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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 89/62

2:30 p.m., May 23, 1989

M. Camdessus, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	C. Enoch
	Zhang A.
	C. S. Warner
	L. K. Hubloue, Temporary
	J.-P. Schoder, Temporary
	L. B. Monyake
E. A. Evans	
E. V. Feldman	
L. Filardo	M. A. Fernández Ordóñez
	E. Ayales, Temporary
	G. García, Temporary
R. Filosa	
M. Finaish	
	P. Gorjestani, Temporary
G. Grosche	B. Goos
	E. Kiriwat
	A. Vasudevan, Temporary
	L. M. Piantini
	J. R. N. Almeida, Temporary
	D. McCormack
	J.-C. Obame, Temporary
Y. A. Nimatallah	
	M. Fogelholm
	D. Marcel
	G. P. J. Hogeweg
K. Yamazaki	

L. Van Houtven, Secretary and Counsellor
C. Wahlstrom, Assistant

Also Present

IBRD: L. Derbez, Latin America and the Caribbean Regional Office; N. Hicks, Asia Regional Office. Asian Department: P. R. Narvekar, Director; B. Banerjee, U. Baumgartner, D. J. Goldsbrough. Exchange and Trade Relations Department: J. T. Boorman, Deputy Director; T. Leddy, Deputy Director; E. Brau, M. V. Carkovic, K. P. Regling, L. Valdivieso, C. M. Watson, M. Xafa. External Relations Department: G. P. Newman, H. P. Puentes. Fiscal Affairs Department: H. R. Lorie. IMF Institute: A. Samia, Participant. Legal Department: F. P. Gianviti, General Counsel; W. E. Holder, Deputy General Counsel; R. H. Munzberg, Deputy General Counsel; T. M. C. Asser, A. O. Liuksila, J. K. Oh. Research Department: R. Baban, N. R. Chrimes, D. A. DeRosa. Treasurer's Department: D. Gupta, A. Mathuran. Western Hemisphere Department: S. T. Beza, Director; J. Ferrán, Deputy Director; S. Bonilla, L. E. DeMilner, J. Garza-Gomez, C. S. Lee, A. S. Linde, C. M. Loser, E. Sumar, E. Suss. Office of the Managing Director: P. Shome. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: N. Adachi, F. E. R. Alfiler, J. Basiuk, M. B. Chatah, M. Eran, J.-L. Menda, P. D. Péroz, M. Pétursson, S. P. Shrestha, D. C. Templeman, R. Wenzel. Assistants to Executive Directors: H. E. Codrington, E. C. Demaestri, J. Gold, M. E. Hansen, J. Heywood, ~~L. K. Hubloue,~~ K.-H. Kleine, V. K. Malhotra, N. Morshed, A. Napky, A. Rieffel, C. Schioppa, M. J. Shaffrey, Yang J.

1. COSTA RICA - 1989 ARTICLE IV CONSULTATION, AND STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1989 Article IV consultation with Costa Rica and Costa Rica's request for a 12-month stand-by arrangement in an amount equivalent to SDR 42 million, including Costa Rica's intention to request an augmentation of that amount by up to 40 percent of quota (EBS/89/87, 5/3/89; Cor. 1, 5/8/89; and Sup. 1, 5/18/89). They also had before them a background paper on recent economic developments in Costa Rica (SM/89/87, 5/15/89).

Mr. Ayales made the following statement:

On behalf of my Costa Rican authorities, I would like to express appreciation to the Executive Board, management, and staff for their continued support of the country's adjustment efforts and for the cooperative manner in which the negotiations for this stand-by arrangement have been conducted. The staff papers, with which my authorities are in broad agreement, provide a comprehensive and balanced assessment of recent economic and financial developments in Costa Rica.

It is useful to view Costa Rica's economic and financial performance in 1988 in a broader scope and from a longer-term perspective. During 1988, further steps were taken toward the elimination of internal imbalances and the achievement of sustained economic growth, as well as the strengthening of the external position. In the early 1980s, Costa Rica experienced a deep financial and economic crisis: inflation soared to unprecedented levels (domestic prices increased by almost 90 percent in 1982), national output contracted sharply (real GDP fell by 10 percent during 1981-82), and open unemployment climbed to over 9 percent. In addition, the combined public sector deficit reached the equivalent of 14.1 percent of GDP and the external current account deficit widened to 15.8 percent of GDP. Highly negative real interest rates prevailed, and the exchange rate in the parallel market was five times the rate in the banking system.

The firm commitment of the Costa Rican authorities to a process of macroeconomic adjustment and structural reform that began in 1982 has led to a significant reduction of domestic and external imbalances. Over the last five years, Costa Rica's rate of economic growth has been robust, averaging almost 5 percent annually over this period, and inflation has been reduced to about 15 percent. A temporary surge in price indicators in late 1988 owing to weather conditions has since abated. The economic recovery, which has been spurred on by a strong performance of nontraditional exports, has brought down unemployment to a manageable level of about 5 percent. During this period, the combined public sector deficit/GDP ratio was reduced to about 3 percent (including central bank losses on an accrual basis), and the external current account deficit was reduced to one third of its 1981 level. In a major policy change, interest rates were left to be determined by the interplay of market forces, which has resulted in levels that are positive in real terms. Flexibility was introduced in exchange rate policy and most exchange restrictions were eliminated.

These achievements were made possible by a number of factors: (a) the pursuit of sound macroeconomic policies and the authorities' determination to adopt corrective measures when needed; (b) the implementation of a broad program of structural reform; (c) the gradual opening of the economy; (d) the appropriate consideration given to the social costs of the growth strategy, particularly as regards wage and income distribution policies; and (e) the support of the international financial community, not only in terms of the financial assistance provided by multilateral institutions and governments, but also their support in seeking the normalization of the relations between Costa Rica and its commercial bank and bilateral creditors.

Notwithstanding these major strides, the Costa Rican authorities believe that much remains to be done and are fully committed to maintaining the course toward greater stabilization and higher rates of economic growth. They are fully aware of the need to curb continuing inflationary pressures and to find a more permanent solution to the external debt problem. It is important to mention that although there was a departure in the trend of domestic price increases during 1988, the primary causes--the steep devaluation at the beginning of the year, adjustment of controlled prices and public utility tariffs, and interruption of food supplies owing to hurricane damage--are not expected to be present in 1989 and, in fact, the total increase in consumer prices in the first four months of this year was only 1 1/4 percent. While much of this performance is due to declines in food prices, the outlook for the rest of the year is for much more moderate increases than in 1988. A sharp reduction in the rate of inflation should facilitate the implementation of the economic program and the achievement of the objectives of fiscal policies, particularly regarding the wage bill.

The renewed efforts toward stabilization are part of a comprehensive economic program for 1989-90, aimed at raising domestic savings, promoting private investment, and improving the efficiency of resource use, so as to lay the foundation for more rapid and sustained growth of output and employment opportunities. To achieve these objectives the authorities intend to further reduce domestic and external imbalances through the continuation of prudent monetary and credit policies and further improvement of the public finances. At the same time, macroeconomic management will be complemented by the continuation of the program of structural reform, supported by the World Bank, that is focused on the import tariff schedule, the financial sector, agricultural pricing, and the operations of the public enterprises. Furthermore, the authorities will continue to seek, in a cooperative spirit, an accommodation with external creditors to bring debt service payments to a level consistent with the country's medium-term macroeconomic objectives and growth prospects. In this context, Costa Rica requested the Paris Club members to convene in the month on May in order to consider the rescheduling of the country's bilateral debt.

The main elements of the country's economic program for 1989-90, the strategy for dealing with the external debt situation, and the program of structural reform are described below.

With the aim of diversifying exports and competing efficiently with foreign suppliers in the domestic market without reliance on high levels of protection, the Government's adjustment program is oriented toward widening and modernizing the productive base of the economy. Within this framework, adequate private sector access to domestic resources is being supported by flexible exchange rate and interest rate policies. Since the staff report explains in detail the provisions and objectives of the economic program for 1989-90, I will only highlight its main elements.

The program foresees a reduction in the combined deficit of the public sector, including the Central Bank's net operating losses on an accrual basis to 2.8 percent of GDP from 3.7 percent of GDP in 1988. In view of the limited scope for reducing these losses, which mainly reflect the impact of the depreciation of the colón on the external debt, this will be achieved through a reduction in the deficit of the Central Administration and an increase in the surplus of the rest of the nonfinancial public sector.

The tax reform approved in late 1987 encountered some obstacles in its first year of implementation; these obstacles have now been removed and the reform is expected to have its full impact in 1989. The expected improvement in revenue performance will be complemented by a contribution from banana exporters and producers to cover part of the cost of upgrading export infrastructure.

The Government will continue to pursue a restrained fiscal policy, focusing on prudent wage policies, a reduction in transfers to the rest of the public sector, and reform of export incentives. The Government will continue the freeze in public sect employment that has been in effect since 1985 and will ensure that salary adjustments will not cause the public sector wage bill to rise in real terms.

In an effort to strengthen further the financial situation of the decentralized agencies and public enterprises, tariffs and charges will continue to be adjusted to reflect variations in operating and debt-servicing costs, as well as investment requirements. In this light, the electricity and telecommunications tariffs and the prices of various grain products were raised in recent months.

Regarding monetary and credit policy, lower domestic financing requirements by the public sector in 1989 will allow for an increase in bank credit to the private sector, in the context of a prudent overall credit program. Furthermore, in an effort to maintain the attractiveness of savings in domestic currency, the authorities will continue to pursue a flexible interest rate policy.

In order to further improve export performance, especially in nontraditional activities, while reducing the country's dependence on imports, the Government intends to continue its flexible exchange rate policy. In this regard, the exchange rate will continue to be adjusted according to price movements in Costa Rica and its trading partners, so as at a minimum to maintain the real effective value of the colón at the level of December 1988.

Notwithstanding Costa Rica's successful implementation of economic and financial stabilization policies while undergoing a process of structural reform over the 1983-88 period, the country's external debt has remained a serious constraint upon its efforts to achieve sustained economic growth. The agreements for the rescheduling of the external commercial debt in September 1983 and in May 1985, and the Paris Club agreements in January 1983 and in April 1985, contributed only partially to alleviating the country's critical external debt problem, as they focused on solving short-term cash flow liquidity difficulties rather than long-term balance of payments viability and growth prospects.

The multilateral institutions have been of the view that Costa Rica's medium-term balance of payments prospects hinge on the willingness and ability of major donors to provide substantial concessional assistance and further debt reschedulings. Furthermore, there has been a consensus that even under the most optimistic scenario, there will be a continuous need for substantial debt relief in the years ahead. Based on these and other considerations, the Government undertook a reassessment of Costa Rica's external debt strategy in 1986, which has led to attempts to find solutions with a longer-term perspective.

Since 1986, Costa Rica has been discussing with its creditors approaches to its debt-servicing difficulties that would help create the conditions necessary for a more orderly and effective implementation of the structural adjustment program. As described in more detail in the chronology circulated for the informal meeting on Costa Rica on January 18, 1989, there have been three stages to these discussions. In the first stage, from mid-1986 to early 1988, Costa Rica sought to regularize its payments situation with creditors in a traditional framework and to explore, beyond that, longer-term arrangements that would recognize the special circumstances surrounding Costa Rica's case as a small, highly indebted middle-income country, and enhance the country's growth prospects. Two proposals were presented, both of which involved a rescheduling of outstanding debt at much longer maturities and grace periods, and initially reduced interest rates. The banks, while fully aware of Costa Rica's payments difficulties, differed somewhat among themselves on their approach to this situation, and in any case could not support a precedent-setting proposal that would affect their negotiations with larger debtor countries. At the same time, they did not respond to the authorities' request for payments relief with proposals for a conventional approach. There had indeed developed a consensus among the banks for some time that "new money" was not appropriate in the case of Costa Rica.

In a second stage, which began in the spring of 1988, the authorities cooperated with Bank of America and the World Bank in trying to work out a debt rescheduling which involved (a) principal collateralization with a zero coupon bond (or an insurance-type guarantee) purchased by the banks, and (b) below-market interest payments guaranteed by a fund administered by the World Bank and financed by Costa Rica. In June 1988 it became clear that the new approach had some technical flaws related to the tax advantages presumed by Bank of America. More importantly, it generated strong opposition by other banks and creditor country authorities. On the one hand, some of the banks once again were concerned about setting a precedent; on the other hand, official sectors in creditor countries feared a possible transfer of risk from the private sector to multilateral institutions.

The third stage began in the summer of 1988. In view of the failure of traditional approaches to deal with Costa Rica's case, discussions between Costa Rica and its commercial creditors centered on a menu of options to deal with different interests among banks. These differences and the knowledge that some of the banks wanted to dispose of their Costa Rican debt led to the idea of a two-stage approach. The first stage would be a cash buy-back, which was considered to be the most expeditious debt reduction mechanism; the second stage would consist of a menu of financing alternatives to be negotiated when the buy-back is completed. Work on this approach took place in the fall of 1988, including draft waivers for the buy-back operation and the identification of sources of financing for the transaction. However, the announcement of the Brady initiative last March and public dialogue of new techniques for debt reduction, including participation of multilateral institutions, led to a change in the environment. Consequently, following a meeting of the Costa Rican authorities with the Advisory Committee on May 12 and subsequent contacts with the lead bank, it was decided to consider from the beginning a more comprehensive and simultaneous approach to debt reduction. As agreed with the banks during that meeting, the authorities are planning to convene the Advisory Committee shortly to accord the necessary broader waivers.

The Government is fully committed to continuing the structural adjustment efforts initiated in 1983, with the financial support of the World Bank. A wide-ranging set of global and sectoral objectives has been outlined to promote a higher and more substantial rate of growth, a better allocation and more efficient use of domestic resources, as well as strengthening of Costa Rica's creditworthiness.

The first phase of the program, which was supported by a structural adjustment loan from the World Bank, focused attention on two main areas--trade and public finance. The trade reform aimed at lowering the effective protection and included tariff reductions, a shift of specific tariffs to an ad valorem basis, introduction of a modern nomenclature, and reduction of import surcharges. In the public sector, investment programs were rationalized, employment was reduced, and a program for improving the financial situation of decentralized institutions and enterprises was initiated.

