving education and training programs in order to provide Kuwaitis with the skills needed to compete with foreign labor in the private sector. In early 1997, a program was established to provide guidance in terms of skills, training, and information to facilitate placement of Kuwaitis interested in private sector employment. At the same time, the programs of privatization and deregulation are intended to increase employment opportunities in the private sector.

Kuwait's trade and payments system remains highly liberal, and its generous foreign aid policy has been maintained in spite of the compelling domestic demands for financial resources. The number of countries receiving assistance has increased, and notwithstanding a slight dip in the early nineties, aid to developing countries has averaged 2 percent of GDP in recent years, most of which is on concessional terms. Additionally, Kuwait is a strong supporter of the Fund and is a participant in the New Arrangements to Borrow.

Finally, on behalf of the authorities, I would like to express my thanks to the staff for the useful policy discussions conducted in the context of the 1997 Article IV consultation and look forward to continued close policy dialogue with the Fund.

Mr. Mirakhor made the following statement:

As the staff report and Mr. Shaalan's statement attest, recent economic and financial developments in Kuwait have been very favorable. Due to the implementation of prudent and well designed economic policies but also, in part, as a result of higher oil prices, Kuwait's fiscal and balance of payments positions have improved substantially. This has enabled the country to resume its policy of rebuilding official assets for future generations. Real activity in the non-oil sector has risen, while inflation has remained well under control, reflecting openness of the economy, stability of the exchange rate, and the supportive role of firm macroeconomic policies. Progress was made in the structural area in resolving the bank debt problem within the framework of the DCP, prudential regulations and bank supervision were strengthened, and the divestiture program advanced further. Growing confidence in management of the economy was reflected in higher private capital inflows and a surge of activity in the Kuwait stock market.

Given this favorable confluence of outcomes, we share the staff's assessment that the economy's present strength offers "a solid foundation" from which a new agenda of ambitious structural reforms could be launched that would help extend the authorities' efforts to diversify the economy, ensure a propitious environment for the private sector, and strengthen Kuwait's medium-term growth and employment prospects. At the heart of this strategy lies the need for initiatives that would facilitate a progressive disengagement of government from the economy. This will require a well-coordinated set of policies across a wide front that includes a strengthening of the budget structure, privatization and deregulation, and labor market reforms. In this context, the early passage of the Five-Year Development Plan and the Privatization Bill by the National Assembly will lend credence to the authorities' medium-term structural reform agenda.

Kuwait's medium-term fiscal position is expected to remain comfortable. Nevertheless, reform of the budget structure remains a matter of priority, and the menu of options suggested by the staff to diversify the sources of fiscal revenue and reorder expenditure priorities deserves careful consideration. While the authorities are to be commended for the generally prudent stance of fiscal policy in 1997/98, specific revenue-raising measures that could further help reduce the economy's excessive dependence on volatile oil revenue would have been helpful. However, we are assured by the authorities' commitment to fiscal reform, as articulated in the Five-Year Development Plan.

The financial sector in Kuwait continues to be well managed. Bank profitability has improved significantly, and supervision and prudential regulations have been strengthened. Furthermore, as Mr. Shaalan notes, progress toward the resolution of the difficult debt problem within the framework of the DCP continues to be made. This is an important accomplishment. Looking ahead, further measures to foster greater competition and efficiency in this sector would be welcome.

Impressive progress has been made under the government's divestiture program. However, as the authorities recognize, the next phase of privatization will pose special challenges. It will call for striking an appropriate balance between ensuring successful privatization and addressing legitimate concerns over possible adverse employment and price effects. The staff is correct to caution the authorities against attaching employment conditions and/or targets to privatization operations. In the same vein, while the high priority being attached to increased employment opportunities for a growing Kuwaiti labor force is appropriate, it is important to ensure that this objective be guided by considerations of overall competitiveness and efficiency.

Mr. Al-Turki made the following statement:

The Kuwaiti authorities should be complimented for the economy's continued impressive progress over the past twelve months. The ongoing fiscal consolidation coupled with higher oil prices led to a major strengthening of the fiscal accounts. These developments, along with the country's open exchange and trade systems, prudent monetary policies, and flexible labor market have led to lower inflation and a very comfortable external position. This attests to the authorities' clear commitment to sound economic policies and the rewards of such a commitment.

In view of these achievements, staff discussions with the authorities were appropriately focused on medium-term challenges. In this regard, the authorities' emphasis on maintaining a prudent macroeconomic stance and accelerating human resource development, deregulation, and privatization should enhance the role of the private sector and increase diversification.

The major turnaround in the fiscal position in 1996/1997 is most encouraging. While higher oil prices were a factor, the authorities deserve credit for sustaining the consolidation effort. Indeed, expenditures as a percent of GDP fell substantially during the fiscal year. I am also encouraged that a large surplus is projected for 1997/98. This reflects the authorities' continued emphasis on reducing current spending which should further improve the structure of the budget. The authorities' commitment to enhance non-oil revenues also bodes well for strengthening the budget structure over the medium term.

In the financial area, I welcome efforts to improve the regulatory framework governing the stock exchange. Those efforts coupled with the ambitious divestiture program, should contribute to the deepening of the financial market and increase private investment and growth. I also welcome the progress made in strengthening bank supervision and prudential regulations. The Central Bank of Kuwait's ongoing efforts in this area and the progress made in resolving the difficult debt problem should further enhance confidence in the financial sector. Here I agree with the staff on the critical importance of continuing to enforce repayments under the Debt Collection Program in order to avoid moral hazard and welcome the remark made by Mr. Jbili at the beginning of the discussion in this regard.

Turning to the external sector, Kuwait's exchange rate policy has served the country well. Moreover, the authorities' liberal exchange and trade policies and their commitment to cooperation and harmonization in the context of the GCC bode well for future growth.

Kuwait's flexible labor policies have encouraged investment and growth. The challenge is to maintain as much flexibility as possible while at the same time increasing employment of Kuwaitis in the private sector. This is not an easy task and addressing it is clearly a long-term issue. In this regard, increased education and training of Kuwaitis is a priority. A combination of other measures, some of which are mentioned in Box 2, aimed at improving incentives for hiring nationals may also be needed.

Finally, I join the staff in commending the authorities for their generous foreign assistance program. Kuwait's foreign aid remains substantially higher than the agreed UN target.

With these comments, I wish the Kuwaiti authorities further success in their endeavors.

Mr. Salleh made the following statement:

This chair concurs with the broad thrust of the staff's findings on the economic situation in Kuwait and the staff's recommendations. On the whole, the Kuwaiti authorities deserve to be commended for their notable achievements in the past year on many fronts. In particular, the encouraging trend in terms of the fiscal balance should allow external assets for future generations to reaccumulate. This will provide the basic ingredients for improving growth prospects in the medium term.

Inflation has remained low. Typical of most oil-exporting countries, the foremost challenge confronting the Kuwaiti economy is how to successfully diversify the economy so that it moves away from overdependence on the oil/gas sector. Central to achieving this objective are the efforts to downsize the government and privatize some of its functional activities, the labor market reforms, and, of course, the improvements in the fiscal structure. With regard to the divestiture and privatization program, this chair notes the substantial progress that has been accomplished thus far. The timely passage of the privatization bill being considered by the national assembly will certainly provide added impetus for the privatization program.

The labor market seems to be a slightly elusive area. While this chair shares the authorities' views on the need to gradually but substantially improve the employment opportunities for Kuwaiti nationals, it concurs with the staff's assessment that it is necessary to avoid measures that could further distort the labor market. Thus, the proposal to introduce the quantitative employment requirements in favor of Kuwaitis, as well as the proposed social allowances to Kuwaitis, should be given further consideration. As suggested by the staff, labor market concerns could be addressed effectively through such related measures as government downsizing, the elimination of subsidies, and privatization.

In the fiscal area, we note a major improvement in the fiscal balance over the fiscal year 1995/96. Owing to improved oil prices and continued fiscal restraint, the economy experienced a fiscal surplus of 9 percent of GDP in fiscal year 1996/97. While it notes the uncertain nature of oil price developments, this chair remains optimistic that, given the commitment of the authorities to pursue tight fiscal policies, as well as the expected progress in debt reduction of already-identified revenue measures, the prospects for beginning the rebuilding of foreign assets for future generations could materialize sooner. As regards diversification, this chair is encouraged to learn of the substantial progress achieved thus far.

The ongoing efforts by the Kuwaiti authorities to strengthen prudential regulations and banking supervision will certainly contribute toward further improving the soundness of the banking sector. This chair also noted the timely intention of the authorities to legislate the activities of the Islamic financial institutions.

We would also like to echo our support for the competent policy of the Kuwaiti government in maintaining a very generous foreign assistance program in many areas.

Mr. Disanayaka made the following statement:

We commend the Kuwaiti authorities for the significant progress achieved in 1996 and so far in 1997 through the pursuit of sound macroeconomic policies that enabled them to achieve a reasonable level of economic growth with low inflation. Of course favorable oil prices in 1996 contributed a lot toward this progress but as usual, Kuwaiti authorities have followed a tight fiscal policy despite the favorable external position. The authorities have been able to achieve further progress in their divestiture program, in the debt collection program and have repaid the last instalment of the 1992 jumbo loan.

A comfortable fiscal position registering a surplus of about 9 percent of GDP in 1996/97 has enabled the authorities to accelerate their traditional accumulation of resources for the future generations. We congratulate the authorities for achieving a budget surplus in 1996/97. Higher oil revenues also have raised the external current account surplus in 1996 to 23 percent from 17 percent in 1995.

Despite these commendable developments, the Kuwaiti economy suffers from several inherent weaknesses. Overdependence on the oil industry for its growth is one such weakness. Diversification of the economy, through further expansion of the non-oil sector should therefore constitute an important medium-term goal. The involvement of the state in the management of the economy is still strong. This has to be addressed through acceleration of the privatization and improvement of the environment for private sector growth. Labor market is segmented and the incentives for attracting the growing number of those joining the labor market to private sector has to be improved.

Financial sector needs further strengthening, particularly through enhanced supervision and the development of a regulatory framework governing stock exchange transactions and Islamic banking instruments. We appreciate the steps the authorities are taking to implement these policy objectives through a medium-term development strategy. We would therefore urge that the five-year plan and the privatization bill that are presently before the parliament be approved soon so as to facilitate the early implementation of the medium-term plan.

We would encourage the authorities to make further improvements to the structure of the budget to reduce its heavy dependence on oil revenues. This could be achieved through non-oil revenue enhancing measures. The staff has suggested some of these measures in the report; restructuring of company taxes, introduction of a consumption tax and increase in fees on charges on public sector services. We support these recommendations. Budget could also be further improved through reduction of subsidies and transfers which constitute about 20 percent of total government expenditure as well as through containment of wage growth. In this respect we feel that the rather generous compensation and other benefits in public sector are a disincentive toward attracting labor to private sector jobs. We would therefore welcome the measures the government is taking toward leveling the playing field between the public and private sectors in the area of employment. We would however caution that these measures should not create a heavy burden on the budget nor leave room for abuse.

Talking further about the Kuwaiti labor market, we sympathize with the government efforts to compel private sector to absorb a higher proportion of Kuwaitis to their jobs. Box 2 on page 15 of the staff report reveals that 96 percent of the labor in the private sector is non-Kuwaiti. However laying down quantitative restrictions on labor employment might add to the distortions already existing in this market. Better alternatives may therefore have to be sought. Further expansion of the role of the private sector in the economy, improving education and training facilities, reducing subsidies and increasing social benefits for private sector employees would, in our view, constitute more prudent mechanisms to deal with this problem. In this regard, we welcome the steps taken by the authorities to encourage the development of local entrepreneurship through the establishment of a national investment fund to support the establishment of small and medium-sized enterprises by Kuwaiti nationals.

We commend the authorities for the progress already made in divesting government shares in commercial enterprises. We would encourage the authorities to expand privatization to the utilities sector as well. As mentioned above, the government should encourage greater participation of the private sector, both local and foreign, in the economy to achieve a faster expansion of the economy and a more efficient use of resources. In particular, emphasis should be laid on attracting investment into the non-oil sector. We hope that the proposed privatization bill, once it is approved by parliament, would lead to acceleration of the privatization effort.

We could support the prudent monetary policy presently followed by the authorities as well as the pegged exchange rate regime. They have served the country well so far. We would however encourage the Central Bank of Kuwait to further strengthen bank supervision including an early warning system and bring Islamic banking instruments too under its prudential regulation. We welcome the closer vigilance the authorities are exercising on the stock exchange transactions, particularly in light of the past difficulties that arose in this area. We also welcome their efforts to strengthen the regulatory framework governing stock exchange operations. We would encourage the central bank authorities to rely more on indirect investments for monetary management. Accordingly we are pleased to note that consideration is being given to the elimination of ceiling on interest rates in near future.

Finally, we commend the Kuwaiti authorities for their continued generous assistance to development efforts of many developing countries. We wish them every success in their endeavors.