A second structural adjustment loan from the World Bank, cofinanced by the Government of Japan, will support the Government's efforts in a second phase of the program, which is concentrated in four areas: reform of the import tariff system and incentives in the external sector; reform of the financial sector; restructuring of the pricing, marketing, and subsidy policies in the agricultural sector; and privatization and rationalization of public sector enterprises. The main objectives of these reforms can be summarized as follows: (a) fostering export-led growth and diversification by reducing the level and dispersion of effective protection and by reducing the fiscal costs and distortionary effects of the present export incentive scheme--this will facilitate the country's access to GATT, which is expected to become effective next July; (b) improving the quality of the state banks' portfolio, strengthening the supervision and control of financial intermediaries, and increasing competition in the banking sector; (c) reducing pricing and marketing distortions in the agricultural sector; and (d) promoting cost effectiveness and rationalization of expenditure in the public enterprises. The Government's letter of intent in support of the request for this stand-by arrangement provides a more detailed account of the measures to be implemented to achieve those objectives.

My authorities believe that the efforts in recent years to eliminate domestic and external imbalances have yielded positive results. While temporary events and circumstances might have provoked departures from quantitative targets in the past, the authorities have always reacted promptly by implementing the corrective measures necessary to attain the broader macroeconomic objectives. As in the past, they remain committed to the path they have chosen and stand ready to take any further measures that may become appropriate to achieve the objectives of the current economic program.

The impressive adjustment of the Costa Rican economy achieved since 1982 has been made possible, to a large extent, by the firm support of the Fund. However, my authorities remain concerned about the high vulnerability of the country to external developments, particularly in view of the very delicate political situation in the region and the uncertainties regarding the external financial environment.

My authorities believe that their commitment to the economic program is a necessary--though not sufficient--condition to come to a lasting agreement with the international financial community. They feel that the continued support of the Fund is essential, not only for the financial resources and assistance with policy design, but more importantly in signaling its support of the adjustment program to the rest of the international financial community. While Costa Rica has already approached the Paris Club and other bilateral official creditors in an effort to reach a financing agreement, the Fund's support of the country's program would facilitate a final agreement with commercial creditors, in a clear example of the catalytic role of this institution.

Extending his remarks, Mr. Ayales said that recent data on domestic financial developments were very encouraging. As for the rate of inflation, the data for January-April were extremely promising, putting the target of a one-digit inflation rate for 1989 well within reach; that would, in turn, facilitate the achievements of the program objectives in the fiscal sector. Regarding the external debt situation, the authorities had scheduled a meeting with the Chairman of the Advisory Committee of the commercial banks soon after the negotiations with the Paris Club. They hoped that those discussions would result in an agreement on the corrections to the waiver that would need to be made for Costa Rica to be able to engage in a more comprehensive and simultaneous approach to debt reduction than buy-back operations. In that connection, a clearer definition of the global debt strategy would certainly facilitate a prompt agreement. For the past six years, the Fund had played a very important role in the process of adjustment with growth in Costa Rica, and the authorities were expecting the Fund's full support also in the future. His authorities had expressed interest in requesting an augmentation of the amount of the stand-by arrangement by an amount of up to the equivalent of 40 percent of the country's quota to support debt reduction operations. Nevertheless, they understood that the activation of an augmentation would be subject to the presentation of a full financing package.

Mr. Warner made the following statement:

We are pleased that Costa Rica is the first country to request access to Fund resources for the purpose of debt and debt service reduction. My authorities feel that Costa Rica has not received the attention it deserved from the international financial community during the past two years. They are quite disappointed that Costa Rica and its commercial bank creditors have had so much difficulty agreeing upon financing packages consistent with the economic programs adopted by Costa Rica. Consequently, our recent proposals for strengthening the debt strategy have sought to ensure that good performers like Costa Rica obtain the external financial support they need in a timely fashion.

Let me say at the outset that we support Costa Rica's request for a stand-by arrangement. I will make a few comments about developments since the last Article IV consultation, and about the program for 1989. Then I would like to take up the manner of applying to this case the guidelines agreed by the Board earlier for the Fund's role in the strengthened debt strategy.

With respect to recent developments, we have the impression that Costa Rica's adjustment efforts have generally improved over the past year. Nevertheless, we regret the policy slippages that occurred in the second half of 1988, especially in the area of fiscal policy. These slippages contributed to inflationary and balance of payments pressures, and slowed down the pace of progress toward external viability. Among the slippages, we are particularly concerned that the surplus of the nonfinancial public sector, apart from the Central Government, was half of the targeted level. We would like to see a better outcome in 1989, and in this connection, we would like to know why the target for this year has been set at 1.9 percent of GDP when the target for last year was 2.8 percent. We are also concerned that the fiscal objectives are apparently being met by compressing capital formation by the public sector to the lowest ratio in the past five years.

Turning to other elements of the 1989 program, we would like to underscore the importance of containing social security expenditures. We see considerable risk to the fiscal targets unless the system is maintained on an actuarially sound basis. In addition, we agree with the staff on the importance of closely monitoring wage developments. With unemployment currently at approximately 5 percent, the risks from this quarter are also significant.

With regard to monetary policy, we commend the authorities for their successful management last year of an outbreak of insolvencies in the financial system. Now that the situation has stabilized, and the process of restructuring is moving forward, it will be important to avoid arrangements that have a budgetary cost. Furthermore, we urge the authorities to reconsider the credit ceilings on banks that were reimposed last year. While the Government and the banks may find some comfort in these ceilings, they must be viewed as an obstacle to achieving greater efficiency in this sector.

With regard to the external sector, we welcome the commitment of the authorities to avoid any appreciation of the colón above the end-1988 level. In this connection, we would be interested in knowing how the authorities have reacted to the strengthening of the U.S. dollar in recent weeks. We believe that exchange rate policy has contributed importantly to the rapid growth of nontraditional exports in recent years, a trend that would be jeopardized by a change in this policy. My only other comment in this area is that we consider that the projected growth rate for imports--3.9 percent in volume terms--may be on the high side.

With regard to structural reforms, it appears that the World Bank is thoroughly involved in the reforms that are urgently needed in the key areas of foreign trade, financial institutions, public sector enterprises, and agriculture. It is not apparent, however, that there are any structural reforms being monitored by the Fund beyond those covered by the World Bank's structural adjustment loan. This chair has often stressed the importance of incorporating essential structural reforms in stand-by arrangements. Therefore, we would like to see some progress on structural reforms under the stand-by arrangement for Costa Rica. For example, it might be appropriate to expand the scope of activity for private banks in short-term money market instruments, or to accelerate the pace of reform with respect to certain public sector enterprises.

Now I would like to turn to the subject of external financing to support Costa Rica's 1989 program. Multilateral and bilateral official institutions have been providing generous support for Costa Rica's adjustment efforts, and are expected to continue doing so. Commercial banks, however, account for about 40 percent of Costa Rica's external public debt, and they appear not to have been cooperating fully in seeking a solution to

Costa Rica's financing needs. When we approved Costa Rica's last stand-by arrangement, in October 1987, we thought that a commercial bank financing package would materialize within six months. And when we held our last review of this stand-by arrangement, in August 1988, we thought agreement on a package was close at hand. As Mr. Ayales points out in his useful statement, the Advisory Committee has decided within the last ten days to change course once again and pursue a new approach to Costa Rica's request for financial support. It is conceivable that the new approach will succeed where the others failed, but a degree of skepticism is certainly warranted. We regard early action by the banks to be highly desirable in this case, and we trust that they will not find any excuse for delay either in the content of Costa Rica's program or in the support it is receiving from official institutions.

With respect to the application of our new guidelines to the case of Costa Rica, we welcome the request of the Costa Rican authorities to set aside 25 percent of the access available under the stand-by arrangement for debt reduction. We can support this amount, or even a somewhat higher amount. In view of the extensive discussions that have taken place between Costa Rica and its commercial bank creditors, however, we are not persuaded that the resources for debt reduction must be set aside by the Fund while Costa Rica accrues rights to draw these amounts. We believe it would be appropriate to make these amounts available to Costa Rica as they would be under a stand-by arrangement without any debt reduction features. Costa Rica, then, would set aside within its foreign exchange reserves the agreed amounts for debt reduction. At the same time, the stand-by arrangement should allow for acceleration of the amounts for debt reduction once an agreement with the banks consistent with the program has been concluded. We consider this alternative approach to be consistent with the guidelines adopted by the Board earlier today.

With regard to additional access for interest support, we welcome the announcement by Mr. Ayales that his authorities are interested in augmenting Costa Rica's stand-by arrangement by 40 percent of quota for the purpose of supporting interest payments to commercial banks in the context of debt reduction arrangements. We see no reason for the Board to hesitate in responding positively to this request. Our guidelines for this new feature of stand-by and extended arrangements appear to fit closely the circumstances facing Costa Rica. Indeed, by failing to act today, the Board might introduce an element of uncertainty in Costa Rica's negotiations with commercial banks that would become an excuse for further delays.

As to financing assurances, I would like to remind the Board that, after considerable debate, the Fund decided not to approve Costa Rica's exchange restrictions giving rise to arrears to commercial banks on three separate occasions in the past 20 months when the Fund approved and reviewed Costa Rica's previous stand-by arrangement. We understand the rationale of the staff for recommending approval, namely, that such approval is consistent with the 1970 Board decision on payment arrears. It is also appropriate, however, for the Board to stand by the position it has taken previously in interpreting this decision and the broad interests of the Fund at the present time. Given the circumstances of this particular case, my authorities are not prepared to depart from the approach that has been followed until now with Costa Rica. Accordingly, we propose that the second sentence of paragraph 2 of the proposed decision be deleted or modified to resemble the decisions we have adopted before. We are, of course, prepared to reconsider the matter following a formal review of our policy on the approval of exchange restrictions, or whenever the circumstances of the Costa Rican case change in a way that would justify approval.

In conclusion, Costa Rica has been extremely prudent in its use of Fund resources, and scrupulous in honoring its repayment obligations. As a consequence, after four stand-by arrangements and an extended arrangement since 1980, Fund credit outstanding to Costa Rica now amounts to only 58 percent of quota. We believe that Costa Rica will continue its cautious attitude toward the use of Fund resources, and therefore we can support full disbursement of the set-aside amounts rather than the accrual of rights to these amounts. We can also support immediate augmentation of the stand-by arrangement by 40 percent of quota as needed to support interests payments to commercial banks that have entered into debt reduction arrangements with Costa Rica.

With these modifications, we believe that Costa Rica will be in a stronger position to achieve the objectives of its economic program. At the same time, Costa Rica will be blazing a trail that will make it easier for other countries to ursue growth-oriented adjustment programs consistent with balance of payments viability in the medium term. We appreciate the special attention given by Fund staff to this case, and we ask Mr. Ayales to convey to his authorities our best wishes for success.

Mr. Yamazaki made the following statement:

The economic performance of Costa Rica was mixed in 1988. The economy grew more than projected, exports increased buoyantly, and the current account deficit was reduced significantly to 5.6 percent of GDP. However, the rate of inflation increased, with consumer prices rising by 20.8 percent. The overall fiscal position of the nonfinancial public sector recorded a deficit of 0.6 percent of GDP, rather than a surplus of 0.8 percent of GDP as had been projected. On the external front, external financing fell short of the projections, and the accumulation of external payments arrears continued.

Thus, the challenges facing Costa Rica are evident, namely to consolidate the improvement in external balances, sustain economic growth, and bring down the inflation rate to a more comfortable level. In 1988, the authorities made various efforts to this end, but much more remains to be done. In 1989, the authorities should intensify their efforts to redress the external and domestic imbalances.

Clearly, the slippages in the public sector deficit that emerged in the second half of 1988 were most worrisome. The authorities are strongly encouraged to carry out their commitment to reduce the public sector deficit. Moreover, while we recognize that the political situation is sensitive during an election year. we would urge the authorities to study the possibility of further tax revisions.

On monetary policy, the authorities' commitment to reduce the inflation rate by 50 percent is welcome. However, further efforts to bring down the rate of inflation to a more comfortable level would be essential in the areas of both credit policy and fiscal policy. In this context, I agree with the staff on the need to monitor wage developments. On the external side, a flexible exchange rate policy should continue to be pursued.

I feel uneasy about supporting Costa Rica's request for a stand-by arrangement, as it deviates somewhat from the guidelines on Fund involvement in the debt strategy approved at the previous meeting EBM/89/61 (5/23/89). We are particularly concerned about the lack of a medium-term program, although we recognize the likelihood of a change in administration in the fall of 1989. We are disappointed that the program does not include measures to repatriate flight capital and attract private direct investment, as illustrated by the projected decline in private capital inflows in 1989. We are also concerned about the protracted nature of the negotiations between Costa Rica and the commercial banks, as well as the accumulation of arrears to the commercial banks. However, we do see some merit in approving the arrangement outright, since approval would demonstrate the Fund's commitment to the new strategy, thereby adding further impetus to strengthening the debt strategy as a whole, beyond the boundaries of Costa Rica. Therefore, we support the proposed decision on the stand-by arrangement.

However, we would urge the authorities to formulate and reach an agreement with the Fund on a far-reaching medium-term adjustment program--a substantial component of which should be structural reforms and measures to repatriate flight capital and attract private investment--as soon as the political situation has improved. We would also urge the need for the authorities to negotiate in good faith with the commercial banks and make every effort to come to an agreement as soon as possible. In addition, the authorities have to make every effort to clear their arrears. At the current stage, we firmly believe that it would be desirable to approve additional resources to be used for interest support in connection with debt reduction operations; therefore, we support Costa Rica's request for additional access, and urge the authorities to develop the specific modalities of interest support as soon as possible. Furthermore, we agree with the disbursement of the set-aside from the initial stage.

Finally, with regard to the proposed approval of the exchange restrictions under Article VIII, Sections 2(a) and 3, we believe that a general review of Article VIII, Section 2(b) would be essential before granting an approval.

The Deputy Managing Director then took the chair.

Mr. Feldman made the following statement:

In recent years, Costa Rica's economic performance has been highly satisfactory, particularly in the context of regional performance. GDP growth has been about 4-5 percent a year, the rate of inflation has remained at about 15 percent--except in late 1988, when the rate increased owing to bad weather conditions--and the public sector and external current account deficits have been maintained at manageable levels. Furthermore, in light of the deep economic and financial crisis that affected the country in the early 1980s, the 1989 program has been designed to consolidate the gains already achieved in recent years, by reducing the rate of inflation, strengthening the external sector, and implementing structural reforms, as these measures will help to achieve high and sustained rates of growth. However, as the authorities indicate in their letter of intent, the high level of external debt obligations is an obstacle to the Government's efforts to implement the program.

Costa Rica's debt overhang is the central issue of today's Board discussion. In this connection, I fully agree with the staff appraisal and the thrust of the program. Costa Rica's program implies a substantial domestic effort, as the achievement of external viability in the medium term is essential for attaining the objective of growth with stability.

The 1989/90 program includes the appropriate macroeconomic policies and structural policies to achieve the economic objectives of Costa Rica. We agree with the reasons given by the staff for the Fund's early approval of the proposed stand-by arrangement, such as to show a clear sign of endorsement of the authorities' program and debt negotiations with external creditors, and to provide an appropriate balance of payments framework within which to develop the financial package.

Costa Rica has shown clear willingness to negotiate in good faith with commercial banks. According to Mr. Ayales, in the period 1986-89, banks have been reluctant, or lacked the necessary cohesion, to support Costa Rica's successive requests. The result has been that Costa Rica has not obtained converted financing or debt alleviation, and has, therefore, fallen into arrears with commercial banks--a most inefficient and undesirable outcome. Accordingly, we feel that the present approach is realistic, as it involves a strong adjustment effort, combined with a request for a financial package that is suitable for addressing the debt overhang.

Reflecting the firm commitment of the authorities, Costa Rica has recognized the Fund's preferred creditor status, as demonstrated by its record of net repurchases during the past stand-by arrangement. The net use of Fund credit in 1989 and 1990 will be rather small in proportion to its repayments; during the previous arrangement, Costa Rica made net repayments to the Fund in an amount equivalent to about 70 percent of quota. Costa Rica's request for net financial support from the Fund is rather small in amount, but it is a good example of the Fund's catalytic role, and of how the Fund's support of the country's program could facilitate an agreement with official and commercial creditors. We believe that the program deserves our endorsement; a more flexible approach on financing assurances is justified in this case.

Finally, we support the proposed decisions. In particular, we support the authorities' request to set aside 25 percent of each purchase under the stand-by arrangement for debt reduction operations. We also endorse the authorities' intention to request an augmentation of the amount of the stand-by arrangement by up to 40 percent of quota, in the event that the financing arrangements with commercial bank creditors for debt service reduction are concluded, and upon the determination by the Fund that such arrangements are consistent with the objectives of the program. We hope that the negotiations with the commercial banks will be conducted as quickly as possible, and that an agreement on a financing package consistent with the objectives of Costa Rica's adjustment program will be reached soon.

Mr. Piantini made the following statement:

The success of the strengthened debt strategy will depend on the magnitude and timing of the financial support given by the international financial community to eligible countries that are implementing strong adjustment programs, and that need to overcome the adverse effects of the debt overhang, in order to restore external creditworthiness and steady economic growth. The willingness of commercial bank creditors to take part in this process through debt reduction schemes or new money will be essential for the success of this approach. Costa Rica's case would be an early test of its effectiveness. We support the proposed decisions, including the authorities' intention to request additional resources of up to 40 percent of quota for debt service reduction operations.

In 1987, the authorities adopted a growth-oriented adjustment program supported by a 17-month stand-by arrangement. However, the arrangement expired with some deviations from quantitative performance criteria: the external quantitative targets were not met, as the negotiations with the commercial banks were not finalized and important external assistance did not materialize. Thus, external financial support was 10 percent of GDP lower than projected. Nevertheless, the authorities acted prudently and no purchase was made from the Fund during the program period.

The authorities were unable to meet the domestic quantitative targets owing to the lack of external assistance; however, the slippages in fiscal targets were also the result of delays in the implementation of the 1987 reforms. The reduction of fiscal revenue was offset by a reduction of current expenditures; the overall deficit of the nonfinancial public sector was 0.6 percent of GDP. The slippages in monetary targets were the result of the relaxation of credit policy during the first half of 1988, which bolstered liquidity in the financial system and enabled it to deal with the failure of a number of financial companies. During the second half of 1988, confidence was restored and credit was tightened, which, together with a deterioration in real wages, helped restrain the rate of inflation. I note that the rate of inflation increased owing to severe damage to the agricultural sector caused by the hurricane, the lagging effect of a strong devaluation of the colón in 1987, and the sharp rise in public tariffs.

Despite the lack of external assistance, the authorities acted resolutely to keep on track the implementation of a wide range of structural measures aimed at trade and financial liberalization, elimination of fiscal exemptions, broadening of the tax base, and acceleration of the privatization of public enterprises. These reforms underpinned market-oriented demand-management policies during 1988, which, together with a strong performance of nontraditional exports, helped the Costa Rican economy to grow faster than programmed.

Flexible exchange rate policy and the tariff reforms undertaken since 1987 to reduce the anti export bias, have promoted a better allocation of resources and maintained the competitiveness of Costa Rica's traded goods. Thus, the value of nontraditional exports has risen by about 50 percent since 1987, and the external current account deficit has fallen by 40 percent as a ratio to GDP.

The growth-oriented adjustment program designed by the authorities appears to be consistent with the objectives of consolidating the gains already achieved and deepening structural reforms to improve the supply side of the economy, thus strengthening the long-term sustainability of economic growth. The maintenance of exchange rate flexibility will be essential to protect the program target of net international reserves from the effects of tariff reforms, to broaden the diversification of the export sector, and to restore private capital flows.

While the level of private savings is already relatively high, the public sector must make substantial adjustments in this area; an improvement in the fiscal balance will be needed to correct the domestic savings/investment imbalance and reduce the external current account deficit. Although asset sales and special contributions of exporters to cover infrastructure costs will help to meet the fiscal target during the program period, other permanent measures will be needed to strengthen public finances in the long term.

The decline of net domestic credit to the public sector, together with greater flexibility of the financial system and maintenance of a market-determined interest rate, will help achieve the inflation target, foster domestic savings, and stimulate private capital inflows. The staff's medium-term baseline scenario assumes a continuation of growth-oriented adjustment and a sharp increase in public savings, in order to promote economic growth of 5 percent a year in the period 1989-92. This scenario also assumes that the financial gap of the balance of payments would be filled mainly through debt reduction operations with commercial bank creditors. Debt service and interest ratios, as a percentage of exports, are projected to decline from 49 percent and 19 percent in 1988 to 16 percent and 8 percent respectively by 1992, and external public debt is projected to drop to 58 percent of GDP in 1992 under the baseline scenario. This outcome would underline the effectiveness of debt and debt service reduction operations aimed at allowing heavily indebted countries to grow out of their debt, and eliminate debt fatigue in a permanent way. An alternative medium-term scenario assumes the refusal of commercial banks to support debt relief arrangements envisaged in the program, thus maintaining the debt service ratio at 24 percent of GDP and external debt at about 80 percent of GDP in 1992, keeping the debt overhang, and endangering efforts to restore external viability and sustainable economic growth over the long term.

Since 1986, Costa Rica has presented many different proposals to commercial creditors to deal with its debt-servicing difficulties; however, no arrangement has been reached. We welcome the staff's indications that the commercial banks and Costa Rica are ready to arrive at an agreement in a short period of time, including debt and debt service reduction mechanisms. Approval of this stand-by arrangement prior to the conclusion of the negotiations with commercial creditors should send strong signals to the international financial community about the Fund's confidence in the economic process, and should protect the country from undue pressures by the banks. Therefore, we encourage the international community to give strong financial support to Costa Rica to ensure the success of this first approach to bring a lasting solution to the problems of highly indebted middle-income countries.

Mr. Marcel made the following statement:

Since the beginning of the 1980s, Costa Rica has maintained a close relationship with the Fund. The willingness to cooperate on the part of the authorities should be given due consideration in examining their request for a stand-by arrangement. In the Fund's first application of the strengthened debt strategy, some questions of principle arise as a result of the inability of the Costa Rican authorities to reach an agreement with the commercial banks, as well as the building up of arrears. These concerns are all the more important since, although Costa Rica has had seven arrangements with the Fund since 1980 and two Paris Club debt reschedulings since 1983, it has not yet been able to restore external viability.

As to the fiscal position, it is clear that despite some slippages in the second half of 1988, progress has been made since 1985. However, it is worrisome that these slippages have occurred mainly on the revenue side. We were pleased to note the surplus position of public enterprises in 1988, but the recent deterioration must be halted. The steps taken toward privatization are most welcome.

The most disturbing feature in 1988 was the upsurge in the rate of inflation. Although we can understand that the acceleration of the rate of inflation in December 1988 occurred following shortages owing to hurricane damage, it is clear that the acceleration had started earlier, because of lax monetary control over credit expansion and the structural weaknesses of the financial system. In such a system, credit ceilings on banks should only be a transitory step toward a more market-oriented monetary policy. I would welcome additional staff comments on the intended interest rate policy and the concrete steps that are being taken to reform the financial system.

The external sector is a sensitive area of the program. Despite an active exchange rate policy, Costa Rica continues to run an external account deficit. As a result of rising oil prices, the balance of trade could still be in deficit in 1992--at the time the staff expects the current account to be in balance. A central element of the program is exchange rate policy, which must help to maintain the balance between competitiveness and internal equilibrium. Costa Rica's external position has been considerably weakened in the past years. Eager to rehabilitate its domestic economy, Costa Rica has suffered from several years of misallocation of external resources; public debt and debt service obligation have reached unsustainable levels, and the country can no longer afford not to consolidate its external debt. Furthermore, Costa Rica will probably be unable, for a considerable period of time, to strengthen its external position in a lasting way without the assistance of bilateral donors.

On the question of financing assurances, Costa Rica is a difficult case. After rescheduling and projected balance of payments support from bilateral and multilateral institutions, a substantial financing gap equivalent to more than 2 percent of GDP will remain in 1989 and thereafter. In addition, the lengthy discussions between Costa Rica and the commercial banks during the past two years have given rise to some legitimate doubts about the willingness of the authorities to reach a workable agreement. At this stage, we need further explanations from the staff on the exact prospects of the negotiations; in particular, concrete steps in the discussions of waivers should help to give a clear signal that the negotiations are succeeding.

My authorities are very concerned about the continued buildup of arrears. At end-1988, Costa Rica's payments arrears amounted to $893 million, including $625 million owed to commercial banks. Despite Costa Rica's intention to clear all external arrears at the end of the period covered by the stand-by arrangement, the staff regards the end of June 1989 as the deadline for regularizing Costa Rica's accounts with bilateral creditors, but this is not a performance criterion that needs to be met. Therefore, there is reason to expect that, if the accounts are not regularized by April 1990, all of the planned SDR drawings will have taken place before the completion of negotiations with the banks. We consider that the regularization of accounts with foreign creditors is of the utmost importance; this concern will have to be carefully scrutinized at the review of the stand-by arrangement scheduled in September. As regards a possible implementation of the Fund's new guidelines on the strengthened debt strategy for Costa Rica, I can go along with the scenario and proposed decisions in Supplement 1 to EBS/89/87. However, I have to stress that given the present status of the negotiations with the banks, we should be very careful not to disburse any funds without having a much clearer understanding of the likely outcome of the whole process. The attribution of any additional amount should be decided by the Executive Board after detailed information has been presented on the operations to be supported. We have to be very vigilant about observing the performance criteria in the stand-by arrangement.

While I support the proposed decisions, I understand Mr. Warner's concern regarding the approval of exchange restrictions evidenced by external payment arrears, and I would prefer to reserve my position for later.

Mr. McCormack made the following statement:

We commend Costa Rica's authorities on their success in implementing major economic reforms since the early 1980s. As clearly explained in Mr. Ayales's opening statement, these policies have revived economic growth, brought the rate of inflation down to manageable levels, and substantially reduced domestic and external imbalances. Nevertheless, the country's heavy external debt obligations continue to exert a drag on the economy and could constrain medium-term growth prospects.

There is a risk that owing to the complexity of debt reduction operations and the problem of financing assurances, a declining amount of time will be spent discussing the issues of primary importance to the Board and the countries in question--the appropriate design of adjustment programs. Such a tendency to neglect discussion of the economic strategy of member countries should be resisted.

Under the past stand-by arrangement, Costa Rica enjoyed strong economic growth and made good progress with regard to several objectives, including a sizable depreciation of the colón and further liberalization of imports. Nevertheless, there were a number of slippages from the program targets, including slippages in credit policy, deterioration in the public sector deficit, acceleration of the rate of inflation, and less than programmed improvement in the current account--despite the high growth of exports. The staff's explanation of why Costa Rica's program went off track should have been somewhat more analytical and comprehensive, particularly the reasons given for the slippage in the implementation of fiscal policy. In addition, I wonder what contingencies have been discussed to avoid similar slippages in the coming program period.

I believe that the planned adjustment program is a step in the right direction; however, it could perhaps be strengthened somewhat. On the fiscal front, I am concerned about the continued strong growth of current expenditures and the extent to which the deficit reduction effort relies on temporary revenue measures. I agree with the staff that there is a need to replace these temporary measures--such as the sale of assets and the special contributions of banana growers--with more permanent measures. Moreover, there is a need to examine current expenditures to identify room for further savings.

On the monetary side, given the upsurge in the rate of inflation in 1988, we urge the authorities to ensure that a tight policy stance and positive real interest rates are maintained. The latter are clearly needed if national savings are to increase as projected. We support the authorities in their continuing pursuit of financial liberalization. However, the renewed reliance placed on the use of credit ceilings for individual banks is not consistent with this goal, and we would urge the authorities to remove such constraints as soon as possible.

On exchange rate policy, we note that it is the intention of the authorities not to permit an appreciation of the colón in real terms from its level of December 1988. However, it is evident from Chart 1 in the staff report that such an appreciation took place during the first quarter of 1989. We would caution the authorities on the need to take quick action to maintain Costa Rica's competitive position.

With respect to the medium-term prospects, Chart 2 in the staff report shows that irrespective of any debt reduction operation, the debt service ratio will fall below 30 percent of GDP by 1991, and to about 25 percent of GDP by 1992. By international standards, these figures seem to suggest that the debt burden is not unmanageable, and could call into question the necessity for debt reduction.

It is somewhat ironic that the new developments in the strengthened debt strategy, instead of making it easier for Costa Rica to find a solution to its problems, may actually have complicated matters. As Mr. Cassell stated at one of our informal discussions, before the unveiling of the strengthened debt strategy, the Board would most likely have approved Costa Rica's program outright. Currently, we are all concerned about the program's consistency with the Fund's guidelines on debt and debt service reduction, and we do not want to set any unwarranted precedents. Moreover, the new debt proposals have further delayed an agreement with the commercial banks, which are rightly, from their point of view, concerned that they might miss any opportunities to obtain the best deal possible.