Mr. Barro Chambrier made the following statement:

We are pleased to see that confidence is gaining momentum in Kuwait owing to the continued pursuit of appropriate policies and higher international oil prices. It is to be noted that Kuwait has made significant progress during the last two years in many areas of economic reforms as evidenced by the elimination of financial imbalances and the enhancing of the financial system. The fiscal deficit has been reduced thanks to expenditure restraint and improved oil prices, the current account has recorded a surplus while the authorities have successfully resolved the difficult debt problem.

As I share most of the staff recommendations, I can be brief.

On fiscal policy as regards the 1997/98 budget, the pursuit of prudent fiscal stance by the authorities is commendable. We encourage the authorities to focus on further expenditure restraint which should be helped by the significant decline in foreign interest payments. However, we are of the view that the revenue measures, particularly through enhancing non oil revenues, should be pursued in order to improve the structure of the budget.

On monetary policy, it is important for the authorities to strengthen bank supervision as well as prudential regulations with a view to enhancing the banks capacity to assess credit risks and reduce moral hazard risks.

In that spirit I believe that enforcing repayment to the banks and initiating bankruptcy procedures when required are another critical task the Kuwait authorities are handling forcefully. We concur with the staff that the authorities' actions should contribute to improve the early warning system that could enhance the efficiency of the banking sector. Efforts should also be geared at closely monitoring nonbank lending institutions and trading on the stock exchange, as activities in this sector have recently surged.

We encourage the authorities to eliminate the remaining ceiling on lending rates and to review and relax the quantitative limits on personal loans as soon as possible. We also find appropriate the authorities intention to pursue a prudent monetary policy in support of the current exchange rate arrangement.

The major challenge facing Kuwait authorities now remains as clearly expressed in the staff report and in Mr. Shaalan very helpful statement, the acceleration of structural reforms; therefore, we encourage the authorities to push ahead their divestiture process in the financial sector as well as further deregulation in support of bolder competition and efficiency. The critical objectives for the Kuwait economy for the medium-term are well spelt out in the Five-year Development Plan that will allow the country, if fully implemented, to make far-reaching progress as regards divestiture, privatization, and the reform of the labor market. At this juncture it is clear that promoting broader based economic growth supported by diversification beyond the petroleum sector will serve well the objective of creating new jobs.

During the recent years the authorities have showed their commitment to pursue forcefully the needed reforms that are now starting to produce some effects. We are confident that they will strengthen their effort in order to consolidate the gains already achieved and thus put Kuwait's economy on a more sustainable path.

Finally, we would like to commend the authorities for their generous foreign aid policy toward developing countries.

With these comments I wish the authorities every success.

Mr. Qi made the following statement:

Thanks to the right policy mix implemented by the authorities and the favorable world market oil prices, Kuwait has made further achievements in the reconstruction of its economy over the past years. The staff paper is well written and focused and I share the main thrust of its appraisal. I would like to make a few comments for emphasis.

Strengthening structural reforms is very crucial for the medium- and long-term development of the country, among which diversifying the economy plays a dominant role. It is very encouraging to see from Mr. Shaalan's helpful statement that Kuwait's diversification strategy, through both the development of the non-oil sector, mainly in petrochemical production and financial services, and the acquisition of foreign assets, has been successful in reducing the dependence on oil and improving the budget and balance of payments situations. However, it seems to me that in recent years the net foreign assets of the country have largely been on a declining trend. Does this indicate that the authorities are changing their strategy on the acquisition of other countries' assets? Comments from the staff or Mr. Shaalan are welcome.

The authorities' efforts to boost the development of the financial sector is in the right direction, which, in the meantime, requires monetary policy, financial supervision and regulation safeguards. I am glad to see that the authorities will continue to rely on indirect instruments and eliminate the remaining ceiling on lending rates. The authorities' ongoing efforts to strengthen banking supervision, the nonbank lending institutions, and the stock exchange are quite impressive.

Finally, as stated by previous speakers, I very much appreciate the authorities' continuing generous financial assistance to developing countries.

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

Mr. Rigász made the following statement:

The main message of the staff report is clear: strong fundamentals and a strong external financial position, supported by a favorable external environment, make this an opportune time for Kuwait to address such medium-term objectives as improving the structure of the budget, diversifying the economic base, promoting private sector activity, and creating employment for Kuwaiti nationals.

The fact that 95 percent of Kuwait's exports and 76 percent of its total budget revenues come from oil shows that diversifying the economy beyond the hydrocarbon sector is the single most important task facing the authorities. We are glad that they consider this diversification a key challenge, since it is the only way for Kuwait to escape its high vulnerability to volatile oil prices. It goes without saying that at best, this shift can only be achieved in a longer term framework, and will require, in the staff's words, sustained policy reforms in a wide range of areas, especially the area of privatization. The private sector, that presently still accounts for only 25 percent of GDP, should become the main force behind diversification drive. But for this to happen will require the government to make further progress with its privatization agenda. We note that a team from the Kuwait Investment Authority visited the World Bank to study other countries' experience in generating public support for privatization programs. Considering the public sector's large share in the economy, it is prudent of the government to engage in consensus-building activities, since without the necessary consensus, strong resistance from the affected public employees and their unions could derail the government's plans.

Privatization and fostering private sector development also offer important opportunities for creating employment for Kuwaitis entering the labor force. Statistics indicate that over 42 percent of the population is presently under 20 years of age, and even more important, the population is growing at over 5 percent annually. Also, at present, the public sector employs 93 percent of total Kuwaiti labor force. With population growth so high, it is unlikely that the public sector can continue to employ all Kuwaiti nationals needing work, as it has done so far. New jobs will have to come from private businesses. In this connection, we applaud the government's plans to eliminate all disincentives that keep Kuwaitis from actively seeking employment in the private sector.

As to the budget, Kuwait's present favorable performance should be used to improve the budget's underlying structure. It is therefore regrettable that parliament did not pass the government's suggested revenue-raising measures together with the 1997/1998 budget. If there is to be real progress in reducing the budget's excessive dependence on oil revenues, then such measures will have to be implemented sooner or later.

Finally, I understand from news reports that the cabinet has instructed the Ministry of Planning to work on Kuwait's first long-term, 25-year strategic plan. Since I could find no reference to this in the staff report, I would appreciate it if the staff could provide the Board with any additional details it may have about this undoubtedly very important document.

Mrs. Brizuela made the following statement:

Developments during 1996 indicate that the Kuwaiti economy continues to recover impressively, to a great extent as a consequence of the strong efforts to rebuild the country's infrastructure and of favorable oil prices. In this context, Kuwaiti authorities have improved both the fiscal and balance of payments position, thanks to well designed measures. Inflation has remained under control. Stability in the exchange rate has been maintained. Bank supervision has been strengthened. The performance of the private sector shows an increase in confidence, as reflected in the increase of capital inflows; positive development in the stock market; and, stronger demand for money.

However, the country continues to face important challenges, including accelerating the pace of fiscal consolidation, the reform of the budget structure and the privatization program. As a national of an oil country such as Venezuela, I encourage Kuwaiti authorities to make further and stronger efforts to diversify the economy, and to reduce the vulnerability of its external sector and the extensive subsidy and regulation systems.

A critical issue for the sustained health of the Kuwaiti economy is the need to generate increased employment opportunities for Kuwaiti nationals. From my point of view, the authorities' policy response to the problem contains some contradictions:

Three of the objectives of the labor policy are: to promote private sector employment for Kuwaitis; to restrain the growth of the public sector employment; and to modify the segmentation on the labor market.

The following policy responses to these objectives are unclear:

First, the measure to replace expatriates currently employed in the public sector with Kuwaitis would contribute to increase the segmentation, and to maintain the nationals out of private sector employment.

Second, the measure to control the inflow of expatriate labor would affect the private sector activities, due to the replacement of skilled foreign workers with a nonskilled Kuwaiti labor force, and to the preference of Kuwaitis for public sector employment with a higher earnings bracket.

I would appreciate further comments from the staff on this subject.

Finally, I wish the Kuwaiti authorities every success in their continued efforts aimed at building a strong economy.

Mr. Schneider made the following statement:

Kuwait's economy has performed relatively well over the past year, reflecting both higher oil prices and intensified policy efforts. Of particular note was the strength of the non-oil sector, the continued low level of inflation, and the strengthened confidence in the financial system. In essence, the reconstruction of the economy in the wake of the Iraqi invasion has been completed. The authorities deserve credit for their efforts on these fronts.

However, we share staff's assessment that with the immediate task of reconstruction now complete, attention needs to shift to the medium term, and structural measures that will ensure sustained economic growth and reduce Kuwait's vulnerability to fluctuations in international oil prices. There has been some credible progress in this regard over the past year. We welcome what appears to be a growing level of consensus between the staff and the authorities on the need to focus on key structural measures to further reduce the state's role in economic activity, broaden the revenue base, and move away from the extremely heavy reliance on oil production. In particular, we noted: the strong progress to date on privatization, and the authorities' intention to push forward with the next phase involving the sale of utilities and services despite what difficulties may arise; the consideration being given to opening such key sectors as downstream oil activities, transport, and telecommunications; the focus on improving education and training programs to better prepare Kuwaitis for employment in the private sector; and measures to strengthen banking supervision—perhaps as a prelude to allowing greater competition in this sector.

The larger task of restructuring the Kuwaiti economy to better support long-term, private-sector growth remains incomplete, however. The staff paper presents a range of recommendations to speed this process along, and we support their analysis. I was particularly struck by the staff's assertion that policy measures must be mutually reinforcing. Restructuring of the budget must coincide with redirecting the labor force toward private sector employment, which must in turn be supported by measures that would level the playing field between the public and private sector, and opening more sectors of the economy to foreign investment and competition. This clearly highlights the need to avoid a piecemeal approach to reform, and we would urge the authorities to take this into account in their discussions of the Five-Year Plan and the Privatization Bill currently before the National Assembly. It was disappointing, for example, that the envisaged additional revenue measures were not incorporated in the 1997/98 budget, and it would be unfortunate if other key elements of the reform program were to fall by the wayside.

Mr. Brooke made the following statement:

Like other Directors, I strongly endorse the authorities' plans for economic diversification, which will require a comprehensive program of reforms to be implemented over a sustained period, focused on privatization, the elimination of subsidies, deregulation, greater emphasis on education and training, and reduced labor market distortions. Like other Directors, I note that there was a substantial improvement in public finances last year, and I recognize the significant contribution of this year's expenditure reductions. However, the large swings in the budget position from year to year continue to emphasize the dependence of government revenues on tax receipts from the hydrocarbon sector. The magnitude of these movements is clearly not helpful for economic planning, and I therefore endorse the staff's calls for a reform of the budget structure to increase the share of non-oil revenues.

Unfortunately, improvements in Kuwait's statistical reporting continue to be slow to materialize. I note from the appendix of the staff report that published real GDP data are only available through 1995 and that consumer price index data have been released with a six-month lag. This performance seems somewhat disappointing, especially when one takes into consideration the importance attached to the Special Data Dissemination Standard and the General Data Dissemination System by this Board and the comments made at this morning's meeting about the benefits of transparency and full disclosure of data information. I hope the authorities will give higher priority to the shortcomings in Kuwait's data over the next 12-month period.

Furthermore, as Kuwait has no short-term macroeconomic problems at present and there has been strong continuity in the staff's messages to the authorities between this Article IV consultation report and the previous one, I would consider Kuwait to be a good candidate for a 24-month consultation cycle. However, the staff report indicates that the next consultation cycle will be held on the standard 12-month basis. Could the staff please outline the reasons for this decision. In particular, was the case of Cyprus considered, in which every other year there is only a small staff visit, with a short note for the record produced, rather than a full Article IV report?

The staff representative from the Middle Eastern Department said that before the Gulf War, a substantial amount of Kuwait's foreign assets had been held by the central bank and by the General Reserve Fund for Future Generations. Part of those assets had been used to pay for the cost of the war and the reconstruction effort, as well as to repay a large loan incurred during the regional crisis. However, based on improvements in the fiscal situation and in the overall balance of payments, the authorities had indicated that the reserve fund's assets had increased and that a policy of rebuilding its assets was under way.

The issue of labor market policies was a complex one not only for Kuwait, but also for other countries in the region, the staff representative stated. The authorities' objective was to increase the employment of Kuwaiti nationals and reduce reliance on expatriates. While those countries had liberal policies regarding imported labor, their labor markets were highly segmented, and national and expatriate workers sometimes did not compete in the same segments of the labor market. In Kuwait, the authorities were taking measures to increase the employment of national workers. In the public sector, for example, expatriates were being replaced with Kuwaitis who had the required skills. At present, about 93 percent of Kuwaiti workers were employed in the public sector, primarily because the wages and benefits in the public sector were higher than those in the private sector.

Controls on the inflow of labor could lead to distortions in the private sector, the staff representative remarked, as the private sector was the main employer of imported labor. Imported labor was inexpensive and provided the required skills. The labor market problem would have to be resolved in the medium term through a set of reforms that had already begun to be implemented in both the government and private sectors, aimed at encouraging privatization and an increased private sector role, enhancing education and training, and accelerating deregulation.

The mission had not discussed with the authorities the 25-year strategy plan, which was probably still under preparation, the staff representative continued. The staff would discuss such a plan with the authorities in more detail, if it were approved, at the next Article IV consultation discussion.

The authorities preferred to maintain the present annual consultation cycle, as it provided them with an opportunity to discuss their policies, exchange views with the staff, and benefit from the Fund's policy advice, the staff representative noted. Moreover, because Kuwait was of systemic importance as a major oil producer with substantial foreign assets and a major foreign aid contributor, the staff believed that Kuwait should continue under the present 12-month consultation cycle.

Mr. Shaalan thanked Executive Directors for their comments, which he would relay to the Kuwaiti authorities. The fact that the Kuwaiti authorities desired annual consultations with the Fund was an indication of the importance that they attached to staff visits, as well as to the views of the Board.

As many Directors had noted, the fiscal turnaround and the successful accomplishments in reconstruction and rehabilitation in recent years had permitted the authorities to focus their attention on structural reforms, Mr. Shaalan observed. In that connection, when promoting diversification, it was important to realize that a country needed to diversify into areas in which it had a comparative advantage and to create an environment conducive to investment in such areas. Along those lines, in addition to its investments in the petrochemical industry, Kuwait had been diversifying into financial services. Kuwait invested part of its oil income in the assets of other countries, which was also a form of diversification. In that way, the sources of revenues to the budget also became more diversified.

The authorities were fully aware of the problems in the labor market, Mr. Shaalan commented. As the staff had indicated, it was a complex issue, and the authorities were carefully weighing a set of labor policies aimed at increasing Kuwaiti nationals' job opportunities outside the public sector with a minimum of distortions or budgetary costs. He would stress that Kuwait was not replacing inefficient national workers with expatriate workers; rather, the Kuwaiti government had well-financed and well-managed training programs for its citizens, and trained workers were not being placed in jobs simply because they happened to be Kuwaiti citizens.

The data showed clearly that government involvement in managing the economy had been reduced substantially, Mr. Shaalan emphasized. That was reflected in the declining share of government expenditures in the budget and in the continuing divestiture and privatization efforts. The divestiture of the Kuwait Investment Authority's remaining holdings in government assets—22 companies—would be completed by 1999, and a privatization law was being considered by the parliament; the World Bank was providing assistance in that area.

Mention had been made of the importance of strengthening the regulatory and supervisory environment, including the establishment of an early warning system, Mr. Shaalan observed. That advice was well taken; indeed, the government had for some time been making substantial efforts to strengthen the banking sector.

Kuwait had agreed to the release of a Press Information Notice, Mr. Shaalan concluded.

The Acting Chairman made the following summing up:

> Executive Directors agreed with the thrust of the staff appraisal. They commended the authorities for the significant progress achieved in 1996 in eliminating fiscal imbalances, enhancing bank supervision, making progress toward resolving the difficult debt problem, and moving forward with the divestiture program. Reflecting that progress, and aided by higher oil export prices, confidence had improved, economic activity had picked up, inflation had remained low, and the stock of foreign assets had risen.
>
> Directors noted that those favorable developments offered a sound basis for an ambitious medium-term program of structural reforms aimed at diversifying the economic base, strengthening the role of the private sector in economic activity, and providing employment opportunities for the growing number of Kuwaitis entering the labor force.

Directors observed that commendable progress had been made in the sale of government shares in commercial enterprises, and they urged the authorities to proceed with the next phase of privatization, involving the transfer to the private sector of public utilities and services. Prompt approval of the legislation currently before the National Assembly—the Five-Year Plan and the Privatization Bill—would be important to lay the foundation for the privatization program, as well as other key elements of the medium-term structural reform agenda. Directors also emphasized the importance of permitting greater private sector participation, local and foreign, in all sectors of the economy. Directors stressed the need to pursue labor market reform, in particular to preserve labor market flexibility. Directors generally cautioned against the setting of quantitative requirements governing employment of Kuwaiti nationals in the private sector. Instead, they thought that the emphasis should be placed on education and training, removing disincentives for Kuwaitis to seek employment in the private sector, and fostering the development of the private sector.

Directors noted that, notwithstanding the relatively favorable fiscal prospects over the medium term, the structure of the budget would need to be strengthened by raising the share of non-oil revenues, in order to minimize the volatility of revenues, and by rationalizing spending consistent with the need to transfer responsibilities from the public to the private sector and to enhance resource allocation. Revenue-raising measures could include a restructuring of company taxes, the introduction of a consumption tax, and increases in fees and charges on public sector services. Expenditure measures should aim at reducing subsidies and transfers and at containing the growth of wages and salaries through an overhaul of the salary and benefit structure. Directors welcomed the authorities' intention to pursue continued expenditure restraint, but disappointment was expressed that the additional revenue measures proposed in the 1997/98 budget had not been adopted by the National Assembly, given the contribution of such measures to improving the structure of the budget.

Directors noted that the steps taken to enhance bank supervision, together with the successful implementation of the Debt Collection Program (DCP), had strengthened the soundness of the financial system and reduced moral hazard risks. They stressed, in particular, the need for continued vigilance in enforcing repayments under the DCP. Directors encouraged the authorities to continue to rely on indirect instruments of monetary management, and they welcomed the consideration being given to the possible elimination of the interest rate ceiling.

Directors commended the authorities for pursuing an open exchange and trade system and prudent fiscal and monetary policies in support of the pegged exchange rate arrangement, which had served the economy well.

Directors commended Kuwait for its very generous foreign economic assistance program.

Directors encouraged the authorities to continue in their efforts to make further substantial progress to improve statistics, particularly data on national accounts and prices, and public finances.

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

5. PHILIPPINES—REVIEW UNDER EMERGENCY FINANCING PROCEDURES

The Executive Directors considered a staff paper on the review under the emergency financing procedures under the Extended Arrangement for the Philippines (EBS/97/186, 10/9/97; and Sup. 1, 10/15/97).

Mr. Taylor made the following statement:

As noted in the staff paper, developments since the approval of the request for extension and augmentation of the Extended Arrangement for the Philippines turned out to be much more difficult than envisaged. Nevertheless, the implementation of the program has remained broadly on track, although there are indications that the fiscal target may be exceeded due to continuing customs revenue shortfalls following the significant slowdown in imports, as well as some catch-up in September in programmed capital expenditures.

It remains to be seen the extent to which growth slows and inflation rises in late 1997 and 1998. These issues no doubt will be the subject of consideration in the Consultation next month. However, they underlie the importance of avoiding unnecessary pressure on the exchange rate wherever possible, and of a restoration of confidence in the region as soon as possible.

As part of a package of policy responses to the currency crisis, the authorities have adopted a number of measures aimed at reducing currency speculation. Annex 1 of the report presents most of the measures that have been taken which, as the staff indicated, did not give rise to exchange restrictions. More recently, the Bangko Sentral ng Pilipinas or BSP (the central bank) required banks to submit a list of their foreign exchange contracts since the start of the year, including those that had been canceled, to determine whether they may have violated the limit on overbought foreign exchange positions. Further, on October 9, when the BSP reopened its overnight repurchase window, safeguards were instituted to prevent the use of borrowed funds for foreign exchange speculation.

My authorities are closely examining the impact of high interest rates and the peso depreciation on the banking system and the corporate sector. However, at this stage, the impact on nonperforming loans is not considered to be a significant problem.

Nevertheless, the authorities have taken important steps to further strengthen the financial system and enhance transparency in banks' financial operations. On October 1, the BSP issued a circular tightening the definition of past due loans by reducing the number of installments in arrears from six to three in the case of loans payable monthly and from two to one in the case of loans payable quarterly. On the same date, banks were mandated to set aside a two percent general loan loss provision over and above the provision for probable losses linked to individually identified bad accounts. The staff has raised concern over the appropriateness of the policy response of the BSP in raising the liquidity reserve requirement at a time when it was lowering policy-related interest rates. The use of the liquidity reserve ratio was seen by my authorities as a more effective tool in tightening liquidity without exerting too much upward pressure on banks' intermediation costs. On the whole, my authorities feel that the "conflicting measures" actually represent a harmonization of policies that supports the BSP's delicate balancing act at this time. While the rise in the liquidity reserve ratio tightened liquidity in the system, the reduction in the BSP's key interest rates encouraged the consequent decline in other rates such as the Treasury bill rate, the interbank call loan rate, and banks' lending rates, thus allowing activity to continue in the productive sectors of the economy.

On the peso volatility band which has been imposed by the Bankers' Association of the Philippines (BAP) since October 7, my authorities have a neutral view. The arrangement is symmetrical in its operation, and in fact on the majority of days to date has served to limit the appreciation of the peso. It is expected that the BAP will review the arrangement at some point.

On October 7, the Supreme Court issued a temporary restraining order against further increases in the prices of petroleum products. In particular, the Court issued a resolution ordering the country's three major oil companies to maintain their present prices on gasoline and other petroleum products until November 6, 1997. The Executive branch shares the concerns raised by the staff about the negative signals this may have on potential investors, and the President has remarked that the Supreme Court should not interfere with the oil sector.

My authorities share the critical importance that the staff attach to the passage of the bill covering the remaining elements of the comprehensive tax reform package (CTRP). A bicameral conference committee is now deliberating on the final provisions of the bill to resolve differences between the House and Senate versions. While both chambers support providing tax relief to wage income earners, particularly those in the lower income brackets, they also agree that the bill should have a positive net revenue effect. My authorities are confident about a favorable outcome and the passage of the bill by the end of this month.

In conclusion, my authorities remain firmly committed to implementing the Fund-supported program. My authorities look forward to meeting with the Fund mission in November and to completing the final review under the Extended Arrangement. They reiterate their appreciation to the management and the staff for its support and helpful advice particularly during their trying times.

Extending his remarks, Mr. Taylor said that the Philippine authorities had recently informed him that the outcome for the public sector borrowing requirement was well within the program target. Precise data on the public sector borrowing requirement was expected to become available later that week. That announcement was not intended in any way to lessen the importance of fiscal developments into 1998, but it demonstrated the commitment of the Philippine authorities to meet all performance criteria under the Extended Arrangement. The target for net international reserves was also expected to be met, despite the very difficult circumstances.

As to monetary developments, the growth of credit to the private sector had remained above 30 percent in the year to July, the period before the new monetary policy had been brought into focus, Mr. Taylor noted. According to the data available, which was for the single month of August, the rate of credit growth was about 1 percent, or about one-half of the growth rate prevailing in August the previous year. It would be difficult to assess whether there were any problems at the present stage, as the available data pertained to the period before short-term interest rates were reduced.

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

> A short and clear staff paper calls for short and straightforward comments.
>
> I welcome some recent developments which show that the external sector is responding rapidly to the depreciation of the peso and that the authorities are making serious efforts to comply with the program. Considering the persistent market unrest, some shortcomings are, however, matters for concern.
>
> On the monetary front, I agree with the staff that the choice made by the authorities to reduce early short-term interest rates was confusing (page 12). Although base money objectives have been met, the growth rate of credit to the private sector is still above 30 percent. This is not consistent with the magnitude of the adjustment required in the present environment.
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> On the fiscal front, stronger action is still needed: relying on cuts in public capital expenditures to meet performance criteria is unsatisfactory, and delaying the necessary implementation of the long-awaited fiscal package raises the eventual cost of the adjustments and does not help to restore confidence.
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> On the exchange front, the net international reserves objective has not been reached due to ineffective intervention by the monetary authorities until mid-August. Last July, a majority of Directors had insisted on the need to let market forces bring the peso to a new equilibrium level before envisaging any intervention strategy. Indeed, such action was likely to be costly and useless, as it actually proved.
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> Finally, in the perspective of the formal review, the situation of the Philippine banking sector should be closely monitored. The lack of detailed information is a cause of high uncertainty and low confidence. The protracted

crisis, a greater depreciation of the peso than anticipated, and trends in the property sector cannot but have had a significant impact.

In addition, the next review should be the occasion to establish new macroeconomic projections both in the near and in the medium term. This will help markets understand the authorities' strategy.

Mr. Shaalan made the following statement:

In spite of a generally appropriate policy response to the financial and currency crisis originating elsewhere in Southeast Asia, the Philippines continues to experience further turmoil, the extent of which was not anticipated by the staff. Policywise, I believe we are in an area of uncharted waters, but it is evident that the policy options before the authorities are rather delicate as the macroeconomic situation has become more difficult. What is clearly needed though is the pursuit of policies that would restore confidence, in particular to the financial sector. The high interest rates combined with a slow economy, as well as the sudden sharp drop in the peso, have complicated the problems facing the banking sector. The extent of the damage is yet to await a more thorough analysis by the Fund and Bank that would permit instituting appropriate measures to regain confidence in this crucial sector. Here is a question to the staff—what are we estimating for economic growth in 1997 and 1998? The data I see around appear to be on the high side.

I saw the supplement to the staff report issued today and must express my concern at what appears to be excessive intervention in exchange markets and by the seemingly weakened commitment to the announced floatation of the exchange rate.