My authorities believe that Costa Rica should not be penalized by these recent developments. At the same time, they continue to be concerned about the security of Fund resources, and would have preferred to have more tangible evidence of progress in the negotiations with the commercial banks. According to Mr. Ayales, the negotiations are now in their fourth stage. The new approach seems promising, and may prove to be an effective way to circumvent the free rider problem. Nevertheless, considerable time may still elapse before an agreement is concluded.

With respect to the set-aside, the staff suggests that the resources should only be made available if the debt buy-back operation is fully financed. Could the staff provide us with some information on what options are open to Costa Rica, if the bilateral sources necessary to complete the operation do not materialize? What would be the implication of such a development for the stand-by arrangement? In addition, Costa Rica may request augmentation of the amount of the stand-by arrangement by up to 40 percent of quota. In principle, we are prepared to support such a request, although we would want to see considerably more detail about the financing agreements with the commercial banks.

Despite the uncertainties of this case, my authorities believe that the program deserves the Fund's support. Costa Rica should not have been unfairly disadvantaged by the banks' previous unwillingness seriously to discuss financing arrangements, nor should Costa Rica be disadvantaged now by the recent developments in the debt strategy. Moreover, Costa Rica has a proven track record of sustained adjustment and prudent use of Fund resources. We share the views of Mr. Warner and Mr. Yamazaki on the need for a review of the entire range of issues associated with Article VIII, Section 2(b) before exchange restrictions arising from external arrears are approved. In addition, there should be a review of the financing negotiations before the next purchase on July 31, 1989.

Finally, Costa Rica, the Philippines, and Mexico are cases that were all to be considered by the Board, regardless of U.S. Treasury Secretary Brady's debt initiative. Board consideration of these countries, and the timely implementation of these countries' adjustment programs, should not be delayed by this initiative. At the same time, these countries should not serve as precedents for later cases; we would expect that the financing arrangements should generally be in more advanced stages before being considered by the Board.

Mr. Enoch made the following statement:

Under its last stand-by arrangement, Costa Rica made considerable progress in its adjustment efforts. I note especially the significant reduction in the public sector deficit, and the adoption and maintenance of a sound exchange rate policy. However, as the staff report notes, slippages occurred in the second half of 1988, and there has been no conclusion of Costa Rica's external financing arrangements--despite high hopes at the time the program was approved, and at subsequent reviews.

The authorities are seeking another stand-by arrangement, and intend to make drawings from the Fund, which they did not do under the previous arrangement. The aim of the program is to consolidate the adjustment process, and to achieve a lasting solution to the problem of domestic and external imbalances. Clearly, an important element in this strategy will be the establishment of orderly relations with external creditors. However, this element alone will not solve Costa Rica's problems; the maintenance of a strong adjustment effort is the essential prerequisite.

Fiscal policy will be crucial in this effort, and the measures proposed in the program reflect this. I agree with the staff that asset sales and postponement of investment outlays do not provide a long-term solution to the fiscal problem. Expenditure plans seem to be sound, and I commend the authorities for their maintenance of the freeze on public sector employment, which has been in effect since 1986. However, further action may be needed to enhance revenue flows, and I welcome the intention of the authorities to adjust the tariffs and charges of public enterprises as required.

Monetary policy was an area of some concern in 1988, and the authorities are clearly doing what they can to address this problem. I have some reservations about the maintenance of ceilings on credit for individual banks, as there is a possibility that these ceilings might cause distortions in the allocation of credit. Nevertheless, I note that the authorities are committed to maintaining positive real interest rates, for which I commend them.

On exchange rate policy, I note the authorities' commitment to ensure that the colón does not appreciate in real terms during the course of the program. The measures planned to reform the structure of import tariffs and export incentives will also make a useful contribution to the authorities' external policies.

However sound the program appears to be, the major question of financing assurances remains. At the Board's last review of Costa Rica's previous stand-by arrangement, we supported the program--despite the absence of satisfactory financing assurances--on the grounds that the quality of the program was adequate, performance had been broadly satisfactory, the delays in securing financing had been largely, although not entirely, attributable to the commercial banks' reluctance to negotiate, and significant progress appeared to have been made toward bringing the negotiations with the banks to a successful conclusion. We were also influenced by the fact that the authorities did not intend to make use of Fund resources.

The situation has developed in many ways since then, and the authorities now intend to make drawings from the Fund. According to the staff papers, the negotiations with the banks have advanced a little further, although, after two years of waiting, I wonder how much further advancement is needed before a final conclusion is reached. The Board has agreed on a Fund policy for support of debt reduction operations, and I will look for a speedy resolution at the meeting of the Advisory Committee, which is to be convened shortly; I trust that the Board's decisions on the Fund's involvement in the debt strategy will aid the process.

An agreement with the banks is very important, as the proposed set-aside of Fund resources in the revised stand-by arrangement represents only a fraction of the amount needed to halve commercial bank debt; if the required level of debt relief is not achieved, there is a danger that the existing financing gap will grow and arrears to all of Costa Rica's creditors will increase. I note that the staff approves the use of excess reserves generated by internal adjustment for debt buy-back, and I have no objection to this approach. However, we cannot presume that such reserves will be either available or sufficient; therefore, I would be interested in learning how the Fund's resources are to be secured. In light of our discussions of the Fund's involvement in the debt strategy, I would also welcome explicit assurances of seniority for official creditors.

I have several other concerns about the program itself. First, as the Chairman's summing up of the discussion of Fund involvement in the debt strategy noted (EBM/89/61), it is important that if the Fund is to provide resources for debt buy-back, the member concerned should be a signatory of the Multilateral Investment Guarantee Agency convention. Second, the Board has previously noted that the program associated with such a disbursement of resources should include measures to increase domestic investment. Yet, Table 6 of the staff report projects a reduction of inward investment from 1988 levels, despite the assumption in the medium-term outlook that the intended policy mix will encourage the inflow of capital from abroad. I would be interested in learning about the staff's views on this matter.

In the revised text of the stand-by arrangement in Supplement 1 to the staff report, I note that use of the set-aside will be conditional upon completion by the Fund of a review of the debt reduction agreements--the implication being that the Fund has some idea of what will be an appropriate agreement. However, it seems that this approach must imply an a priori view of what is an efficient use of resources. I note also the explicit statement that the set-aside may be released in the absence of successful negotiations, as long as the program is on track. Noncompliance with the program means no disbursement, even if the bank negotiations were to be a success: I wonder if we should not openly state this fact. I also suggest that we review performance under the program, and the progress of negotiations with the banks, before the second disbursement on July 31, 1989, rather than waiting until September.

It is not necessary to discuss at present the authorities' intention to request augmentation of the stand-by arrangement for interest support. Obviously, we will need to consider whether this is an appropriate use of resources at the time of the authorities' actual request. In the decision, no specific amount is endorsed, but I feel that it is unnecessary to mention in the decision that the authorities intend to request an augmentation of up to 40 percent of Costa Rica's quota. To avoid prejudging the issue, the decision should only note the intention of Costa Rica to make a request in accordance with the Fund's new guidelines.

In the particular circumstances of Costa Rica, I would like to be able to support the program and approve disbursements in the absence of full financing assurances. However, I, like some of my colleagues, find myself unable to do so while explicit approval for arrears is given under Article VIII. I see no reason to depart from the decision taken in 1987, relating to Costa Rica's exchange measures subject to Article VIII in 1987; at that time, the Board did not approve exchange restrictions under Article VIII. If such approval was not necessary in 1987, I do not see why it is necessary now. Moreover, when the Board discussed the policy of financing assurances two weeks ago, it was agreed that further consideration would need to be given to the question of approval of such restrictions under Article VIII. It would seem inappropriate to prejudge the Board's consideration of this issue by giving approval in the case of Costa Rica. Therefore, I associate myself with the position of Mr. Warner and others, and will give the program my support on condition that the wording of the proposed decision is amended to exclude reference to Article VIII.

Mr. Schoder made the following statement:

The opening statement of Mr. Ayales gave us a complete summary of Costa Rica's economic policy since the beginning of the 1980s, and showed the considerable distance traveled by Costa Rica on the path toward a balanced growth pattern. Substantial progress has been achieved in the areas of inflation, growth, unemployment, the public sector, and the current account.

The slippages in program implementation, which marred hat positive adjustment picture in 1988, were regrettably counter-productive. The authorities reacted promptly by implementing the corrective measures necessary to attain the broader macroeconomic objectives, but we nonetheless urge the authorities to keep the economy firmly on course to avoid costly and time-consuming stop and go policies. The economic policy program proposed for 1989/90 continues the adjustment process that started in the early 1980s. Since we find the program comprehensive and consistent, we can approve it.

A general objective of the proposed adjustment program is to increase domestic savings. Fiscal policy is especially relevant in this connection; it is expected that the combined public sector deficit will be reduced from 3.7 percent of GDP in 1986 to 2.8 percent in 1989. The Central Government's contribution to this aspect of adjustment consists mainly of temporary measures, such as a levy on banana growers and exporters to cover some of the costs of infrastructure improvements, as well as further postponement of planned public sector investment. We fully understand the sociopolitical considerations that justify reliance on such measures for 1989, but the staff rightly recognizes that these short-term measures need to be replaced by more durable ones. Nonetheless, we are disappointed that although the staff's medium-term outlook, covering the period 1990-92, projects an elimination of the overall public sector deficit by the end of the period, there is no indication by the authorities or staff about what kind of more permanent measures may be under consideration for 1990 and beyond. What are the assumptions that underlie this projection? Are the permanent measures to be adopted by the Central Government not yet known? Or is the projected elimination of the deficit supposed to be achieved by continuing to resort to temporary expedients?

The current account deficit is projected to shrink to 5 percent of GDP in 1989. The staff's assumptions include a 2.25 percent deterioration in the terms of trade, but the authorities' letter of intent assumes no change. Would the staff care to comment on this apparent contradiction?

As to the proposed stand-by arrangement, we approve in principle the idea of considering the request for a stand-by arrangement before the negotiations with the commercial banks have been satisfactorily concluded. In this connection, we especially welcome the monitoring procedures that have been adopted to permit possible later adaptation of the program targets to developments not foreseen at present, in order to ensure that the internal adjustment process will proceed as planned. We would appreciate the staff's comments on the operational meaning of paragraph 2(c) of the stand-by arrangement.

I understand that Fund resources will be made available to Costa Rica after a review of the modalities of the debt reduction operations, including the discount involved in these transactions. In this connection, do the staff and Mr. Ayales have any indication about the evolution of the discount at which Costa Rica's debt has been traded since the launching of U.S. Treasury Secretary Brady's initiative?

Paragraph 2(b) of the proposed stand-by arrangement notes the possibility of discontinuing the designation of amounts for debt reduction provided that the Fund determines that the objectives of Costa Rica's program can be achieved in any event. How can the objectives of the program possibly be achieved in the absence of debt reduction operations?

As to a possible request of the authorities for an augmentation of the amount of the stand-by arrangement by up to 40 percent of Costa Rica's quota, I understand that we are not expected to make a decision on this point today, but simply to note Costa Rica's intentions. The approval of such a request for augmentation, as well as the amounts involved, would be decided after a formal review by the Board. However, we would have preferred to see these additional resources imbedded in a stand-by arrangement of longer duration, or preferably in the context of an extended arrangement. Nevertheless, we have a positive attitude toward the approval of additional resources for debt service reduction operations. We can support the proposed decisions, but our approval of the decision on tolerating arrears on a temporary basis should not be seen as a precedent; we expect a general review of the Fund's policy on exchange restrictions evidenced by external payment arrears as soon as possible.

Mr. Goos made the following statement:

After carefully studying the staff papers on Costa Rica, I was left with quite mixed feelings. On the one hand, one cannot deny that the Costa Rican authorities have come a long way toward substantial improvements in the overall situation of their economy. Those improvements are certainly all the more impressive considering the very difficult external financial situations that they have been encountering since the early 1980s. On the other hand, I feel that Costa Rica's performance under the previous stand-by arrangement was clearly less than satisfactory, and the program before us, including the Fund's financial support for debt and interest reduction operations, is giving rise to a number of questions about the appropriateness of the intended arrangement.

As to the program, I largely share the feelings expressed by Mr. McCormack. It is clear that the envisaged correction of financial imbalances is quite tangible compared with the outcome of 1988; however, that outcome reflects substantial slippages that are a matter of serious concern. Many of those slippages can be attributed to the crisis in the financial sector and the damages caused by last year's hurricane. Nevertheless, it appears that many of the slippages were of a homemade nature, including the rapid rise in domestic credit, which occurred before the financial sector crisis last year.

Moreover, I note that the substantial shortfalls in crucial program targets occurred in an export environment that was much more favorable than anticipated under the program. As to the expectation that the favorable external conditions for exports are to prevail in 1989, and considering the very difficult external financial situation, I would have expected a substantial effort under the program to regain what was lost in 1988. Compared with the program targets for 1988, the projected improvements for 1989 are either marginal, as in the case of the fiscal position; nonexistent, as projected for the external current account ratio to GDP; or even negative, with respect to the expected outcome for the trade balance and, even more seriously, for the savings performance of the public sector, I note that public sector savings, which were projected to reach 7 percent of GDP in 1989, are likely to reach only 4.7 percent of GDP.

There are several other areas where I would have liked to see more progress as well. I note the disappointing developments in the external capital account where private sector capital inflows fell short of last year's program projections, and are, actually, expected to decline by about 50 percent under the program. The adjustment record of 1988, together with envisaged adjustment in 1989, appear to be anything but impressive.

These developments need, of course, to be assessed against the authorities' intention to seek the Fund's financial support for debt reduction operations. Certainly, one has to give both the authorities and the staff credit for having negotiated a program without knowing the results of the Board's discussions of the Fund's involvement in the debt strategy; therefore it might be somewhat unfair to compare the program before us with the guidelines approved at EBM/89/61. But, one fundamental prerequisite for Fund support, on which the Board has unanimously agreed, is the need for a convincing adjustment program that would promise a strong response of private capital flows, including the return of capital flight, and an increase in foreign direct investment. On the contrary, however, capital inflows are actually expected to decline substantially under the program. Moreover, I missed any reference in the staff papers to the authorities' willingness to engage in further debt/equity swap operations, which is another requirement that has been widely stressed by the Board.

Given my doubts about the appropriateness of the program, I would like the staff to comment on why it believes that the program is strong and deserves Fund support, particularly in the context of debt reduction operations.