While welcome fiscal measures have been put in place, I believe enactment and implementation of the comprehensive tax reform package should be accorded the highest priority. This would help restore confidence. While it appears that the Senate version of the bill is somewhat better than that of the House, as I understand from the staff, neither of them is totally satisfactory. It would be most unfortunate if at the bicameral stage a watered-down compromise reform package was agreed to. What is needed is a strengthened version of the Senate bill to attain the original objectives of the fiscal reform.

Mr. Mori made the following statement:

The Philippine economy is experiencing a difficult process of adjustment to face the changing circumstance of high volatility in capital flows. Decisive and timely policy responses are required to influence households, firms, and financial institutions' attitudes with the objective of restoring macroeconomic equilibrium through a smooth transition process. The efforts of the Philippine authorities to implement the necessary policy actions are commendable.

In stabilizing the exchange rate to a new level of equilibrium, monetary policy is an important element for ordering the convergence process. An appropriate level of interest rates may abate pressures on the exchange market by preventing arbitrage opportunities, delays in selling, and anticipation in buying foreign currencies. It is essential that domestic financial assets yield competitive rewards as compared to those expected on external assets.

Under current external conditions, however, efforts in individual countries, even when appropriate, seem not to be sufficient to overcome the problems in the exchange market. As, to a certain extent, the behavior of the Philippine financial markets is influenced by turbulence in markets elsewhere, the adjustment process in the Philippines would be reinforced by successful policy implementation in other affected countries in the region.

On policy implementation, monetary policy, as mentioned, has an important indicative role for the decision-making of economic agents in a context of a volatile exchange rate pattern. In this sense, the central bank's policy of raising the liquidity requirements and, at the same time, of reducing basic rates appears to be ambiguous. In terms of policy objectives, however, if the combined effect of these actions is a tightening of domestic liquidity, this fact is a relevant matter—though a straightforward, unambiguous policy is preferable.

Regarding exchange market behavior, the policy of floating the exchange rate in the Philippines and elsewhere seems to have generated an excessive depreciation of the currency not consistent with economic fundamentals. A similar misalignment may also occur in the other direction in a situation of large and continuous capital inflows. Free fluctuation of exchange rates could lead to an undue and protracted appreciation or depreciation of domestic currency resulting in macroeconomic imbalances. Therefore, international liquidity conditions have to be closely monitored and the necessary policy instruments timely implemented to avoid driving the economy to an unsustainable situation.

Finally, in a context of uncertainties and changing circumstances, there is a need for the adjustment program to allow certain flexibility in the establishment of nominal targets.

Mr. Ono made the following statement:

Policy reaction to regional currency turmoil by the Philippine authorities over the last few months has been basically appropriate. As the staff rightly pointed out in the Board paper, it is true that some policy reactions, for example, the introduction of ad hoc measures in order to stabilize the foreign exchange market and the sending of conflicting signals to the market by a combination of reducing interest rates and increasing liquidity requirements, need reconsideration. However, given that the persistence and scale of the turmoil in regional financial and exchange markets have been much larger than most people anticipated in July at the time of rearrangement of the program under the Extended Arrangement for the Philippines, it seems to me to be too harsh to criticize the authorities for some policy confusion mentioned above. I rather prefer to commend the authorities for conducting their major macroeconomic policies in the right direction, such as in the introduction of a floating exchange rate system, an enormous fiscal effort to restore the program on track, and maintaining the restrictive stance of monetary policy.

This chair broadly agrees with the staff appraisal and its policy recommendation. We fully expect the authorities to overcome the current difficult situation by taking appropriate policy measures in a timely fashion with a suitable response to future market developments, while maintaining close consultation and cooperation with the Fund staff.

I would like to focus my comments on a few issues which I think deserve attention.

First, needless to say, maintaining a flexible exchange rate system is of particular importance. In this regard, I would like to commend the authorities for their courageous decision to introduce a floating exchange rate regime and welcome their commitment to preserving it.

One important lesson to be drawn from the recent currency turmoil in Southeast Asia is that many emerging market economies, after achieving impressive economic growth over many years, are now approaching a stage at which they face difficulties with a continuing rigid exchange rate system. From this point of view, I would heartily encourage the authorities to maintain a flexible exchange rate policy.

I, therefore, support the staff's view that the peso should continue to float freely with limited interventions to the so-called smoothing operation.

Second, keeping a prudent and restrictive policy stance both in fiscal and monetary policy is the key to success in order to overcome the current difficult situation. The authorities should make a major effort to meet the fiscal targets for the year as a whole, especially in order to improve macroeconomic imbalance, namely resolution of the current account deficit, while at the same time avoiding excessive burden on monetary policy.

As for the Tax Reform Package, it is welcome to see that the Tax Reform Program bill passed by the Senate is preferable to the House version. I would like to encourage the formation of a bicameral committee with the purpose of achieving further improvements in revenue enhancement of the Tax Reform Bill. A disciplined comprehensive tax reform package is expected not only to contribute to a healthy fiscal system, but also to send a strong, positive signal to the financial and forex markets.

On the monetary policy front, given the recent edging up of the inflation rate, a cautious policy stance should be required. The current policy measure of a combination of lower interest rates and higher liquidity requirements taken by the authorities might be considered as one policy option. However, as long as depreciation pressures against the peso remain strong, such a policy runs the risk of inducing further currency depreciation. In this connection, the staff's recommendation that raising short-term interest rates and lowering reserve requirements would provide a more transparent signal to the market, is worth considering.

With these remarks, I wish the authorities success in overcoming their current difficulties through international assistance, namely the Fund.

Mr. Wijnholds made the following statement:

This is a timely discussion, particularly in view of the continuing lack of confidence that is extending the financial crisis in Southeast Asia beyond what most of us had expected after the program for Thailand was put together in August.

In the case of the Philippines, where contagion seems to have played an important role in the fall of the peso, and presumably also of the stock market, it certainly is disappointing to see that the weakness continues, although the latest news on the peso is a little better.

It seems clear to me that for the Philippines there has been an overshooting of the exchange rate. Indeed, the size of the depreciation is such that the danger of much higher inflation and weaker growth is quite acute. This may imply that a fresh look may be necessary on how to stop the extreme currency weakness and perhaps to reverse it to some extent. After all, the measures agreed with the Philippines in July were based on the assumption of a much more modest depreciation.

While a considerable part of the Philippines' continuing problems can be attributed to contagion, I agree with the staff that the policy tool mix following the floating of the peso in July is far from optimal. In particular I believe that the central bank would have been much better off by resorting to absorbing liquidity through market-oriented policy instruments such as reverse repos rather than raising the reserve requirements. In addition, by lowering the reverse repo interest rate to below market rates the central bank ceased to affect the marginal market interest rate and appears to have completely given up its flexibility in controlling interest rates.

A key policy question, in addition to the flexibility of monetary policy, is whether short-term interest rates should have been set at a higher level. It seems to me that interest rates were and probably still are not high enough in respect to the region as a whole. As to the effect of tight monetary policy on the financial sector and the stock market, the effect of a boost in market confidence could well exceed its possible adverse effects. Let us not forget that the experience of the past two months is that stock prices plummeted in conjunction with the decrease in the value of the peso and under the current not too tight monetary conditions.

Since I believe that at this stage further depreciation would be undesirable, I have some doubts about a strong insistence on a so-called clean float. At the same time, I am very much mindful of the danger of frittering away reserves in intervention when sales of foreign exchange are not backed up by strong policies, particularly in the area of interest rates. A mix of relatively high short-term interest rates with a judicious use of foreign exchange intervention would seem to me to be the best way to address the present overshooting of the peso. To those who espouse nonintervention even in these circumstances, I would like to quote from the most recent *World Economic Outlook*: "As a practical matter, developing countries for the most part are not in a position to allow their exchange rates to float freely as in the case of major currencies. Financial markets in many developing countries are not highly developed and foreign exchange markets are often thin, so that considerable volatility can arise in an unmanaged market, with a few transactions causing extremely large short-term exchange rate movements . . . There is thus generally a need for active management to help guide the market."

Let me be clear on my position: while I believe intervention to support the currency is warranted under the present circumstances, it will only make sense if there is a willingness to vigorously use the interest rate as the main line of defense. If the authorities are not prepared to do this, then intervention will be wasting resources and the peso will remain weak.

As to the effects on economic growth of relatively high short-term interest rates, I would argue that as high rates would only have to be maintained for a limited time and since it is long-term rates that mainly have an impact on growth, the authorities should not be excessively concerned about it. Moreover, wanting to maintain as high a growth rate as possible in the short term could well jeopardize growth in the longer term as the resulting policies causes the lack of confidence to continue.

Mr. Mirakhor said that he agreed with Mr. Wijnholds and Mr. Mori that the recent depreciation of the exchange rate had gone beyond the level justified by economic fundamentals. He wondered whether the staff could comment on the degree of overshooting that had taken place.

The recent turmoil in the currency markets in Asia seemed to warrant further studies on financial and exchange market crises in order to quantify their likely contagion effects, Mr. Mirakhor considered. He wondered whether the staff had begun work in that area, looking not only at exchange rate developments, but also at the likely impact of contagion effects on fiscal and monetary policies.

He agreed with Mr. Mori that, in cases like the Philippines, which were fraught with uncertainties and changing circumstances, there was a need for adjustment programs to allow flexibility in the establishment of nominal targets, Mr. Mirakhor stated. He wondered how much flexibility had been incorporated in the Extended Arrangement for the Philippines.

The Acting Chairman commented that it would be difficult to attempt to quantify the contagion effects involved in the Asian exchange and financial market crisis at the present stage. Such a study would need to take carefully into account the extent to which exchange rate fluctuations could be seen as justifiable based on economic fundamentals. An objective assessment of recent developments in Asia likely would not be possible for some, although the staff would begin studies on the experience in Asia soon.

Mr. Jonáš made the following statement:

First, I would like to say a few words on exchange rate management. I understand the authorities' concern about peso's high volatility, but this volatility seems largely exogenous in origin. Accordingly, I am not sure that the authorities can do much to reduce this volatility without undermining the functioning of foreign exchange market and making their own policy intentions harder to understand. The limited effectiveness of foreign exchange interventions during the first month after the float illustrate this point. The decision to stop these interventions is therefore welcome, but for the same reasons I doubt the appropriateness of introducing a volatility band and resuming official interventions in October. The staff argues that this band should be wide enough to allow the exchange rate to respond to market forces. But it is precisely at times of high volatility that this band could turn out to be quite restrictive to foreign exchange market. In addition, the repeated hesitation of the authorities to allow the exchange rate to be fully market determined could itself become an important cause of exchange rate volatility.

My second remark concerns the present mix of interest rate and reserve requirements. The authorities are using these two instruments in generally opposite directions, and sending conflicting signals about their monetary policy stance. Also, as shown in Chart 1, the reserve requirements have been changed quite often. The staff mentions that reserve requirements are usually not used for short-term monetary policy management. Indeed, it could be difficult for banks to adjust to frequent changes in reserve requirements, and high level of required reserves imposes a burden on peso intermediation. This comes at a difficult moment for the banks, who must deal with the possible credit risk of their foreign currency denominated loans to domestic clients. I think that reserve requirements should be used less flexibly as a tool of liquidity management, and the authorities should aim at their reduction in a preannounced way.

In conclusion, I hope the authorities will take the staff's concerns seriously. I share the staff's assessment that the authorities deserve the continued support of the international community.

Mr. Guzmán-Calafell made the following statement:

The problems faced by the Philippine economy following the financial turmoil in Southeast Asia have been more serious than initially expected. The blame for these difficulties rests to a great extent on the contagion effects of the crisis in Thailand and in other countries in the region. However, as the staff point out in the report, the situation has been complicated by market uncertainties related to certain features of the implementation of economic policy, and especially exchange rate policy.

The authorities have made courageous efforts to keep fiscal and monetary policies on track. In addition, they have attempted to improve some of the aspects of exchange rate policy that have been a source of concern. There remain, however, a number of areas in which the situation is not fully clear. I would like to refer briefly to some of them.

The implementation of exchange rate policy has been a central subject of discussion in the past few months. In particular, doubts have been expressed on the commitment of the authorities to a full market determination of the exchange rate. The decision to eliminate some of the controversial measures introduced to limit pressures on the peso is welcome. However, most of them remain in place and it is worrisome to see that intervention in October has been substantial again. Furthermore, the staff notes that the decision of the Bankers' Association to introduce a volatility band for the peso/U.S. dollar exchange rate may raise further doubts on the authorities' commitment to the floating regime. Independently of the merits or disadvantages of a band of this nature, I was surprised by the central bank's hands off position in this respect. In any event, I presume that the central issue here is to keep this mechanism under close scrutiny, and to eliminate it if the staff's fears materialize and it is perceived by the markets to be inconsistent with the floating regime, since otherwise the danger of speculative pressures on the peso would be accentuated.