Another critical requirement for the Fund's support of debt reduction operations is the need to demonstrate, through analysis in medium-term scenarios, that such operations would offer the greatest potential for external viability and economic growth. There is some medium-term analysis in the staff papers, but I would have preferred if the staff had analyzed also more traditional kinds of debt relief, including rescheduling arrangements with the commercial banks. The mere fact that the authorities have been unable to agree with the banks on traditional kinds of debt relief does not necessarily conclude that there is a case for debt reduction operations. Moreover, looking at the external debt service ratios, in particular interest ratios, the external debt service burden is not excessively high compared with many other countries. Accordingly, I would have liked to see a convincing analysis in the staff papers of Costa Rica's case for Fund financial support for debt reduction operations. However, I would admit that the strength of these arguments is substantially weakened by the fact that the Advisory Committee has expressed the view that debt reduction operations would be appropriate.

As to the Fund's policy on financing assurances, it appears that the willingness to engage in debt reduction operations is, at least for the time being, limited to the Advisory Committee if not only to the lead bank. There are no indications that the commercial banks at large would be prepared to follow suit and accept the notion of debt reduction. There are few, if any, convincing arguments that the balance of payments gap will be closed through the kinds of operations expected by the authorities and the staff. Having in mind the thwarted expectations under the previous arrangement, we believe that not even the reduced level of financing assurances agreed under the Fund's new policy is yet in place. As a minimum, we should await a basic agreement between the authorities and the Advisory Committee on mutually acceptable financing operations. The Advisory Committee is expected to meet at the beginning of June to refine the details of its new approach. Given the unsatisfactory experience under the previous program with respect to the expectation that the negotiations would be concluded in a timely manner, I feel that it would be advisable to await, at least, the outcome of the forthcoming meeting of the Advisory Committee before investing the Fund's financial resources.

Under the present circumstances, and keeping in mind the concern about the Fund's financial integrity, I can therefore endorse the program before us only on the basis of an approval in principle.

In conclusion, I support the modalities that are envisaged for disbursement of the set-aside and additional resources, as explained in the staff papers. I would hope that the request for interest support will be complemented by a strong effort on the part of the authorities to conclude financing arrangements with commercial bank creditors. I fully support Mr. Warner's proposed amendment of the decision on exchange measures subject to Article VIII. I am not quite clear about the timing of the second disbursement or the first review under the stand-by arrangement. However, I would assume that the second disbursement would be made subject to prior review of the Board of the arrears situation, and the prospects for closing the financing gap.

Mr. Filosa made the following statement:

The stand-by arrangement for Costa Rica has to be discussed with great care and in light of the new guidelines on Fund involvement in the debt strategy approved at EBM/89/61. Indeed, the case of Costa Rica could set a precedent, which I feel somewhat uncomfortable about, since I have some doubts about the adequacy of the proposed program. What I find particularly worrisome are the slippages that occurred in the fiscal sector during the second half of 1988 and the upsurge in the rate of inflation. In contrast to the increased domestic imbalances, I welcome the significant improvements in the external sector in 1988, as evidenced by the reduction in the current account deficit from 9.1 percent of GDP to 5.6 percent of GDP. However, Costa Rica's external arrears increased substantially by $334 million--mostly to commercial banks.

In light of recent developments, it would appear that stronger front-loaded adjustment measures than those envisaged in the program are required. I agree with the staff that closing the financing gap should not be done entirely through internal adjustment. However, I am concerned that the program might not be strong enough to achieve the desired results. In particular, the adjustment in the fiscal sector appears to be uncertain, given the fact that the Central Bank's losses appear to be largely beyond the control of the authorities. In addition, no specific measures have been envisaged to raise central government revenues, aside from asset sales and special contributions from banana exporters and producers, to upgrading infrastructure. Thus, the authorities' expectations seem to rely chiefly on the recovery of tax revenues--resulting from the full implementation of the 1987 tax reform--which is worrisome since expenditure restraint to the degree required may be difficult to achieve, given the high rate of inflation. Short-term measures, such as asset sales and reduction in investment expenditures, cannot be considered an adequate response to the problems in the fiscal sector. To be convincing, the program should include measures of a longer-term nature, both on the revenue and expenditure side.

As to the medium-term balance of payments prospects, the staff indicates that the "planned internal adjustment would yield a balance of payments surplus, part of which could be used to finance the buy-back of commercial bank debt." However, Table 6 of the staff report does not seem to support this remark; according to the table, it would appear that the expected surpluses can only arise in the context of debt relief.

Although the goal of maintaining the real effective exchange rate at the level of December 1988 seems appropriate, the prospective reduction in import duties and export subsidies gives rise to some doubts about this approach, if external competitiveness is to be maintained. Furthermore, the absence of any income policy for the private sector might cause the exchange rate to move in a way tending to accommodate, if not accelerate, the rate of inflation. If wages in the private sector would exceed the increase in productivity, it would be very difficult to achieve the planned standstill in real wages of the public sector. Income policy should be pursued more forcefully, in particular since fiscal consolidation is slow.

In light of these considerations about the strength and consistency of the program, we have some doubts as to the advisability and outright approval of the stand-by arrangement, although we recognize the importance of the staff's arguments. I have some doubts about the precedent we would set for the implementation of the strengthened debt strategy. However, as I do not wish to postpone a decision on this matter, I would like to express a distinct preference for an approval in principle, as that would give a positive signal to Costa Rica's creditors, and allow the negotiations with the Paris Club and the commercial banks to proceed successfully. If, however, the majority of Directors wishes to approve the program outright, I would like to suggest that the first drawing be postponed until the end of June, when we might have a clearer picture of the progress of the debt negotiations, as well as of the authorities' further policies and intentions.

Before approving any exchange restrictions evidenced by external arrears, I look forward to consideration of the staff paper on restrictions under Article VIII, Section 2(b). Therefore, I join other speakers in asking for an amendment of the proposed decision on exchange measures subject to Article VIII.

Mr. Ayales remarked that the authorities' commitment to a process of macroeconomic adjustment and structural reform since 1982 had led to significant reductions of domestic and external imbalances. Since 1986, Costa Rica had been discussing with its creditors various approaches to solve the country's debt servicing difficulties, but it was recognized that the outcome of those discussions was basically beyond the control of the authorities. The authorities' commitment to adjustment had been convincing; the rate of inflation had declined from about 90 percent in 1982 to about 15 percent in 1988, the public sector deficit to GDP ratio had been reduced to about 3 percent, the level of unemployment had dropped to less than 5 percent, and the current account deficit had declined to about 4 percent of GDP. While policy slippages had occurred in the second half of 1988, it was more important to focus on broader macroeconomic objectives. The authorities had made serious efforts to solve the problem of a heavy external debt burden. However, the commercial banks had not been cooperating fully in seeking a solution to Costa Rica's financing needs. Therefore, the Fund's support was essential in signaling its support of the adjustment program to the rest of the international financial community. Accordingly, to approve the stand-by arrangement only in principle would aggravate the problem of reaching a final agreement with the country's commercial creditors.

Mr. Goos said that he did not doubt the authorities' commitment to adjustment, and he had acknowledged the impressive adjustment efforts that the authorities had made so far. However, although the objectives and structure of Costa Rica's stand-by arrangement seemed appropriate, the arrangement was not consistent with the new guidelines on Fund involvement in the debt strategy. He noted that private sector capital inflows had fallen short of the 1988 program projections, and were expected to decline by about 50 percent under the new program. Furthermore, there had been no indications that the Government would continue with debt/equity swaps, whose importance had been stressed repeatedly in the Board.

The Board had approved a 17-month stand-by arrangement in October 1987, despite the lack of full financing assurances, under which Costa Rica had made no purchases, Mr. Goos noted. However, the authorities' intention under the new stand-by arrangement was to make purchases; therefore, the assurances with respect to financing had to be adequate. When the stand-by arrangement had been approved in October 1987, it was expected that the negotiations on financing arrangements with the Advisory Committee of commercial bank creditors would be concluded in time for the second review of the program. Needless to say, no agreement had been reached between the authorities and the Advisory Committee. In view of the difficulties in securing the necessary financing under the previous stand-by arrangement, he, like Mr. Filosa, believed that it would be appropriate to approve the proposed stand-by arrangement only in principle until the Advisory Committee had refined the details of the new one-stage debt reduction proposal.

Mr. Ayales commented that the authorities had preferred to be cautious in estimating private sector capital inflows for 1989, as the political situation remained very uncertain, and in view of the substantial depreciation of the colón during the past 15 months. Costa Rica had had a program for debt/equity swaps for several years, but during the negotiations on financing arrangements with the commercial banks, the authorities had been requested to suspend that program. However, the new one-stage approach implied that all commercial bank debt would be treated simultaneously according to a menu of financing options, including a buy-back, debt/equity swaps, and debt exchange. He failed to comprehend why, although two Directors believed that the structure of the proposed stand-by arrangement seemed appropriate, they were willing to approve the proposed arrangement only in principle.

Mr. Goos said that while he could support the program in principle, he did not expect that a financing package consistent with external viability would be agreed within a reasonable period of time. The Advisory Committee would meet in about two weeks to discuss the details of the new one-stage debt reduction proposal; it seemed appropriate to await the outcome of those discussions before approving the program. While noting Costa Rica's excellent payment record to the Fund, he was concerned about the security of the Fund's resources, as no indication had been made as to whether a financing package would be agreed within a reasonable period of time.

Mr. Ayales remarked that his authorities had made considerable efforts to secure the necessary financing, and they believed that progress had been made in the negotiations with the commercial banks. In addition, the guidelines on Fund involvement in the debt strategy approved at EBM/89/61 would, indeed, be helpful in the negotiations. As in the past, his authorities remained committed to the economic program, but that commitment did not appear to be a sufficient condition to come to a lasting agreement with the international financial community. The Fund's continued support was essential not only to obtain the needed resources and assistance with policy design, but also to signal its support of the adjustment program to the rest of the international financial community. If the Board decided to postpone approval of the stand-by arrangement, a final agreement with Costa Rica's commercial creditors would be difficult to achieve.

Mr. Piantini said that he agreed with Mr. Ayales that an approval in principle was likely to hurt the negotiations between the authorities and the commercial banks. The authorities had implemented a broad range of policy actions to eliminate domestic and external imbalances, and the Fund should show its support by approving the arrangement outright.

Mr. Filosa stated that he was confident that Costa Rica would remain committed to adjustment in order to achieve the objectives of the economic program. However, although it was important to signal the Fund's support of Costa Rica's adjustment program to the international financial community, it was also important to signal the Fund's commitment to its new guidelines on the debt strategy approved at EBM/89/61. In addition, a number of Directors had stressed during the discussions of the strengthened debt strategy that utilization of debt/equity swaps was a particularly affective means of attracting a return of flight capital. In that respect, Costa Rica's economic program was not fully consistent with the new guidelines.

Mr. Nimatallah commented that in order for the Advisory Committee of commercial banks to accept a debt reduction plan, including a buy-back, debt/equity swaps, and debt exchange, they would expect the Fund's outright approval of Costa Rica's request for a stand-by arrangement. An approval in principle was likely to further delay the negotiations between the authorities and the commercial banks. During the discussions of the strengthened debt strategy, Directors had recognized that in some cases significant time might be needed for commercial banks and the authorities to agree on an appropriate financing package. In such circumstances, the Fund could on a case-by-case basis approve an arrangement outright before the conclusion of the negotiations.

Mr. Ayales said that he stood fully behind Mr. Nimatallah's comments. He recognized the emphasis placed by Directors on the need to protect the Fund's resources; he believed that Costa Rica's economic program was consistent with that objective, as the authorities had requested that 25 percent of each purchase under the stand-by arrangement be set aside for debt reduction. In addition, Costa Rica intended to request an augmentation of the amount of the stand-by arrangement by up to 40 percent of quota in the event that financing arrangements were concluded with commercial bank creditors.

Mr. Gorjestani said that he supported the proposed decisions, in light of the assurances given in Mr. Ayales's opening statement and the authorities' commitment to continue their adjustment program.

Mr. Fogelholm made the following statement:

> With respect to the proposed stand-by arrangement for Costa Rica, we appreciate the fact that many of the necessary macroeconomic and structural adjustment measures have already been implemented, and that the adjustment process will continue. However, more ambitious program targets are needed; this point holds particularly true with respect to fiscal policies, as slippages have occurred in that area in recent years. A stronger fiscal program would be essential in light of the important linkage between enhanced domestic savings and debt reduction. I am concerned about the fact that some of the planned measures in the fiscal package are only of a short-term, or even nonrecurrent, nature. However, I appreciate Mr. Ayales's assurances that his authorities are committed to carrying the program through.

We can approve a relaxation of the requirements of financing assurances before Costa Rica makes the first drawing under the arrangement, despite the fact that the experience in the case of Costa Rica has, so far, not been particularly encouraging. We would insist, however, that financing assurances have to be secured before the second drawing is made. The Nordic countries can accept the temporary buildup of arrears to commercial banks in order to be able to close part of the financing gap. However, we want to stress that all arrears must be settled before, or at the time, the program expires. In this context, we hope that the banks will show a higher degree of flexibility than they have shown up to date, and will come to an agreement with the authorities.

In principle, we support that a proportion of each purchase under the arrangement be set aside for debt reduction. The activation of this set-aside portion should, however, be in accordance with the guidelines on Fund involvement in the debt strategy; in particular, activation would be conditional on completion by the Fund of a review of the agreement on debt reduction operations between Costa Rica and its commercial bank creditors. Unfortunately, not much information is available for making a clear assessment of the present situation and the amounts needed for this purpose.

As to Costa Rica's intention to request augmentation of the amount of the stand-by arrangement, the guidelines on Fund involvement in the debt strategy approved today should be followed; therefore, I can agree to the present text of the proposed decision. However, I would like to support Mr. Enoch's view that no explicit mention in the decision of "40 percent" is necessary at this stage. With these qualifications, I can support the proposed decisions.

Finally, with respect to the implementation of the Fund's new guidelines on debt and debt service reduction, I agree with Mr. McCormack that the three potential cases can hardly be considered as precedents, owing to the extremely short period of time that the Executive Board was given for reflection and preparation for the discussion of these cases.

Mr. Hogeweg made the following statement:

I was impressed by Mr. McCormack's remark that we are so preoccupied with the questions of debt reduction operations and financing assurances that we may give the contents of the adjustment programs less attention than they deserve. The strength of the program is highly essential and, although I do not go deeply into that subject today, it certainly is not my intention to deny that fact. I expect the authorities to find more durable solutions to their fiscal problems than by asset sales and other temporary measures, as those measures are more a form of financing than a solution. Also, I would like some staff comments on the way Costa Rica will provide incentives for nontraditional exports other than via the exchange rate.

I appreciate the staff's medium-term scenarios and the illustrative graphs depicting the outlook both with and without envisaged debt reduction. The baseline scenario illustrates that when the envisaged debt reduction materializes, return to balance of payments viability is possible. However, it appears that the scenario is based on the assumption that Costa Rica will be able to buy back half of its commercial bank debt at a very low price. In addition, the assumptions regarding the treatment of the remaining debt, after buy-back, have not been made explicit. It is important that these assumptions are realistic and fit into an evenhanded approach by the Fund vis-à-vis debtor and creditors. I would appreciate staff comments on this issue, as well as some elaboration on the quantification of the effects on private capital inflows, investment, and growth from reduced uncertainties regarding future taxation and exchange rate stability, as a result of debt reduction operations.

I realize, of course, that the situation changed drastically after the commercial banks learned about U.S. Treasury Secretary Brady's debt proposal; consequently, the negotiations have changed course. A one-step approach, which Costa Rica originally preferred, might reduce the uncertainties regarding the terms for dealing with the remaining debt in what was originally referred to as phase two of the operation. However, a one-step approach, compared with a two-step approach, may take considerably longer to negotiate, which raises questions as to how long we should continue to pronounce the program as being on track in the absence of an agreement between the authorities and the commercial banks. It does not look promising that we, already at the present stage, make provision for what might happen with the set-aside, in case no--or no satisfactory--agreement is reached with the banks.

I note the intention of the authorities to request additional resources from the Fund to be used for interest support in connection with debt reduction; I assume that this will be an important factor in the negotiations with the banks. The staff does not indicate whether the debt relief in prospect with the one-step approach will be more, equal, or less than that envisaged in the previous two-step approach. I suppose that the debt relief will not be less in the one-step approach than in the two-step approach, as that would necessitate a whole new way of thinking about the program and medium-term scenarios. The more money is available for debt and debt service reduction, the greater the results would be. I would be very disappointed if the amount of debt relief was the same in both approaches, as that would imply that the commercial banks would agree on a financing package that they already basically agreed on before the Brady proposal ever was presented. This concern refers to the case of Costa Rica, but it also reflects a more general concern that once we have announced that we will make additional resources available, conditions in the market are affected. Obviously, the Fund's intention in its involvement in the debt strategy is to adopt guidelines that will benefit member countries. However, the reality might be that it is not the Fund members, but the banking system that is the major beneficiary of the strengthened debt strategy; that, I believe, is not the intention of this whole exercise.

The staff indicates that the banks expect the various financing options in the strengthened debt strategy to be equivalent in terms of present value before tax. However, I would have expected that tax and regulatory treatment of these various alternatives would result in equality after tax rather than before. If that was the case, how would it affect the outcome from Costa Rica's point of view?

In normal circumstances, a complete change in the outlook of the negotiations with commercial banks is a sufficient reason to wait with the approval of an arrangement until the prospects for an agreement between the authorities and the banks can be better assessed. I realize that the present circumstances are not normal, and I believe that the Fund should support Costa Rica's efforts by approving the arrangement outright, as the Fund would otherwise fall back into the disadvantages of its former strict financing assurances policy. However, I agree with Mr. Fogelholm that adequate financing assurances should be in place before the second drawing of the stand-by arrangement.

I, like Mr. Enoch and Mr. Fogelholm, would prefer to leave out of the decision the reference to "up to 40 percent of quota," relating to Costa Rica's intended request for additional Fund resources. This is a general matter of Fund policy, which has been adequately described in the new guidelines on Fund involvement in the debt strategy approved at EBM/89/61. Also, I understand the hesitation of many Directors to approve exchange restrictions evidenced by external payment arrears before we have had a more general review of this issue.

Mr. Nimatallah said that he supported the proposed decisions. As a general rule, he suggested that the percentage of the quota of augmented amounts should not be mentioned in decisions on authorities' intentions to request such augmentations. The reference to "up to 40 percent" in paragraph 3 of the proposed stand-by arrangement was not necessary; however, to exclude that reference from the decision did not imply that he was prejudging the authorities' intention to request an augmentation. He agreed with previous speakers' suggested amendment of paragraph 2 of the decision with respect to the exchange measures subject to Article VIII.

The staff representative from the Western Hemisphere Department said that the targets for net international reserves had not been fully observed under Costa Rica's economic adjustment program for 1987/88, especially not in the second half of 1988, partly owing to a shortfall in external financing. Agreements with commercial banks and the Paris Club had not been reached, and the disbursement of the World Bank structural adjustment loan had been delayed. There were also slippages in fiscal policies; the target for the combined public sector deficit was missed by nearly 0.75 percent of GDP and central government expenditure exceeded the program limit by almost 0.5 percent of GDP. Nevertheless, real GDP in 1988 rose faster than projected, mainly owing to the strength of exports. Nontraditional exports, including light manufactures, winter vegetables, nuts, and cut flowers, expanded by about one fourth compared with the previous year, and exceeded the value of traditional exports. The rate of inflation was higher than expected in 1988, as food supplies were interrupted by hurricane damages and because public utility rates were raised. However, the inflation rate had declined sharply at the beginning of 1989. Consumer prices and wholesale prices had grown far more slowly in the first quarter of 1989, compared with the same period of 1988.

As to the strength of the 1989/90 program, the basic objective was to further reduce domestic imbalances, the staff representative commented. The authorities had introduced measures that would bring the combined public sector deficit down to 2.75 percent of GDP--nearly a full percentage point lower than in 1988. In the external sector, the main reform efforts in 1989 would involve the banking system, the structure of import tariffs, and the rationalization of direct export incentives. As to the exchange rate, the colón had been devalued in real effective terms by 6 percent in 1986, and by 17.5 percent in 1987, but had kept its real effective value in 1988. For 1989, the authorities intended not to permit any appreciation of the colón with respect to its level in December 1988.

The staff, like many Directors, recognized that some of the measures in the fiscal package, such as the sale of assets and the special contributions of banana growers and exporters to cover infrastructure costs, were of a short-term nature, and would have to be replaced by more permanent measures, the staff representative noted. However, those fiscal measures represented only 0.3 percent of GDP, which was less than one third of the envisaged total reduction in the fiscal deficit. Fiscal adjustment in recent years had relied heavily on cuts in public investment programs. In view of the country's longer-term growth prospects, it would be important that adequate attention be given to investment in infrastructure. The reduction of capital expenditures by the public sector was basically the result of postponements of certain outlays, such as expenditures by the telecommunication company, but was also related to the privatization of a number of public enterprises. The projected improvement in the current account surplus of the public sector was due to the expectation that the broad package of tax measures adopted in late 1987 would yield full results in 1989. In addition, the public sector wage bill had been declining since 1986 owing to restraint in public sector hiring. Growth in private sector employment had been strong in 1987/88, and efforts were being made to eliminate positions in the public sector in the year ahead.

As reported, movements of private capital inflows were expected to decline by about 50 percent in 1989, the staff representative commented. In the period 1983-86, private capital inflows amounted to $60 million a year, while the numbers in 1987 and 1988 were $112 million and $120 million, respectively. The increases were related to the sharp depreciation of the colón in 1986-87 and the recent problems in neighboring Panama. In 1989, private capital inflows were projected to return to the levels observed in the period 1983-86.

As to the alternative medium-term scenario, it assumed that there would be no debt reduction; instead, arrears to commercial banks would continue to accumulate, the staff representative noted. However, the alternative medium-term scenario did not appear to be a viable one. In the alternative scenario, the stock of external debt would be about 80 percent of GDP in 1992, compared with 58 percent under the baseline scenario. If the medium-term scenario had been extended beyond 1992, the difference in the debt service ratios between the baseline scenario and the alternative would be more substantial.

In 1988, the surplus of the nonfinancial public sector had been 1.5 percent of GDP, which was half of the targeted level of 2.8 percent of GDP, the staff representative said. The target for 1989 had been set at 1.9 percent of GDP. The reason for the underperformance in 1988 was partly due to the fact that certain transactions could affect either the losses of the Central Bank or the deficit of the nonfinancial public sector, depending on how the transactions were classified; for example, the bilateral agreements pursuant to the 1985 Paris Club rescheduling required assumption of the debts by the nonfinancial public sector instead of the Central Bank. In addition, the Central Bank's losses had been revised from 3.8 percent of GDP to 3.1 percent of GDP; that revision was the mirror image of the deviation with respect to the projected target for the surplus of the rest of the nonfinancial public sector.

Despite the recent strengthening of the U.S. dollar vis-à-vis other currencies, the real effective value of the colón had only appreciated by about 1.5 percent in the first quarter of 1989, the staff representative noted. It was the Government's intention not to permit an appreciation of the colón in real terms with respect to its level in December 1988. Since 1985, the authorities had used a crawling peg exchange rate policy, and they would continue to adjust the exchange rate in accordance with price developments in Costa Rica and its trading partners. The present appreciation of the colón was related mainly to the movement of the U.S. dollar and it was likely to have only a minor immediate impact on nontraditional exports, as most of those exports--mainly vegetables, flowers, nuts, and light assembly products--were exported to the United States. In addition to the authorities' policy of exchange rate adjustments, nontraditional exports would be promoted through a reduction in export taxes. Expanded fiscal incentives, such as tax certificates, had been instrumental in the export diversification effort, but did, unfortunately, create a fiscal burden.

Since 1984, the authorities had been pursuing a financial liberalization program, which by the end of 1986 had given the banks considerable freedom to set interest rates, the staff representative said. The main goal of the financial sector reform involved strengthening the supervision of the banking system, rather than changing the interest rate policy. Interest rates were positive in real terms, and there was no evidence of outward movements in the capital account signaling problems in the interest rate structure.

As to the negotiations between Costa Rica and the commercial banks, the intention of the authorities was to reach an agreement consistent with the new debt strategy as soon as possible, the staff representative observed. However, the change in approach might lead to some delays, as all the outstanding commercial bank debt would be dealt with comprehensively through a menu of options, including a buy-back, debt/equity swaps, and debt exchange. The staff would keep the Board informed about any developments in the negotiations between the authorities and the commercial banks. In addition to the review under the stand-by arrangement, which would take place before November 30, 1989, management could initiate a review at any particular time. As to the possibility of using Costa Rica's foreign exchange reserves for a debt buy-back and how, if such reserves were not sufficient, the Fund's resources could be secured, he noted that there was no reason to question Costa Rica's commitment to meet its obligations to the Fund on time given its recent track record; the country had made a large number of repurchases over the past two years without any delays. He noted also that there had been no noticeable change in the price of Costa Rica's debt in the secondary market since U.S. Treasury Secretary Brady's debt initiative had been announced.

On income policies, there was no automatic mechanism for adjusting wages in accordance with the rate of inflation in Costa Rica, either in the public sector or the private sector, the staff representative from the Western Hemisphere Department said. However, certain guidelines were followed in both the public and private sectors.

The staff representative from the Exchange and Trade Relations Department noted that at the time the staff report for Costa Rica's request for a stand-by arrangement had been prepared, the negotiations between the authorities and the Advisory Committee had been well advanced and centered on a two-stage debt reduction proposal. However, at the request of commercial banks, the two parties had recently agreed to pursue a one-stage approach, in which all the commercial bank debt would be treated simultaneously according to a menu of financing options. The official creditors, including the Fund, would have to decide to what extent they would participate in the strengthened debt strategy.

The alternative medium-term scenario included in the staff report assumed that there would be no debt reduction; arrears to banks were assumed to continue to accumulate, the staff representative remarked. Nevertheless, the alternative medium-term scenario did assume rescheduling of principal.

The fact that 25 percent of each purchase under the stand-by arrangement would be set aside for debt reduction, at Costa Rica's request, as well as the possible augmentation of the amount of the stand-by arrangement of up to 40 percent of quota, seemed fully consistent with the new guidelines on Fund involvement in the debt strategy, the staff representative commented. The Executive Board would be presented with detailed information about the operations to be supported before the disbursements would take place and before the augmentation would be approved.

A temporary accumulation of arrears to commercial banks might have to be tolerated in the case of Costa Rica; however, the seniority of arrears to official creditors was explicitly respected, the staff representative noted. In that context, a Paris Club rescheduling was expected to take place on May 25, 1989. The staff had recommended approval of exchange restrictions, because the debt service obligations that had fallen due to Paris Club creditors since September 1988, and that would fall due during the period of the program supported by the stand-by arrangement, were expected to be rescheduled shortly after the approval of the arrangement. However, it would also be feasible to wait with the approval of exchange restrictions until the general review of the matter.

In accordance with the guidelines on Fund involvement in the debt strategy, the staff would monitor the progress in Costa Rica's negotiations with bank creditors, the staff representative remarked. Some Directors had commented that there should be adequate financing assurances before Costa Rica made a second drawing under their stand-by arrangement; certainly, on the initiative of management, periodic reviews of the progress in the negotiations could be considered.

As to paragraph 2(c) of the stand-by arrangement, it had been included to allow flexibility in making purchases under the set-aside, depending on the timing of the debt reduction operations, the staff representative said. The paragraph would be invoked only upon completion of a review by the Board of the debt reduction plan. Paragraph 2(d) of the stand-by arrangement made provision for what might happen with the set-aside if no debt reduction program was agreed or if the Board was dissatisfied with the authorities' description of the debt reduction program.

The General Counsel noted that while arrears could not be disregarded, the opinion of the staff was that Costa Rica met the conditions prescribed by the Fund for approval of a member's exchange restrictions evidenced by arrears. Thus, in accordance with the Fund policy on payments arrears set forth in Decision No. 3153-(70/95) adopted October 26, 1970, the staff had proposed that, in view of Costa Rica's program for the elimination of payments arrears, the exchange restriction evidenced by external payments arrears should be approved until a review under the stand-by arrangement or on November 30, 1989, whichever was earlier. Paragraph 4 of Decision No. 3153-(70/95) on payments arrears stated that "Fund financial assistance to members having payments arrears should be granted on the basis of performance criteria or policies with respect to the treatment of arrears similar to the criteria or policies described in the preceding paragraph for approval of the payments restrictions." The use of the term "similar" was taken to mean that a member's treatment of arrears, if it met the conditions for approval, would normally also meet the conditions for use of Fund resources, and vice versa. In practice, in virtually all cases under that decision, policies that had been sufficient to warrant the use of Fund resources had also been found by the Board to be sufficient to warrant approval of exchange restrictions evidenced by external payments arrears. However, the Board could decide whether or not the test of similarity was met in the particular situation of Costa Rica.