The staff report underlines the authorities' determination to strengthen public finances. Following the slippages observed in the second quarter, a number of corrective measures were introduced involving efforts on both the revenue and expenditure sides. It is not clear, however, what are the reasons for the weakening of the National government finances in September. I welcome the actions identified recently to improve fiscal performance, as well as Mr. Taylor's comments regarding the authorities' intention to adhere to the programmed path.

The report deems the Comprehensive Tax Reform Package an essential component in the process of fiscal consolidation, and concludes that it is critical that the revenue-enhancing features of the reform are put in place. I sympathize with these views, but it is not clear to me to what extent is the government still in a position to have an influence on this issue.

While the overall orientation of monetary policy has been consistent with the program's objectives, I share the concerns expressed by the staff on the danger of giving conflicting signals to the market by increasing liquidity reserve requirements and simultaneously reducing policy related interest rates. I agree that these policy measures may hamper an adequate evaluation by markets of the monetary policy stance and delay the restoration of confidence.

I note that notwithstanding a sharp deceleration in the course of this year, credit growth to the private sector continues to show a sharp expansion, which is projected to reach 31 percent in 1997, slightly above the programmed figures. In light of Mr. Taylor's comments in this respect, it may be useful to hear the staff's views on the likely future evolution of credit and on the risks the economy faces from this source. This is an important issue given its potential implications for the banking system. Regarding the latter, Mr. Taylor notes that the authorities are monitoring the impact on the banking sector of the weaker peso and higher interest rates, and that they do not consider the impact on nonperforming loans a significant problem. Staff comments on this would be appreciated.

Mr. Donecker made the following statement:

In view of the ongoing confidence crisis in the Southeast Asian region, the Philippine authorities certainly need to persevere in strengthening the credibility of their adjustment measures.

We agree with the staff's assessment, that in the present situation the priority must be to ensure that the Philippine peso floats freely, with intervention limited to smoothing operations, and that this exchange rate policy is accompanied by—and supported through—tight fiscal and monetary policies.

Such a policy stance should also help to prevent a devaluation induced wage-price spiral and to contain the current account deficit to manageable size.

It is imperative that the authorities avoid giving any signals that might create new uncertainties about their determination to adhere to the agreed adjustment program and to reinforce it where necessary. In this context, we have considerable doubts about the usefulness of the volatility band, that was introduced on October 7, by the Banker's Association since such a band can create unwelcome incentives for speculation about a further currency depreciation, particularly so whenever the exchange rate is close to or at the lower end of the band. In comparison, a truly flexible exchange rate regime increases the risk of losses for speculators dramatically—and does not force the authorities to intervene with scarce reserves.

I am therefore concerned that the recent significant interventions together with the earlier introduction of the volatility band will encourage markets to test the authorities' commitment to a floating exchange rate. Can the staff tell us more about the likely effects of these interventions for the Philippine's adherence to the programmed net international reserve targets?

With regard to balance of payments developments it is useful to keep in mind not only the changes in the composition of the current account deficit, described by the staff, but also the fact that a large share of the imported goods needed for the production of export goods and other essential imports are invoiced in U.S. dollars. Thus the recent strong depreciation of the peso likely will have further reduced the competitiveness of the Philippines vis-à-vis other trading partners in the region such as China or Vietnam.

As regards fiscal policy, in view of the weak revenue performance we support the staff's call for sustained strengthening of budget revenues. At the same time, the authorities should seek a further reduction of current expenditures. A further compression of the already relatively low capital expenditures does not seem advisable. Fiscal policy, indeed, has a crucial role to play in supporting the efforts of the monetary authorities to tighten aggregate demand conditions. It is thus very important, that parliament will agree on a strong Comprehensive Tax Reform Package which ensures that the original objectives of the tax reform in terms of efficiency, equity and revenue improvement will be achieved.

I assume that the next review paper will also include a staff assessment of the situation of the banking system and of the appropriateness of the existing banking supervision regime in the Philippines.

Mr. Han made the following statement:

Although the Philippines is unfortunately affected by the currency crisis in the region, the authorities are courageous in having boldly floated the peso and delivered heavy remedial measures to protect the economy. After almost three months of implementation of the Fund's program under the Extended Arrangement, the authorities should be commended for adherence to the fiscal and monetary targets set by the program, despite more difficult economic development and increased pressure on the peso. Therefore, we view the implementation of the program as mainly on track and support the authorities' further efforts in this regards. However, in view of the more difficult macroeconomic situation: such as the slower growth, the expected rise in inflation and the difficulties in restoring the capital inflows, the overall macroeconomic policies need to be kept tight.

In general, sharp depreciation of the peso has resulted in the increase in inflation and the slowing down of the economy. In such circumstances, the authorities are facing a policy dilemma, for it is difficult to focus on reducing inflation without greatly hurting the economy. It is crystal clear that the current priority lies in restoring the market confidence as soon as possible; success in achieving such a goal is really a matter of skillfulness in managing the combination, timing, and dosage of policy recipes. In this connection, Mr. Taylor's helpful statement provided some clues to the answer. Now, let me comment on some important policy issues.

First, tighter monetary policy is central to the success of anti-attack action. I welcome the authorities' adherence to the monetary program through end-August. In particular, I welcome the authorities' action in strengthening the oversight on banks' foreign exchange positions and enhancing the banking supervision standard, as indicated in Mr. Taylor's statement. Regarding the conflict signals, by increasing the reserve requirement and lowering the interest rates, although theoretically I could agree with the staff rationale on raising interest rates and lowering reserve requirements, I can understand from Mr. Taylor's statement that at the present circumstance, where the economy is slowing down, raising the reserve requirement ratio could be less hurting to the economy than increasing interest rates. However, the expected higher inflation may warrant raising interest rates in the end. Therefore, I would like to encourage the authorities to prepare these instruments and other open market operation measures before inflation becomes high.

On the external account, I have no problem with the current account performance which is in line with the program. The shift in the composition is a result of the technical reclassification of services. However, I noted that the size of external debt will be increased in the staff projection, and the analysis of the external debt is not mentioned in the staff report. Could the staff inform us of the composition of external debt in the Philippines, especially the short-term debt, as it has strong impact on the financial market.

On fiscal policy, I am pleased to note that the overall fiscal performance has improved sharply since June, and the end-September performance criteria for the PSBR has almost been met. Fiscal policy is mainly on the right track since the expenditure-reducing measures dominate the improvement of the fiscal performances. However, these measures which mainly rely on reducing capital expenditure may not be durable, therefore reducing the current expenditures should be the future focus. Given the weak tax revenues, I support the authorities' intention to adjust the public corporations and government expenditure. The passage of the Comprehensive Tax Reform Program bill on September 1 is encouraging and I hope that the bicameral committee will make further improvements to the bill, in particular to rationalize the income tax incentives. In this regard, I welcome the message that both cambers agree that the bill should have a positive net revenue effect.

With these remarks, I wish the authorities success in leading the economy out of the present difficulties.

Mrs. Sein made the following statement:

The Phillippines is facing the downside effects of short term capital inflows, just like those faced by some of the countries in our constituency . The saying that the market reacts first and thinks later is true in the current situation in Southeast Asia. The latest reactions in the market does not adhere to the existing fundamentals of the economies. These countries being attacked are countries with substantial foreign reserves that have clearly surpassed the criteria of the Fund for strong economies whose currencies are eligible for use in the operational budget. These countries are following the suggested remedies of fiscal and monetary policy restraints and structural reforms. Yet these policies have proven to have little or no effect at all. The market is showing its natural instincts, that is, once spooked the normal instinct is to be cautious in returning to the same place. Therefore the key to the puzzle, as the staff and some directors have pointed out, is through confidence building not only for the Philippine economy but for some of the countries in our constituency. These include the following.

The Philippine authorities' confidence building should involve the need for transparency and consistency in both fiscal and monetary policies. This would assure investors that a period of austere management and investor-friendly policies lie ahead. Moreover important statistical information on both monetary and fiscal developments that depict a clear picture of the economic situation needs to be made available with timeliness as a crucial factor. With these policies being implemented, domestic firms may have a better chance of negotiating for the rollover of their loans as foreign creditors' confidence builds up.

On the fiscal front, we are encouraged by the authorities recognition of the importance of the comprehensive tax reform package and structural improvements. These include structural reforms to increase the competitiveness of the agriculture sector through modernization, the implementation of a minimum tax on corporate income and the ongoing expenditure constraints. These actions are welcomed and will continue to build investor confidence in the economy. Despite these favorable actions the authorities should continue, as a precautionary measure, to identify and stand ready to implement further expenditure constraints as revenue shortfalls in customs duties and privatization receipts may happen.

The monetary authorities, in their efforts to mop up liquidity, should refrain from direct controls of liquidity requirements as much as possible so that the market does not misinterpret this as a move by the authorities to more arbitrary controls. Moreover policies when implemented should not depict conflicting signals that create uncertainty in the market as is mentioned in paragraph 12 of the report. Furthermore positive moves, such as the imposition of a mandatory two percent provisioning for general loan loss provision and the reduction in the number of installments in arrears from six to three for loans payable monthly and from two to one in the case of loans payable quarterly, are obviously steps in the right direction.

To conclude, I would like to wish the Philippine authorities success in their endeavors ahead.

Ms. Srejber made the following statement:

I agree with the staff and other speakers on most issues, including on the need to keep the exchange rate floating and keep monetary policy and fiscal policy sufficiently tight. But, in view of the staff's and many other speakers' critique of the techniques for reaching the objectives of the exchange rate and monetary policies, I would like to discuss these issues somewhat more in detail. I am not convinced by the staff's argumentation, and I am not sure I am convinced by the authorities' argumentation either, which might be because the issue is very briefly touched upon, both in the staff report and in the statement, naturally, because normally we do not go into such detail in the techniques. But, as I said, I feel it might be necessary now, in order to clear our thoughts a bit.

Let me then first discuss the rationale for intervention in the foreign exchange markets and the issue of the level of reserves. Let me at the outset say that, as other speakers and the staff, I would continue to caution the Philippine authorities against prematurely focusing on any specific level or band for the exchange rate. But it is my understanding that no such official band exists. Let me come back later to discuss the daily volatility band introduced by the Bankers' Association.

I think it is important to distinguish between the objective of the policies and the means of getting there. As I understand it, the objective at this stage is to maintain the currency floating and at least to have the reserves over the floor for the net international reserves—that is, to replenish reserves. Several speakers have pointed out that the authorities would not be able, through interventions or through announcing some level of exchange rate, to establish a new equilibrium level. Instead, the markets should be left to establish a new equilibrium level of the exchange rate in due time. I am not sure here how to interpret the actions by the Philippine central bank. There is a commitment to keep the exchange rate floating. But, on the other hand, it seems, if you look at the sum of the interventions, that one has been intervening more on the side of selling foreign currency. So there seems to be somewhat different views here. I am not sure, and maybe Mr. Taylor or the staff could enlighten us.

There might thus be some difference on the goals, but let me now turn to the techniques. I think it is useful to distinguish among interventions for different purposes in the exchange markets; interventions with a policy purpose—that is to achieve a specific exchange rate or a band, interventions to replenish reserves, and interventions made to create a market in a disorderly situation. As a central bank, you can have these three different hats on when you approach the markets. The markets do not have any difficulty, really, understanding that, if you are clear.

It might be easier for us to try not to discuss these three purposes at the same time, because I think everybody gets pretty confused then. If we have, then, a float which we want to keep freely floating, obviously policy intervention is not an issue. You should not do policy intervention in order to establish a new equilibrium. But if you have a market that is not used to floating and you have, as is the case now of the Philippines, a situation where there is a lot of unrest in the markets around, it is easy that the markets, especially if it is a small country where the markets are thin from the beginning, that you end up in a situation with excessive volatility. If you have excessive volatility, market participants would be reluctant to take on risk and the market will function badly. You must have market makers in order to make the market work, and market makers must be willing to take on exchange rate risk. But if the volatility is very high, the market makers risk being stuck with a position that would make them lose too much money at the end of the day; they will then not participate in the market as market makers taking on risk, and you get a thinner and a thinner and a thinner market. And then you get more and more and more volatility, and then importers and exporters will have huge problems. If the markets by themselves cannot create a market, normally it is the role of a central bank to create the market, one way or the other. Here I agree with what Mr. Wijnholds said. In small countries with thin markets, especially in developing countries, but also in other small countries, it is the role of the central bank to create the market, to help the market to function. Thus, intervention with this purpose, to give some sort of security or whatever one can call it—some indicative guidance—is not out of place.

I have the impression from the staff papers that the central bank first was intervening and then after a while just left the market on its own, and which might have led the Bankers' Association to introduce this daily volatility band, which obviously could only be introduced with the agreement of the central bank, even if Mr. Taylor says that the central bank is neutral. Here the market tries to establish a market. It cannot do it by taking on positions, because then it would lose money. To my mind, I think we cannot both say that it is bad with a Bankers' Association volatility band and say that it is bad with all central bank interventions because then there will not be any market functioning in the Philippines, I would guess.

I think, in this situation, that the Philippines central bank is in a very difficult situation. It is extremely difficult to create a functioning market when you have an environment like in Southeast Asia and you have a newly introduced floating exchange rate. As I said, my view on this would be that the central bank should stay out of policy intervention, but interventions in order to create a market would not necessarily be wrong. However, I am not sure, that has actually only been what the central bank has been doing. It seems, even if I do not have the exact figures and thus I do not know how much the central bank has been on the buying or the selling side. But I can interpret from the information that the central bank has had difficulty to reach the net international reserves target, that they have been more on the side of selling foreign exchange than buying, and that they have not only been in the business of creating a market. I am open for views from Mr. Taylor and the staff on this.

Then turning to the level of reserves. There, also, I think, we give very confusing messages. There are two ways to accumulate reserves: either you buy foreign exchange in the market, or the government borrows foreign exchange abroad and exchanges this foreign currency off the market in the central bank. There are no other ways of increasing reserves. And since the external debt of the Philippines is already relatively high, around 50 percent, of which the main part is government debt, if I understand correctly, at least I would not suggest increased borrowing in order to keep up reserves. And then the only way to replenish reserves is intervention. Then again, we cannot tell the central bank not to intervene at all. It is possible to intervene and replenish reserves without indicating any level for the exchange rate or to indicate a band. It depends how you do it. Either you can do it by a specific amount each day, so everybody knows there is no policy message there, or you can do it depending on how the push in the market is—how much you can take out of the market. There are many examples of that in practical life.

Then, on the monetary policy, it seems that there is not a total agreement between the staff and the authorities on how to use the monetary policy in order to have some influence on the exchange rate, but I might be wrong here. But it appears that the staff and the authorities agree on that the credit growth is excessive and that there is a need to reduce it. And then again the issue is: how do you do that? What is the best technique? Is it through interest rates, as it seems the staff favors, or is it through direct measures, like increasing reserve requirements, as it seems the authorities favor, although they do very many things? As you know, if you increase a reserve requirement, what you actually do is you introduce (I assume these reserve requirements are not fully remunerated—there is no information on that, but I assume that; otherwise they would not have any interest-increasing effect) a tax wedge between interest on loans and interest on deposits. Theoretically, it is absolutely possible to achieve the same interest rate with both methods. But, of course, if you have an unremunerated reserve requirement, as everybody knows, you give a competitive disadvantage to your domestic banks vis-à-vis the foreign banks; you increase the cost for intermediation. But, here again, I think one has to think a bit about the transmission mechanism. I could well imagine a structure of a market where it might be faster to effect the interest rates through a reserve requirement than through increased short-term policy rates.

If there would be a market structure where there was a clear difference between the market for the government and for the banks, on the one hand, and households and small companies, on the other hand, it could make sense to use somewhat unconventional methods. However, my interpretation of the staff report and of Mr. Taylor's statement is that, as the interest rates have gone down on T-bills, interbank market, and lending rates, it seems to me as if the lowering of the interest rates has not been neutralized by the hike in the reserve requirements. I interpret that as overall the monetary policy has been eased. Maybe Mr. Taylor or the staff could help me, if I am correct on that. That might not be consistent with trying to limit the depreciation of the exchange rate and keeping the inflation down, but I would be very interested in hearing from Mr. Taylor or from the staff a clearer explanation of why the authorities opted for hiking reserve requirements instead of keeping the interest rates up. As I said, I could imagine a market structure where that would make sense, but if another explanation is that the political support for keeping high interest rates is going down and then the authorities choose a less transparent way, the authorities would face a credibility problem on the markets, because in the market they will not have any trouble to see what the authorities do by increasing reserve requirements but, of course, for the general public it would be very difficult to see what the central bank is doing. So the issue then is if the political support for a tight monetary policy is waning, and I am not very sure how to interpret this, Mr. Taylor might help me.

Mr. Mirakhor noted that Ms. Srejber seemed to agree with Mr. Wijnholds that a freely floating exchange rate system would be best for the Philippines, provided the authorities relied on adjustments in short-term interest rates as the main instrument of monetary policy. However, based on the three reasons for exchange market intervention highlighted by Ms. Srejber, active exchange rate management might be appropriate to help guide the markets. As Ms. Srejber had noted, changes in reserve requirements could be just as effective as adjustments in short-term interest rates in controlling monetary conditions. He wondered whether Ms. Srejber had a preference between direct and indirect instruments of monetary management in the case currently under consideration.

Ms. Srejber responded that direct instruments of monetary policy, in particular adjustments in short-term interest rates, clearly helped to enhance transparency and market stability. Nevertheless, there might be valid arguments, depending on the structure of a market, for using indirect methods of monetary management in some cases. In the case of the Philippines, there was clearly a need to tighten monetary conditions. Once agreement was reached on that objective, various methods for achieving it could be evaluated taking into account the particular circumstances of the country, including the need for measures to create a well-functioning market.

Mr. Al-Turki made the following statement:

The Philippines' authorities should be commended for their efforts to put the economy back on track. Unfortunately, despite the measures implemented in the context of a Fund-supported program, the economy did not respond as expected. As the staff notes, the greater than anticipated depreciation of the exchange rate, reflecting continued turmoil in regional currency markets, worsened the prospects for growth and inflation.

The sharp fluctuations in the exchange rate seems to indicate that the value of the peso is more influenced by developments in the regional currency markets than by domestic economic policies. This, of course should not imply that the authorities' policy response is not critical. Indeed, I fully agree with the staff on the need to maintain a tight fiscal stance. Strengthening the comprehensive tax reform package by including the original revenue enhancing elements is critical in that regard.

Finally, I would appreciate staff comments on policy options that are available if the regional currency turmoil continues over the next few months.

With these remarks, I wish the authorities success.

Mr. Eyzaguirre made the following statement:

At the outset, I would like to commend the authorities for their commitment toward macroeconomic stability as well as their flexibility to adapt the policy framework to market developments.

Having said this, however, I fully agree with the staff's assessment of the effectiveness of the measures taken to limit exchange rate volatility after the float was established. During our discussion on July 18, I expressed my concern about the authorities' intention to provide "indicative guidance" to the markets in circumstances of extreme uncertainty. Therefore, I welcome the abandonment of most measures aimed at limiting pressure on the peso by mid-August. While I believe that within a float there is some scope for intervention directed toward smoothing exchange rate movements, I have doubts on the effectiveness of the new band of 4 percent introduced to limit movements in the peso/U.S. dollar rate in any given day. Explicit rules of intervention in the middle of significant turmoil may do little but foster speculation.

With regard to monetary policy, I still find it difficult to understand the logic of reducing policy-related interest rates and urge the authorities to reconsider these measures. However, I do not necessarily share the staff's point of view with regard to lowering reserve requirements. All too often currency turmoil goes hand in hand with instability in bank deposits. Hence, resorting to reserve requirements as a source of potential supply of liquidity may prove adequate.

I welcome the sharp improvement in overall fiscal performance since June, especially given the urgent need to avoid an excessive use of monetary tightening for the purpose of controlling aggregate demand conditions. Excessive monetary tightening could be very detrimental to the financial sector, and entail the risk of inducing a spillover effect from financial instability to currency instability. Like the staff and given the importance of fiscal policy, I regard a strong and comprehensive tax reform package as an essential element in providing short- and medium-term stability. It is comforting to learn about the initiatives toward strengthening the financial sector as conveyed by Mr. Taylor in his informative statement. However, in the future I would very much appreciate more detailed information about the financial sector's health as well as an assessment of the regulatory and supervisory framework.

Finally, I would appreciate further clarification on inflation prospects. The adoption of a free float scheme has allowed a significant depreciation of the currency, a development that may last for some time ahead. In that framework, one should recognize that control of inflation is undermined. While monetary and fiscal policy should strictly control domestic demand to limit the current account deficit—maybe to somewhat less than 4 percent of GDP while the unstable regional situation persists—it seems to me almost unavoidable to accept more inflation. The contraction in the rate of growth of domestic demand that is needed to ensure a moderate current account deficit is presumably less intense than the one necessary to preclude an increase in inflation. A policy stance aimed at a low inflation target that would result in a major real depreciation could only be achieved at the cost of significant losses in output growth and employment. Moreover, given the buoyant export growth it is difficult to argue that a major realignment of the real exchange rate is necessary. Regrettably, this tends to show that, at least in the short run, greater exchange rate flexibility may hamper the effectiveness in controlling inflation. Staff comments are welcomed.

Mr. Mirakhor said that Mr. Eyzaguirre was correct to point out that, in situations of turmoil, it might be best to restrict exchange market intervention. However, he wondered how Mr. Eyzaguirre would respond to the point raised by Ms. Srejber on the need to build international reserves. For a country with a heavy external debt burden, like the Philippines, the only way to acquire additional reserves was through intervention in the market.

Mr. Eyzaguirre responded that, in the case of the Philippines, most exchange market intervention was likely aimed at selling dollars to forestall the downward pressure on the peso. In the circumstances, some volatility in nominal exchange rates was nearly inevitable. Moreover, market intervention could take place only at a high cost in terms of reserves. The authorities were probably not going to be able to counter speculation through adjustments in interest rates alone, as the markets were looking beyond the short-term policy response to the authorities' longer-term commitment to maintain tight fiscal and monetary policies and to allow the exchange rate to be market determined.

Ms. Srejber noted that in cases where the authorities did not take a view on the optimal level of the exchange rate—as should be the case in the Philippines—market intervention could entail either buying or selling currencies, especially in circumstances of extreme volatility. Therefore, it was important to differentiate between the kinds of market intervention taking place.

She agreed with Mr. Eyzaguirre on the importance of defining clearly the purpose of monetary policy in a way that readily transparent to the markets, Ms. Srejber stated.

Mr. Grilli asked whether the staff could comment on the extent to which there was a need to make changes in the program supported by the Extended Arrangement to take into account recent exchange rate developments and the authorities' policy response to them. Would it be necessary for the Philippines to adopt tighter fiscal and monetary policies than originally envisaged? If so, what was the expected time frame for those policy adjustments?

Although the Fund staff considered that the Philippine economy was generally sound in terms of its economic fundamentals, the continued market volatility clearly reflected skepticism on the part of the markets, Mr. Grilli said. He wondered whether there was a need to look at additional factors, such as the political situation of the country. Although political problems were sometimes reflected only in the slowness of parliaments to act, they could have a fundamental impact on they way markets viewed the ability of a government to cope with difficult situations.

Mr. Mozhin made the following statement:

> The developments in Asian currency markets since the inception of the program confirm that the decision to float the peso taken by the Philippines' authorities on July 11 was the only viable option. Moreover, as the scale and length of the turmoil proved to be much greater than anticipated, still no viable alternative to the free float is in sight. The authorities' own experience with interventions and ad hoc measures aimed at stabilizing the foreign exchange market is the best testimony to this conclusion. According to the staff, all these efforts proved essentially ineffective.
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> It is, of course, regrettable that the original program assumptions with respect to growth and inflation proved overoptimistic. As we are still at the very beginning of the learning process of the typical characteristics of modern currency crises, significant errors in assumptions and projections are, probably, unavoidable. However, the fact that in all three cases—Mexico, Thailand, and the Philippines—we have erred significantly on the optimistic side is rather worrisome. The reluctance to consider less optimistic scenarios at an early stage of a currency crisis is quite understandable, as we live in a world of expectations which often play a decisive role. At the same time, the disadvantages of excessive reliance on optimistic scenarios are also rather serious. Perhaps, the fruitless efforts of the Philippine authorities to stabilize the peso exchange rate at a less depreciated level could be explained by the fact

that until mid-August they had remained captives of the overoptimistic assumptions. I would suggest that next time we are faced with a currency crisis we proceed on the basis of several scenarios and think more about contingency planning.

As I consider the clean float the only viable exchange rate policy option at this stage, I am rather skeptical with respect to the decision of the Banker's Association to introduce a volatility band for the peso/dollar rate in an attempt to stabilize the foreign exchange market. I agree with the staff that this step could be interpreted by the market participants as a sign of a weakening of the authorities' commitment to a clean float and may prove counterproductive, as this may only stimulate more speculation. The recent resumption of interventions in the foreign exchange market is also regrettable.

The impact of a much larger than expected depreciation of the peso and high interest rates on corporate and financial sectors is, obviously, a matter of great concern. I understand that this subject will be addressed in detail in the context of the forthcoming final review under the Extended Arrangement. However, I would appreciate it if the staff could share with us their preliminary views and assessments on this subject.

The authorities have to be commended for their persistent efforts to strengthen the fiscal position, even despite some weakening of the revenue performance in September. It is clear that the fate of the Comprehensive Tax Reform Package will be crucial. I would be interested to learn what was the impact of the currency crisis on the parliamentary debate on the tax reform package. I would appreciate staff comments.

Another question that comes to mind is whether the authorities have considered any measures on the structural side aimed at stimulating capital inflows? For example, measures like those undertaken in neighboring Thailand and Indonesia?

In conclusion let me say that I fully agree with the staff that the Philippines' authorities continue to deserve strong support of the international community, as they continue to perform reasonably well under the most difficult circumstances.