He had also noted that Directors had commented that the general matter of approval of exchange restrictions had been raised during recent discussions on financing assurances and would be taken up again at a later date, the General Counsel added. It appeared that some Directors did not want to approve in the proposed decision the retention of Costa Rica's exchange restrictions evidenced by external payments arrears, as doing so might prejudge the Board's consideration of the matter. Therefore, he wondered whether the Board's unwillingness to approve exchange restrictions evidenced by external payments arrears was related only to the particular circumstances of Costa Rica, or if the Board, by not approving Costa Rica's exchange restrictions, would be instructing the staff not to recommend, in any future case, approval of exchange restrictions evidenced by external payments arrears, until a general review of the matter had been conducted. If the latter was the case, it would be interpreted as if the Board temporarily had suspended Decision No. 3153-(70/95) on payments arrears. In that regard, should the same approach be taken with respect to other decisions on approval of exchange restrictions, including Decision No. 144-(52/51) on restrictions for security measures, as several Directors in the past had requested a review or termination of that decision?

Mr. Enoch re-emphasized that his chair did not want to approve Costa Rica's exchange restrictions evidenced by external payments arrears, as doing so might prejudge the Board's general review of the matter.

Mr. Warner said that he agreed with Mr. Enoch's comments.

The Acting Chairman commented that because many Directors did not support approval of Costa Rica's exchange restrictions evidenced by external payments arrears, the proposed decision on exchange measures subject to Article VIII would have to be amended to exclude the second sentence of paragraph 2.

Mr. Hogeweg noted, with reference to the statement by the General Counsel, that Directors, in opposing approval of Costa Rica's exchange restrictions evidenced by external payments arrears, had stated that they did not wish to prejudge the Board's general review of the matter. Consequently, that concern did not seem to relate to the particular circumstances of Costa Rica only. In view of those considerations, he questioned whether, by not approving Costa Rica's exchange restrictions evidenced by external payments arrears, Decision No. 3153-(70/95) on payments arrears would be regarded as suspended.

The General Counsel commented that Decision No. 3153-(70/95) would not be regarded as suspended, as it appeared that the Board's unwillingness to approve exchange restrictions evidenced by external payments arrears was related only to the particular circumstances of Costa Rica.

The Chairman then resumed the chair.

Mr. Nimatallah said that, as a general rule, there should be no need to include in the decision the fact that the Fund would be prepared to consider an augmentation in the event that the arrangements for financing the program were consistent with the objectives of the program.

The staff representative from the Exchange and Trade Relations Department commented that in a case where adequate financing assurances had not been secured, the staff would monitor closely progress in the negotiations between the bank creditors and the authorities. A review of progress in those negotiations could be scheduled at any appropriate time and, normally, before the second disbursement of the arrangement. However, management would decide whether or not a review would be scheduled before the second disbursement.

Mr. Fogelholm stated that, in the case of Costa Rica, a review of progress in the negotiations was definitely necessary before the second disbursement under the arrangement.

Mr. Ayales noted that Directors had expressed concern about the adequacy of the structural adjustment element in the program. He noted also that the structural adjustment element had been a cornerstone of Costa Rica's growth strategy in the past few years. Since 1983, Costa Rica had received substantial technical and financial support from the World Bank. The authorities had considered requesting an extended arrangement, as such an arrangement included a strong structural adjustment element. However, as only one year remained of the current Administration's term, it had decided not to commit itself to an arrangement beyond its term.

The Deputy Managing Director made the following summing up:

Executive Directors noted the country's progress in recent years in strengthening the finances of the public sector, improving exchange and interest rate management, implementing structural reforms, and improving the external current account balance.

Directors observed, however, that some of the objectives of the program supported by the past stand-by arrangement had not been met in 1988. It was noted that inflation was higher than projected, although it was recognized that this was due in part to special factors such as hurricane damage to food crops and needed adjustments of public utility rates. Directors observed that this development was the result of slippage of fiscal policy, particularly in the second half of 1988. Directors also observed that growth had been more rapid than expected, owing in large part to the better than expected performance of exports.

Directors took note of the economic program developed by the authorities to bring the adjustment effort back on track, and of Costa Rica's request for a stand-by arrangement in support of their policies. However, some Directors believed that the economic program should have been stronger in several aspects, and they expressed doubts whether the program was adequate to achieve the targets and objectives.

Directors noted the adjustment in fiscal policy envisaged for 1989, including increases in utility rates and a contribution to the public sector capital outlays by banana growers and exporters. They also observed that certain obstacles to the full implementation of the recent tax reform had been removed, which was expected to facilitate an improvement in the revenue performance. However, some concern was expressed regarding reliance on temporary measures, such as asset sales and postponement of expenditure. More broadly, Directors took the view that Costa Rica should strengthen significantly the savings performance of the nonfinancial public sector with more permanent revenue measures and restraint on the growth of current outlays. They also cautioned that the longer-term problem of putting the social security programs on a sound footing still needed to be addressed. Moreover, concern was expressed regarding the compression of public sector capital investment.

Directors observed that the Central Bank had strengthened control over credit expansion, and that the growth of credit to the private sector had slowed. Some concern was expressed about the authorities' intention to maintain specific ceilings on credit to the private sector, as part of the 1989 credit program. Directors commended the authorities' commitment to positive real interest rates.

Directors noted the continued strength of nontraditional exports and tourism, and their contribution to a stronger current account. While this was an indication that Costa Rica's exchange rate policy had so far been consistent with the maintenance of competitiveness in world markets, Directors emphasized the need for continued flexibility in exchange rate policy in the face of changes in the terms of trade and the continuing lowering of import duties.

Directors welcomed the structural measures that had been implemented already, such as the divestment and privatization of entities of the state holding company and the passage of a broad reform of the supervisory and regulatory apparatus governing the financial sector. The pursuit of further structural reforms in these areas would be needed. Several Directors believed that Costa Rica should develop medium-term policies to encourage repatriation of flight capital and to attract direct foreign investment.

Directors said that they were concerned about the accumulation of payments arrears and the prospects for reaching financing agreements with external creditors. While a few Directors expressed hesitation about approving a Fund program with the financing arrangement still unresolved, most Directors were of the view that the Fund should continue to support Costa Rica's adjustment effort. It was generally emphasized that a strong economic program was an essential condition for Fund support of debt and debt service reduction operations.

Directors noted that the recent initiatives with respect to debt reduction should not result in delays in reaching agreements aimed at regularizing Costa Rica's relations with its creditors and urged Costa Rica and its commercial bank creditors to speed up a solution to the country's debt problems. Directors felt that Costa Rica's economic prospects for the medium term would be enhanced by an early resolution of this matter, but they remarked that the magnitude of the benefits derived by Costa Rica would depend on the extent to which savings generated by the debt reduction exercise were channeled into support of a strong economic program, including investment, particularly private investment, and they therefore stressed the need for continued progress in macroeconomic adjustment and structural reform.

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

The Executive Directors then turned to the proposed decisions.

The Secretary noted that four Directors had questioned the need to include in the decision on the stand-by arrangement the fact that the Fund would be prepared to consider an augmentation in the event that the arrangements for financing the program were consistent with the objectives of the program.

Mr. Nimatallah said that it would be preferable not to mention in the decision that the Fund would be prepared to consider an augmentation of "up to 40 percent," as the actual amount would be decided on a case-by-case basis.

Mr. Warner commented that he disagreed with Mr. Nimatallah's point, because the Board had decided at EBM/89/61 that the Fund would be prepared to approve requests for additional resources of "up to 40 percent" of a member's quota. Therefore, it would be consistent with the new guidelines to mention "up to 40 percent" in the decision.

Mr. Enoch said that he had a strong preference for not including the reference to "up to 40 percent" in the decision, as the Board had agreed that the amount of additional resources to be provided would be determined on a case-by-case basis. The limit for additional access was not to be regarded as a target.

Mr. Goos commented that Fund members were by no means entitled to additional access. In appropriate cases, the Fund would be prepared to approve requests for additional resources to be used for interest support in connection with debt reduction or debt service reduction operations, but members would have to fulfil several requirements in order to receive additional resources.

Mr. Feldman said that it would be important to mention in the decision that the Fund would be prepared to approve requests for additional resources of "up to 40 percent" of a member's quota, as that might help the authorities in their negotiations with bank creditors.

Mr. Ayales commented that the mentioning of "up to 40 percent" reflected the particular request of Costa Rica for additional resources, but should not be considered as an entitlement. He, like Mr. Feldman, believed that it would be important to state in the decision that the Fund would be prepared to approve requests for additional resources, as that might facilitate the negotiations with bank creditors.

The Deputy Managing Director suggested that, in paragraph 3 of the proposed decision on Costa Rica's stand-by arrangement, the wording "the Fund will be prepared to consider such augmentation" be replaced by the wording "the Fund will be prepared to consider an augmentation." That amendment would clarify that the Fund would be prepared to approve a request for additional resources of up to 40 percent of Costa Rica's quota, but that the limit for additional access was not to be regarded as a target.

Mr. Yamazaki said that he supported the Deputy Managing Director's proposed amendment of the decision.

Mr. Hogeweg commented that it would not be appropriate to include in the decision that the Fund would be prepared to approve a request for additional resources of up to 40 percent of Costa Rica's quota, without mentioning the conditions attached to an approval of such a request. He suggested that the guidelines on Fund involvement in the debt strategy should be referred to in the decision on Costa Rica's stand-by arrangement.

The Chairman said that he supported the Deputy Managing Director's proposed amendment of the decision. In addition, it would be appropriate to refer in the decision to the guidelines on Fund involvement in the debt strategy approved at EBM/89/61.

Mr. Enoch said that he agreed with the Chairman's further proposed amendment of the decision, but he had wondered whether it would not be more appropriate to reflect that part of the decision in the summing up instead.

The staff representative from the Legal Department commented that, from a legal point of view, it would not be inappropriate to note in the decision the intention of the Costa Rican authorities to request augmentation. Paragraph 3 of the proposed decision on Costa Rica's stand-by arrangement, as amended, would read: "The Fund will be prepared to consider an augmentation in the event that the arrangements for the financing of Costa Rica's program provide for appropriate debt service reduction and upon determination by the Fund that such arrangements are consistent with the guidelines on Fund involvement in the debt strategy, approved at EBM/89/61."

Mr. Ayales said that he could support the proposed decision, as amended.

Mr. Filosa, Mr. Fogelholm, Mr. Goos, and Mr. Piantini also said that they agreed with the proposed amendment of the decision on Costa Rica's stand-by arrangement.

The decisions were:

Exchange Measures Subject to Article VIII

1. The Fund takes this decision relating to Costa Rica's exchange measures subject to Article VIII, Sections 2(a) and 3, in the light of the 1989 Article IV consultation with Costa Rica conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. Costa Rica maintains a restriction on payments and transfers for current international transactions as evidenced by arrears on certain debt service payments pending the restructuring of external indebtedness owed to nonofficial and official creditors, and engages in a multiple currency practice for certain remittances, all of which are subject to Fund approval under Article VIII, Sections 2(a) and 3. The Fund notes the

temporary nature of the multiple currency practice and grants approval for its retention until a review under the stand-by arrangement or November 30, 1989, whichever is earlier.

Decision No. 9154-(89/62), adopted
May 23, 1989

Stand-By Arrangement

1. The Government of Costa Rica has requested a stand-by arrangement for the period from May 23, 1989 through May 22, 1990 in an amount equivalent to SDR 42 million.

2. The Fund approves the stand-by arrangement set forth in EBS/89/87, Supplement 3.

3. The Fund notes the intention of the Costa Rican authorities to request augmentation of the amount of the stand-by arrangement as set forth in paragraph 1 above, by an amount up to the equivalent of forty (40) percent of Costa Rica's quota of SDR 84.1 million. The Fund will be prepared to consider an augmentation in the event that the arrangements for the financing of Costa Rica's program provide for appropriate debt service reduction and upon determination by the Fund that such arrangements are consistent with the guidelines on Fund involvement in the debt strategy, approved at EBM/89/61 (5/23/89).

Decision No. 9155-(89/62), adopted
May 23, 1989

2. PHILIPPINES - EXTENDED ARRANGEMENT AND EXTERNAL CONTINGENCY FINANCING UNDER COMPENSATORY AND CONTINGENCY FINANCING FACILITY, AND EXCHANGE SYSTEM

The Executive Directors considered the staff paper on the request of the Philippines for an extended arrangement in an amount equivalent to SDR 660.6 million, with possible access to contingency financing under the compensatory and contingency financing facility, including the Philippines' intention to request an augmentation of the extended arrangement by up to 40 percent of quota (EBS/89/59, 3/30/89; Sup. 1, 5/1/89; Cor. 1, 5/18/89; and Sup. 2, 5/23/89).

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

> Economic developments in recent months have been generally in line with the program. Inflation declined slightly to an annual rate of 8 percent by April 1989. Movements in base money were within the program, but broad money growth continued at a rate of over 20 percent in the first quarter, reflecting further

strong growth in time deposits. The deficit of the National Government was in line with the program through the first four months of the year. The growth in tax revenues, at 25 percent, was close to the program target, and there were modest shortfalls in current and capital outlays. The internal cash generation of the monitored government corporations was on target during the first quarter, but there appear to have been shortfalls in capital expenditures. Thus, preliminary estimates indicate that the public sector borrowing requirement (PSBR) for the first quarter was within the program path.

The authorities have announced that the domestic retail prices of petroleum products will be increased effective August 1. The increases, which will average over 20 percent, are in keeping with the Government's policy of gradually adjusting domestic prices in line with the movement in the price of oil on international markets.

Balance of payments developments during the first quarter were broadly on track. Export earnings were an estimated 14 percent higher than a year earlier, mainly reflecting continued strong growth in nontraditional exports; growth of traditional exports was sluggish. The value of imports rose by 19 percent, with capital goods imports showing the fastest increase as the surge in investment continued. The external current account deficit for the first quarter was under $100 million. Gross official reserves declined to about $1.6 billion at end-April, equivalent to one and a half months of projected imports of goods and services.

Beginning in mid-April, the peso depreciated slightly against the U.S. dollar, but so far the cumulative depreciation has amounted to only a little over 1 percent. In real effective terms, the peso has appreciated by 1-2 percent since end-1988 vis-à-vis both trading partners and a group of major Pacific region competitors (Malaysia, Indonesia, and Thailand).