Ms. Lissakers made the following statement:

At this late stage in the speaking order, I am left in the position where one normally associates oneself with the comments of my colleagues. But maybe, in this case, I should be a little more specific.

First of all, on Mr. Mozhin's last point, I very much agree that the Philippine authorities have been working diligently to follow the program and under very difficult circumstances, and they certainly deserve our continued support. Nevertheless, I think the staff has, in their earlier report to the Board, highlighted some areas of concern and some weaknesses in performance, and I thought that Mr. Autheman laid out very succinctly each of those points.

But it leaves us, I think as Ms. Srejber said, with some question marks over the clarity of our own advice. I think she is quite right to point out the need sometimes for central banks to perform as market makers in order to improve the functioning of the foreign exchange market. So, I do not have any objection in principle to the Philippine authorities playing that role. I agree with her this should involve sometimes being on the other side of the market, not always being on the same side of the market. The question is whether they are doing more than that.

When you look at the combination of continued weakness in the currency, the projection by the staff that inflation will be in the double digits by the end of the year, continued strong credit expansion during most of this year—which goes to Mr. Mozhin's point, the fact that bank reserve requirements have actually been lowered gradually and short-term interest rates have come down in the face of continued portfolio outflows from banks, and continued decline in overseas worker remittances—which is a very important balance of payments item for the Philippines—the idea that only market-making is at work does not really hang together.

Accordingly, I wonder whether the interest rate policy makes sense at this time. I do not see that the authorities, under these circumstances, are really left with any other option than to accept a substantially lower growth scenario and to tighten both on the monetary and the fiscal side, because without restoring confidence in the currency nothing else is going to work right. You will not get the turnaround.You will not get the stabilization that is needed. I would be interested in the staff's remarks.

The earlier paper shows reserve-import coverage recovering somewhat between the summer and September, from a low of 2.2 months of reserve cover to a little above 2.4 percent. I wonder if the staff could tell us where the ratio now stands. On balance, it is clear that market confidence has not yet been restored in the Philippines, and I do not think one can attribute all of that to continued turbulence in neighboring markets.

I also think that Mr. Mozhin put his finger on an issue that is relevant not only to the Philippines, but to our programs and policy advice in other neighboring countries undergoing the same sort of exchange rate pressure. Are we encouraging authorities to have unrealistic expectations about maintaining growth in the face of this currency turmoil and could that lead to policy errors because of the expectations that we may be encouraging?

Mr. O'Loghlin made the following statement:

The staff paper is encouraging in some respects about developments since the Phillippines floated the peso. There is comfort in the healthy performance of exports; in the determination to protect banks' integrity implicit in the recent redefinition of past due loans and the mandated general loan-loss provision; and in the removal of a potential source of market uncertainty by disclosure of reserves net of forward transactions.

But the situation clearly remains fraught. Since I agree with the thrust of the staff recommendations, I will confine myself to three points of emphasis:

First, certainty about exchange rate policy is central to the restoration of broad exchange stability. Like the staff, this chair believes that markets will view the new "volatility band" as a weakening of commitment to a free float—and will see recent official intervention in a similar light. We believe that these actions—like some other regulatory measures also adopted/activated since July—obscure the policy stance; and are likely, therefore, both to prolong peso instability and to deepen its adverse impact on real investment and growth. Longer-run interests would be better served, in our view, by a perceptibly stronger commitment to a free float.

Second, even if the Extended Arrangement's end-September fiscal parameter has been observed (as Mr. Taylor has been advised), economic slowdown must shortly begin to impact adversely on the fiscal balance. In this context the early—and full—adoption of the revenue-enhancing elements of the comprehensive tax reform package is critical, to maintain confidence in fiscal policy.

Third, nonfood price pressures have been picking up into the autumn, and there is a devaluation impact still to come. The BSP needs to carefully monitor developments, and, if signs of margin-building by business or demands for offsetting wage adjustments emerge, to further tighten the monetary stance in order to ensure that inflation does not ratchet up substantially.

Finally, I agree with the staff that the authorities have been pursuing a new exchange rate policy under very difficult circumstances. We wish them well in their efforts to fully restore confidence.

Mr. Brooke made the following statement:

The most important issues currently facing the Philippines are the slippages in the fiscal program. As Directors have emphasized on many previous occasions, a substantial strengthening of the fiscal position is an essential ingredient in the achievement of sustained economic growth and external sustainability. Against this background, it should be emphasized that any measures to improve the fiscal position should be of a lasting nature. Actions of only temporary duration are not likely to restore confidence in financial markets.

I fully agree with the staff that a strong comprehensive tax reform package is essential. Further efforts are clearly needed to ensure the achievement of the original objectives of the Comprehensive Tax Reform Package, in terms of efficiency, equity, and revenue enhancements. I welcome the indication from Mr. Taylor that both chambers of the legislature agree that the bill should have a positive net revenue effect. However, the draft bill seems to indicate otherwise. It is to be hoped that Mr. Taylor's assessment of the situation proves to be true.

With respect to the exchange rate, I agree completely with the staff that the priority should be to ensure that the peso floats freely.

I welcome the indication from Mr. Taylor that the authorities have taken further steps to strengthen the financial system and to enhance transparency in the banking sector. Nevertheless, I agree with the concerns expressed by Mr. Autheman about the lack of detailed information. I wonder whether the staff could comment on whether the poor provision of banking sector data reflects poor collection methods or unusual secrecy. It is to be hoped that the authorities will continue to watch out for the emergence of more significant problems in the banking sector.

As this chair noted at the previous discussion on the Philippines, actions to reduce disincentives against peso intermediation are needed. Clearly this objective is not consistent with the recent increases in reserve requirements, although those increases have been reversed somewhat recently.

Finally, I share the concerns expressed by the staff about the recent decision by the Supreme Court to control increases in the prices of petroleum products. This move calls into question both the appropriate role of the Supreme Court in such economic issues and the wisdom of the justices. It is worrying to note that the Supreme Court does not appreciate the negative impact such actions will have on business confidence.

Ms. Srejber said that she could associate herself with the point raised by Ms. Lissakers and Mr. Mozhin that the Fund tended to be overly optimistic at the outset of financial market crises. In that respect, important lessons could be drawn from experience in other countries, including some of the countries in her constituency.

Mr. Disanayaka made the following statement:

I sympathize with the Philippine authorities for the difficulties they are currently facing. They should be encouraged to push ahead with their tough policy package even in the present environment of contagion effects and fluctuating market sentiments.

The measures being taken by the authorities represent a step in the right direction, although as the staff indicated, some corrections in the policy course appear to be necessary. I agree with Ms. Lissakers that the basic objective at the present stage should be to restore market confidence. Toward that end, the authorities will need to pursue tight fiscal and monetary policies and avoid sending any misleading signals to the markets. Other important goals will need to await the economic stabilization and the return of market confidence.

As strong fiscal policies will be essential in this effort, it is to be hoped that the Comprehensive Tax Reform Package will be approved by the legislature soon. In that respect, I strongly agree with the observation made by Mr. Grilli that the political dimension of reform is crucial, even if the Fund does not normally emphasize that aspect of it. It is becoming increasing clear that there is an important political element to the financial crisis in southeast

Asia. As the Fund is not equipped to address that element, the ball is very much in the court of the country authorities concerned.

In the current circumstances, I would encourage the Philippine authorities to push ahead forcefully with courage, foresight, and wisdom. It is to be hoped that, with assistance from the Fund, they will soon be able to overcome the problems currently facing their country. I wish them success in their efforts.

Mr. Barro Chambrier made the following statement:

It is unfortunate that despite the Philippines authorities' efforts to stabilize the economy, the contingent effects have led to the turbulence in the regional financial markets. The pressure on the peso has continued and has been much greater than expected. Indeed, as clearly indicated in the staff report, between July 11 and September 30, the peso depreciated by 23 percent against the U.S. dollar. In light of this difficult situation, priority will be to restore market confidence, so as to limit further intervention in the exchange rate market.

Given the still prevailing uncertainty, I agree that the authorities should continue their efforts to strengthen fisçal policy and pursue a tightened monetary policy.

As regards fiscal policy, efforts should be intensified to further contain expenditures and improve revenue performance. On the latter, I welcome, in particular, the efforts being made to adopt a Comprehensive Tax Reform Program. I note that this reform, if implemented, without delay, would strengthen the fiscal effort over the short and medium term.

With regard to monetary policy, I urge the authorities to adopt the staff recommendation aimed at raising short-term interest rates and lowering reserve requirements. Also, I share the concern regarding inflation, which makes it necessary that a tight monetary policy be maintained. Like others, I also consider it important that the authorities continue to further strengthen the financial system and enhance transparency in banks' financial operations. I am, however, very concerned by the fact that the banking system is likely to face higher ratios of nonperforming loans. Although at this stage, this issue is not considered to be a significant problem, however, it should be monitored very carefully.

Finally, it is critical that the Philippine authorities rely on the support of the international financial community.

With these remarks, I wish the Philippine authorities well in their daunting tasks.

Mr. Kaufmann made the following statement:

> We share the concerns expressed by several Directors about some of the recent policy steps undertaken by the Philippine authorities. On the exchange rate band, we see some merit in halting foreign exchange trade if the market moves too fast in one direction. However, we see little sense in introducing a volatility band in a period of great nervosity in the foreign exchange market, as this might be interpreted as if the authorities remain skeptical about a floating exchange rate regime.
>
> During the last weeks, investors also got mixed signals about the authorities' future policy stance in other policy areas. As the staff points out, there have been inconsistencies on monetary policy. The Supreme Court's decision on petroleum prices adds to the uncertainties. Moreover, we wonder whether the requirement of a two percent general loan loss provision will prove to be adequate, given the protracted high level of interest rates, the large peso depreciation, and the vulnerability of banks to developments in the property market.
>
> Finally, we take note that fiscal adjustment was mainly achieved through cutting public capital spending. We worry about the progress of the Comprehensive Tax Reform Program in the parliamentary process. Much needed adjustment on the revenue side of fiscal policy seems to fall short of expectation.

The staff representative from the Asia and Pacific Department noted that real GNP growth in 1997 would clearly be lower than originally envisaged, and inflation rates were expected to pick up in late 1997 and in 1998. Thus, it was clear that the targets initially set under the Extended Arrangement were no longer viable.

Although the recent difficulties were largely attributable to the contagion effects of the financial and exchange market crisis in Asia, there were fundamental issues within the Philippine economy that needed to the addressed, the staff representative said. As indicated in the program supported by the Extended Arrangement, there was a need to reduce the trade deficit, to pursue fiscal consolidation, and to address remaining structural problems in the banking system. As the nominal targets envisaged under the original program had been overtaken by events in the region as well as by developments in the Philippines, they would need to be revised in setting the authorities' objectives for 1998.

Average inflation for 1997 was currently expected to be within the target, of 6–7 percent set in July 1997, the staff representative stated. However, the sharp depreciation of the peso could push inflation rates up sharply by the end of the 1997 and into 1998. Thus, a key issue was the extent to which the authorities should continue to pursue that inflation target. It would be important to consider not only whether that target could still be seen as plausible, but also what the continued pursuit of that target might mean in terms of the real economy and output. As Ms. Lissakers had indicated, it might be beneficial over the longer run for the economy to take an initial hit in terms of output in order to move more quickly onto a path of recovery.

There were serious constraints on the extent to which fiscal policies could be further tightened in the short run, the staff representative continued. One of the main objectives of the program supported by the Extended Arrangement had been to ease some of those constraints with respect to both revenues and expenditures. Under the program approved in July 1997, the authorities had targeted the achievement of a small fiscal surplus for 1997 and larger surpluses in 1998 and beyond. Despite the recent difficulties, the authorities still hoped to attain that goal. However, it was becoming increasingly less clear whether they would be able to do so, especially given the forthcoming elections. In the circumstances, achievement of the fiscal targets set in July 1997 would represent a major contribution to the stabilization effort.

The spillover effects of the regional currency market crisis could negatively impact the Philippine economy in a number of areas, the staff representative went on. For example, the heavy external debt burden of the Philippines was a cause for concern, especially taking into account the share of short-term external debt. The short-term external debts combined with the net foreign liabilities of the banking system amounted to about 150 percent of gross reserves. Although the trade deficit had declined to about 13 percent of GDP over the past year, it remained relatively large. Moreover, it would be difficult to achieve further significant reductions in the trade deficit over the medium term.

Prior to the exchange market crisis, monetary policy had been geared toward the achievement of the inflation target, the staff representative said. That policy had allowed for some intervention, to sell dollars, but only to the extent needed for market smoothing. In July, the banks had been forced to change the policy stance held for more than 18 months virtually over night. However, that should not be taken to mean that the market was so thin that it had not been possible to establish a market-determined rate. On the contrary, the market quickly revived to a turnover on the order of $150–200 million per day. The disputes within the Bankers' Association reflected the increased ease with which the larger foreign banks were able to respond to the changing situation and the reluctance of some of the smaller banks to act in the new environment.

The volatility band that had been introduced in the first four days after the decision was taken to float the peso had been abandoned, because it had proven unsuccessful, the staff representative stated. Nevertheless, that band had recently been reintroduced. In normal circumstances, use of a volatility band to impose limits on trading of up to 4 percent a day would not have adverse effects on market confidence. However, in the current environment, the reintroduction of the band was giving rise to more volatile exchange rate movements, and the authorities had intervened quite heavily in the market over the past week. Thus, if the purpose of the volatility band was to stabilize the market and improve confidence, it had not had that effect thus far. Over the period ahead, the merits of the volatility band would need to be assessed on the basis of whether or not it was helping to improve confidence.

The overall monetary policy stance remained tight, the staff representative noted. The end-September target for net international reserves had been met. Although the stance of monetary policy had fluctuated somewhat over recent months, the overall policy remained broadly consistent with the initial program supported under the Extended Arrangement.

At the outset of the current program in July, the staff had expressed the hope that short-term interest rates would be maintained at high levels, the staff representative recalled. Nevertheless, the authorities had chosen to reduce them and, instead, to raise the reserve requirements in order to have more direct control over reserve money. Clearly, the staff would continue to recommend reliance on interest rates as the main instrument of policy, given the high costs, especially in terms of confidence, that could be associated with the route taken by the authorities.

It would be very difficult to try to estimate the extent to which the depreciation had gone beyond levels that could be justified by economic fundamentals, the staff representative considered. That question would need to be examined in the context of the next staff visit to the Philippines. Such an estimate would need to take into account the extent to which movements in the exchange rate were being driven by developments in the corporate sector, the extent to which banks were hedging their foreign exchange positions, and the concerns related to financing the current account deficit. The fact that the staff had not foreseen the recent exchange rate movements at the time that the previous meeting took place in July did not, in itself, mean that the depreciation was completely unjustified.

The data on net international reserves were still very preliminary, and the final data for end-September 1997 were not yet available, the staff representative noted. Nevertheless, it seemed that in the most recent period some purchases of foreign exchange had taken place outside of the foreign exchange market. The staff was seeking clarification from the authorities on that question, but if the target for net international reserves was to be met, such operations would likely be unavoidable. Gross reserves had increased by about $0.5 billion in the last week or two of September. Thus, the rebound in the reserves coverage for imports was continuing.

Credit growth was expected to fall back, at a fairly rapid rate, to 30 percent over the remainder of the year, the staff representative said. At the same time, however, the path of credit growth over the year as a whole, especially taking into account the very high rates achieved in the early part of 1997, suggested that a significant credit crunch might be occurring in a number of areas. That possibility would need to be examined carefully in the context of the next mission to the Philippines.

The next mission would also focus on the banking system, the staff representative stated. In that area, the staff would follow up on the previous work carried out by the Monetary and Exchange Affairs Department and the technical assistance provided by the World Bank. The mission would also examine carefully the ways in which the banking sector was reacting to recent market developments.

Data on the banking sector was available with lags, especially with respect to banks' exposure to nonperforming loans, the staff representative noted. However, even on the basis of more up-to-date information, it would be difficult to determine exactly how the banks might respond to future developments. At the present stage, it would be essential to assess the potential risks to the banking system, in particular with respect to the vulnerability of the banks based on their foreign exchange exposure and the likely credit risks emerging after several years of fairly high rates of credit growth.

Against that background, three issues related to prudential supervision should be emphasized, the staff representative from that Asia and Pacific Department considered. First, there was a need to establish a more level playing field for peso/dollar intermediation. That effort would need to take into account both the current situation with respect to reserve requirements and the tax regime. Second, the present laws pertaining to bank secrecy in the Philippines were very rigid. That made it difficult to determine the extent to which bank capital was borrowed. Finally, there was a need to consider an appropriate exit strategy. Given the fairly large number of banks operating in the Philippines, which had a liberal banking system, some were bound to run into difficulties. Thus, it would be useful to determine how the central bank would react to significant banking sector problems should they arise. Those three key issues would be pursued in the context of the next mission.

Mr. Grilli asked whether the staff could comment on the rationale for emphasizing expenditure cuts in the current circumstances. In the absence of forceful efforts to increase revenue, the markets would not likely find the authorities' effort to turnaround fiscal policy credible. Therefore, the primary objective should be the speedy implementation of revenue-enhancing measures.

The staff representative from the Asia and Pacific Department responded that the authorities' main goal was to improve the revenue base over the medium term. In that connection, their priority was to obtain parliamentary approval for the proposed tax legislation aimed at increasing the revenue base and improving the structure of taxation. However, that effort was likely to prove politically difficult and timing consuming. More important, the authorities did not have the ability to raise taxes in the middle of the year. Although the authorities certainly intended to push ahead on that initiative and on improvements in tax administration, in particular to try to recoup some of the slippages that had occurred in the first half of the year, most of the short-term fiscal adjustment would inevitably fall on the expenditure side of the budget.

As to the extent to which the recent crisis had helped focus political efforts on getting the fiscal package through parliament, it should be noted that parliamentary procedures had recently become more difficult, the staff representative said. The timing related to parliamentary consideration of the fiscal package had slipped, and forging a consensus within parliament had become more difficult. At the same time, however, the President had recently called together both the Executive branch of the government and the parliament to push through tax reform measures. It was hoped that it might be possible to build on the momentum gathered in recent weeks to ensure that the final version of the fiscal package would be better than either of the original proposals put forward by the House and by the Senate.

Ms. Lissakers asked whether the staff could comment on the role the World Bank was playing in the work related to financial sector reform. She also wondered whether the strong export performance the Philippines experienced in the first half of the year was expected to decline, owing to the weaker outlook not just for Southeast Asia and Japan, but also for the region as a whole.

Mr. Donecker said that he wondered to what extent the authorities' reluctance to push through decisive revenue-enhancing measures accounted for the recent bouts of exchange rate volatility. As the fiscal reform package was an essential part of the economic adjustment program, any perceived weakness with respect to the authorities' willingness or ability to implement it could give rise to further speculation in the markets. In the circumstances, any efforts by the central bank to help guide the markets could be misguided.

The staff representative from the Asia and Pacific Department noted that, in recent discussions with the Philippine authorities, the World Bank had offered further technical assistance in areas related to the financial sector. The World Bank had already laid a lot of groundwork for improvements in the financial sector in the context of previous technical assistance projects. The Fund staff would continue to work closely with the World Bank in both its surveillance efforts and in the provision of technical assistance to the Philippines.

Exports remained buoyant, registering about 22–23 percent growth in dollar terms for the year, the staff representative stated. As a large part of the export growth in the Philippines was attributable to the strong performance of electronics, particularly to the U.S. market, it might be more protected from the adverse effects of the regional crisis than some other countries. Indeed, the Philippines had benefited from the shift in investment from some other ASEAN countries. The recent change in the exchange rate was not expected to significantly harm competitiveness.

The authorities considered that full implementation of the program supported under the Extended Arrangement, especially the fiscal package, would be critical to rebuilding confidence in the financial markets, the staff representative from the Asia and Pacific Department commented. It was for that reason that the authorities had continued to push forcefully ahead in the effort to obtain parliamentary approval of the proposed tax-reform measures, despite the clear political risks involved.

Ms. Lissakers asked whether the staff was confident that the monetary targets set out under the Extended Arrangement were appropriate for the current circumstances of the Philippines.

The staff representative from the Asia and Pacific Department responded that it would be necessary to review the monetary targets originally set out under the Extended Arrangement in the light of recent developments. Further adjustments would likely be needed, particularly for the period extending beyond the next few months. That would be a key issue in forthcoming discussions with the Philippine authorities. In that respect, it would be important to take into account the buildup of reserves that had been expected to take place from end-December 1998. The original program had been based on the assumption that the authorities would, by that time, regain sufficient access to the foreign exchange market to purchase a significant volume of dollars. That assumption had clearly been overtaken by events. The staff would revisit all of the main elements of the program in its forthcoming discussions with the authorities.

Mr. Taylor thanked Executive Directors for their comments, which would be conveyed to his Philippine authorities. While Directors had congratulated the Philippine authorities for the vigor and diligence of their response to developments in the region, they had criticized almost every method used by the authorities in that response.

As the current discussion was the first review of progress under the Emergency Financing Mechanism, it originally had been envisaged as a short, well-targeted exchange of views on specific matters of particular importance, Mr. Taylor noted. Instead, the discussion had proven to be very thorough. There might be a need to consider how detailed such reviews should be, especially given the frequency with which they were to be held.

It was disappointing to note the suggestion that Mr. Autheman's statement could be seen as an appropriate description of the situation in the Philippines, Mr. Taylor commented. Two or three of the main points put forward in Mr. Autheman's statement had been overtaken by events since the staff paper was circulated. For example, workers' remittances had increased by 18 percent. Also, with respect to the authorities' efforts to obtain parliamentary approval of the CTRP, it should be noted that the Philippine political system was similar to that of the United States; the Executive Branch could not directly control the legislature.

On another factual point, some Directors had seemed to imply the central bank had interfered in the exchange rate volatility band. Mr. Taylor noted. That was not the case, although the central bank had not yet taken steps to eliminate that band. Although the staff and the authorities seemed to differ on the question of appropriate intervention in the exchange market, Directors' views also differed on that subject. Against that background, it was important to note that program target for net international reserves had been met. In the current situation, in which the authorities were faced with forecasts for significantly weaker growth, a sizable pickup in inflation, and a troubled banking system, the role of reserves would become critically important. As the staff had indicated, there was clearly a need to obtain complete information in that area.

With respect to the conduct of monetary policy over recent months, it was important to bear in mind that the monetary targets under the program had been met, Mr. Taylor commented. The authorities had chosen to raise liquidity requirements—rather than interest rates—because they saw that as a more direct and certain means to meet the program target than any of the alternative means available. Clearly the issues related to monetary policy would be an important focus of discussions between the staff and the authorities in the period ahead.

He agreed with other speakers on the importance of fiscal package, particularly the adoption of the CTRP, Mr. Taylor stated. However, it was surprising to note that the current discussion had focused as much on the timetable for parliamentary approval as on the substance of the package, if not more. In the present circumstances, the immediate goal should be to avoid any further slippages on the fiscal front, while efforts to obtain parliamentary approval were under way.

The Acting Chairman noted that the current discussion on the Philippines marked the first review under the Emergency Financing Mechanism adopted by the Fund in 1995. While the procedures called for early and frequent involvement by the Board in monitoring progress until the emergency was definitively resolved, Directors might wish to reflect on the appropriate degree of detail required for such reviews.

The Executive Directors agreed to consider the matter further at the final review under the Extended Arrangement in December 1997.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/97/101 (10/10/97) and EBM/97/102 (10/15/97).

6. REPUBLIC OF CROATIA—REVIEW UNDER EXTENDED ARRANGEMENT

1. The Republic of Croatia has consulted with the Fund in accordance with paragraph 3(d) of the Extended Arrangement for the Republic of Croatia (EBS/97/9, Sup. 2), approved March 12, 1997.

2. The letter of the Minister of Finance and the Governor of the National Bank of Croatia dated June 19, 1997 shall be attached to the Extended Arrangement, and the letters of the Minister of Finance and the Governor of the National Bank of Croatia dated January 23, 1997 and February 17, 1997, and the memorandum attached thereto, shall be supplemented and modified by the letter dated June 19, 1997.

3. Accordingly, the performance criteria set forth in paragraph 3(a) of the Extended Arrangement for end-December 1997 shall be as specified in Annexes I through VI of the letter dated June 19, 1997.

4. The Fund decides that the first review under the Extended Arrangement for the Republic of Croatia has been completed and that, until October 17, 1997, the Republic of Croatia may make purchases under the Extended Arrangement up to an amount equivalent to SDR 86.34 million, notwithstanding the nonavailability of data for the end-September 1997 performance criteria. (EBS/97/115, Sup. 1, 10/8/97)

Decision No. 11588-(97/102), approved
October 9, 1997
effective October 10, 1997

7. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 96/18, 96/68, 96/93, 96/100, 96/111, 97/31, 97/32, and 97/36 are approved.

8. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/97/155 (10/9/97), by Advisors to Executive Directors as set forth in EBAM/97/158 (10/10/97), and by an Assistant to Executive Director as set forth in EBAM/97/154 (10/8/97) is approved.

APPROVAL: May 18, 1998

REINHARD H. MUNZBERG
Secretary

Budget Cycle

Executive	A.	Preparation of budget.
▼	B	Presentation of budget to parliament.
Parliament	A.	Discussion on budget and appropriation.
▼	B.	Passing of Appropriation Act.
Executive	A.	Collecting revenue and other dues.
▼	B.	Spending as per appropriation in the most efficient way to achieve objectives of expenditure.
	C.	Maintenance of transparent accounts as per appropriations authorized by parliament open to inspection after full compilation.
Comptroller & Auditor General ▼		Conducts performance audit and review of expenditure. Presents audit reports and performance review to Parliament.
Parliament ▼		Examines audit reports and accounts to satisfy itself that budget performance was as per expectations. Irregularities, violations are pointed out in reports for government to take appropriate action.
Executive		Complies with parliamentary directions.