The Philippine authorities have expressed strong interest in debt and debt service reduction operations. They are now actively exploring various concrete procedures and intend to seek the necessary waivers from commercial banks at an early stage; they have indicated that some of the transactions that are under consideration would appear not to require waivers. The authorities have indicated that they have been waiting for the Fund and the Bank to finalize the modalities of their support for debt reduction operations before continuing negotiations on these issues with the commercial banks' Advisory Committee. They expect these negotiations to resume within the next few weeks and intend to pursue vigorously an early conclusion.

Mr. Evans made the following statement:

My authorities have no differences of substance with the staff's assessment. That the process of consultation and program formulation has been long and arduous should not be unexpected in the case of a high-debt country, such as the Philippines, intent on re-establishing normal relationships with creditors while nursing its political system back to full democracy.

The success of that process can be measured by the fact that my authorities' program is fully consistent with the staff's requirements. Most importantly, the program--which requires extensive policy achievements--is judged by my authorities to be within the limits of the burdens that can be borne by the Philippine people. It is, in short, an ambitious program but one which is achievable. As such, it should command the respect of the many public and private sector creditors whose support will be essential to its full realization.

Substantial macroeconomic and structural reform measures, initiated in 1984 and intensified in 1986, have made an important contribution to strong and sustained economic recovery, following the external debt crisis that had earlier led the economy into a severe recession and unprecedented inflation. Tight monetary policy and exchange rate flexibility, supported by structural reform measures designed to promote greater efficiency, allowed stimulative fiscal measures without refueling inflation.

The fiscal stimulus, which was directed at increasing incomes and production in the areas most severely affected by the recession, began a period of stronger consumption growth which, together with rapidly expanding exports, provided strong incentives for greater investment. This reflected a strong private sector response to the determined efforts by the authorities to reaffirm the primacy of the private sector in the economy, as indicated in the authorities' development plan. The staff report provides a clear indication of the breadth of that plan, and the charts on trends in key macroeconomic variables on page 6a of EBS/89/59, Supplement 1, provide a good illustration of the authorities' successes in recent years.

The program developed in consultation with Fund staff, supported by the extended arrangement requested by my Philippine authorities, intends to build on these successes. My authorities are confident that they have established a solid economic base from which to progress to what the staff terms "ambitious but attainable" sustained growth.

The program calls for policy action across a broad front, encompassing each of the main arms of macroeconomic policy together with further and substantial structural reform.

Fiscal policy will play a key role. Here the focus will be on further reduction in the ratio to GNP of the consolidated public sector deficit from 3.4 percent in 1988 (progressively reduced from almost 8 percent in 1983) to 2.3 percent by 1992. Within this policy framework, emphasis will be placed on greater capital expenditures in support of the necessary infrastructure for better service delivery, geared toward support of export activities, power generation, poverty alleviation, and countryside development. Financing of the deficit will rely on greater public sector savings expected to be generated, initially, by further substantial improvements in tax administration and, subsequently, new revenue measures. Measures toward these ends are outlined clearly in the staff paper.

My authorities intend to continue with the prudent stance of monetary policy which has been the central feature of their success against inflation and inflationary expectations. Growth rates of broad monetary aggregates will be much lower than in the past, consistent with a more stable financial environment. Open market operations will remain the main policy instrument to influence liquidity movements and preserve positive real interest rates in a more deregulated financial environment. And the monetary base will remain a key performance criterion under the program.

Exchange rate policy will continue to foster exchange rate flexibility which has contributed significantly to the impressive growth in exports, as well as the return of flight capital, during the recovery period.

These efforts to foster a stable macroeconomic environment will be bolstered by the continuation of structural reform. The private sector's response to the dismantling of agricultural monopolies, tax reform, substantial liberalization of trade restrictions, the reform of the financial system, and privatization have encouraged the authorities to vigorously address the remaining rigidities in the economy. The authorities intend to continue with these efforts, with particular focus on the government corporate sector, the commercial banking sector (for which World Bank support had been obtained), agrarian reform, poverty alleviation, natural resource management, and further trade liberalization.

These structural reform efforts have been designed to eliminate the distortions that have fostered inefficient pricing decisions and have tended to favor certain small but politically influential sectors of the economy. The elimination of these inefficiencies is, to my authorities, an important prerequisite to their longer-run objective of allowing the market-pricing mechanism to reflect the true scarcity value of factor inputs.

Needless to say, these undertakings require a substantial amount of financial resources. While measures are in place to enhance domestic resource mobilization and savings, the reality is that the economy is saddled with substantial external debt, the servicing of which demands a substantial part of the country's foreign exchange earnings. That is why, in my authorities' view, the importance of a strong Fund-supported adjustment program cannot be overemphasized.

The creditors of the Philippines, both official and private, are currently awaiting an indication of the Fund's attitude before resuming negotiations on new money, rescheduling, and debt reduction. The creditors are aware that the extended arrangement sought by my authorities can provide, and catalyze, the necessary resources in support of their efforts to re-establish lasting external viability and redress the problems of the past.

While my authorities believe that the extended arrangement sought will be adequate to this task, they agree with the staff that contingency financing under the compensatory and contingency financing facility would protect the past and future gains of the authorities' adjustment efforts from unfavorable external developments. Accordingly, they are requesting that the Fund decide that it will provide such financing should specified adverse external contingencies occur during the period of the extended arrangement.

Agreement with the Paris Club for a restructuring of official debt is expected to follow Board approval along the lines indicated above. The Multilateral Assistance Initiative for the Philippines, which was encouraged by the United States and Japan, major donors and trading partners of the Philippines, and which is expected to generate substantial financial resources over the medium term, would also be facilitated by a Fund-supported program. My authorities are also optimistic that parallel lending from Japan's Eximbank can provide additional resources once such a program is in place.

My authorities attach importance, of course, to obtaining new money to address an unfinanced gap of $1.7 billion for 1989-90, as estimated by the authorities and the Fund staff in their analysis of the country's medium-term program. That said, my authorities also believe that debt and debt service reduction operations could assist in reducing the debt overhang over the medium term and enhance the catalytic effect in the short run. Accordingly, in approaching the country's commercial creditors for new money, they have also proposed the creation of a debt reduction facility and are exploring other possibilities for debt service reductions with them.

With the new emphasis on debt reduction operations under the Brady initiative, and should the Fund determine that it is in the interest of all parties for it to provide additional support for such operations, my authorities trust that the Board will find the case of the Philippines appropriate for additional official support for debt reduction operations.

In this regard, my authorities believe there is merit in the approach, noted in the staff appraisal, that they seek a review of the program's financial structure once the discussion of modalities of the Fund's support for debt reduction operations provides clearer guidelines. In the meantime, they are pursuing with the commercial banks possibilities of waivers on negative pledge clauses to allow greater flexibility for debt and debt service reduction operations.

My authorities are seeking Board approval of the program at a time when agreement with the banks has not yet been finalized. They aim for an immediate resumption of the negotiations and an early conclusion. That would be greatly assisted by an early favorable decision by the Board. My authorities also feel that full approval is essential in facilitating the resumption of official credit flows from Paris Club creditors and, more importantly, prevent the unraveling of the political consensus in the Philippines around the Fund program that could otherwise push back progress made on the economic front and further delay the movement toward external viability.

In conclusion, and given the impressive track record of the Philippine authorities as well as the need for the Fund to demonstrate its support for countries undertaking strong adjustment programs, I agree with the staff that the Philippine request for an extended arrangement and contingency financing under the compensatory and contingency financing facility deserves the full support of the Board.

Mr. Evans, extending his remarks, said that the Philippine authorities had followed very closely the Board's deliberations on the Fund's future involvement in debt and debt service reduction operations. They were fully aware that the case of the Philippines--coming as it did immediately after the Board's decision on Fund involvement in the strengthened debt strategy--would provide an important indication of the extent of support that the Fund would be ready to provide for countries with credible adjustment programs. His authorities believed, and the staff concurred, that the Philippines met the eligibility criteria agreed by the Board. They believed that the Fund's support for debt and debt service reduction would play a significant role in the country's current negotiations with creditors, and would facilitate the return to external viability; it was their intention to seek such support.

Specifically, the Philippines intended to seek Board approval of a 25 percent set-aside of the purchases requested under the extended arrangement and, in support of a debt service reduction program, it would request augmentation of the amount of the extended arrangement by the equivalent of up to 40 percent of quota in accordance with the guidelines on the Fund's involvement in the debt strategy, Mr. Evans remarked. That approach, which accorded with the approach in the staff paper (EBS/89/59, Sup. 2, 5/23/89), would essentially update the proposal that had been prepared prior to the Board's discussions on debt, and would allow the decision on that matter to be given tangible effect in the case of the Philippines. The authorities were committed to following the approach already mentioned. The 25 percent set-aside would impose, particularly in accumulating rights in the manner proposed by the staff, additional short-term calls upon the Philippines' own resources beyond those implied in the original program. In that context, the question of additional Fund resources should be addressed with due process by the Board.

The Philippines did not wish to see consideration of the debt issues cloud the Board's agreement on the basic program proposed in the staff papers, Mr. Evans concluded. Immediate and unconditional approval of that program was essential to the continuation of negotiations with creditors and, of more importance, to the maintenance of support for the program within the Philippines.

Mr. Warner made the following statement:

My authorities fully support Board approval of the Philippines' request for an extended arrangement and possible access to contingency financing under the compensatory and contingency financing facility. We recognize the Philippines' impressive adjustment and reform record in the past few years. Particularly notable have been the record of recovery of real economic growth, containment of inflation to one-digit figures, and pursuit of a cooperative approach to the debt problem. This past record of economic performance reflects generally prudent fiscal and monetary policies, bolstered by progress in structural reforms--especially in the areas of trade liberalization, tax reform, deregulation, and privatization and reorganization of the financial and nonfinancial public enterprises.

Certainly, much remains to be done in some of these areas. We agree with the main aims and policies which are to be pursued over the next few years, focused on sustainable economic growth, a lower rate of inflation, and continuation of various structural reform efforts. However, one general area of concern is the pace of adjustment in reaching a viable balance of payments position.

We believe that prompt application of the strengthened debt strategy offers an excellent opportunity for the Fund to help the Philippines to deal with its balance of payments and debt problems. Therefore, we welcome the request of the authorities to set aside for debt reduction 25 percent of the access available under the extended arrangement. However, we are not persuaded that the resources for debt reduction should be set aside by the Fund while the Philippines accrues rights to draw these amounts. We believe that this approach creates an unnecessary disincentive to set-asides for debt reduction; accordingly, these amounts should be made available to the Philippines in the same way as they would be under any extended arrangement that did not have debt reduction features. In that case, the Philippines would set aside within its foreign exchange reserves the agreed amounts for debt reduction.

We also welcome the intention of the Philippine authorities to request augmentation of the amount of the extended arrangement by up to 40 percent of quota for the purpose of supporting interest payments to commercial banks in the context of debt reduction operations. It is important that the Board's willingness to support such a request be made clear at the earliest moment, so as to avoid introducing an element of uncertainty into the Philippines' negotiations with the commercial banks, as that could become an excuse for delays. While we recognize that the Board will need to review the actual request for augmentation, when made by the authorities, we would stress that the Fund should not attempt to fine tune its assessment of whether the program provides for appropriate debt service reduction, or whether such an augmentation is consistent with the objectives of the program.

As to financing assurances, we strongly support definitive approval today of the extended arrangement. Approval is justified in this particular case and would also be an important signal to the international financial community that the Fund is implementing a prudent adaptation of its financing assurances policy. We believe that outright approval would be entirely consistent with the guidelines on Fund involvement in the strengthened debt strategy, approved at EBM/89/61 (5/23/89), and fully justified by the arguments made by Mr. Evans in his opening statement. In other words, we believe that prompt Fund support is needed to make progress in the implementation of the program and to facilitate the negotiations between the authorities and the commercial banks, with the reasonable expectation of a satisfactory agreement between them.

We would stress the importance of fostering inflows of nondebt capital into the Philippines. To some extent, the important role of capital flight reflows and of foreign direct investment, including debt/equity swaps, has already been recognized in the extended arrangement; for example, it appears that around half of last year's debt/equity swaps of $800 million were carried out by Philippine nationals, suggesting that some capital reflows may have already occurred. We would like to have seen an assumption in the balance of payments projections of at least a moderate amount of capital reflow as a separate line item in the medium-term balance of payments projection, as evidence of the authorities' confidence in the success of the program. In addition to a strengthened debt/equity swap program, maintenance of a competitive exchange rate will be a key element in attracting capital flight reflows.

We believe that debt/equity swaps continue to offer major advantages, not only as a vehicle for capital flight return and new foreign direct investment, but also as an important element of the country's debt management strategy. In the period 1986-88, debt/equity swap operations reduced debt to the banks by 8 percent--a significant figure. We are encouraged that the authorities intend to revamp the program for conversions of central bank debt, which was suspended in February 1988, and continue the program for another two years. However, we feel that a continuing commitment to an expanded and diversified debt/equity swap program will be needed in order to ensure the success of the debt reduction program in the coming years. We are aware of the potential monetary impact of such operations, but believe that it should be possible to take the necessary offsetting measures within the framework of the program under the extended arrangement. Thus, we would strongly encourage the authorities to work together with the staff to amend the program in order to accommodate an expanding level of debt/equity swaps, in particular in the years beyond 1990. We would hope that this amendment exercise could be completed by the time of the first review.

Increased foreign direct investment, in general, can contribute importantly to the aim of sustainable growth based on a growing private sector. We urge the authorities to consider specific measures to improve the regulatory climate for such investment. These measures might include a phasing out of the board of investment, elimination of the 40 percent equity limit on most foreign investment, and a strong commitment to protect intellectual property rights. Measures to improve the Philippines' slow rate of growth of productivity would also help to create a climate of investment that would be more competitive with that in some of its neighboring countries. In addition, maintenance of a competitive exchange rate is an important complement to such policies.

Recovery of domestic private investment is already encouraging and a further increase is anticipated through 1992. However, for this to occur, considerable progress will be needed in mobilizing domestic savings and in intermediating them through a strengthened and expanded banking system and securities markets. Although we support the objectives of the efforts of the World Bank to strengthen the banking system under its financial sector adjustment loan, we feel that the program does not offer reasonable assurances that the policies needed to achieve these objectives will be implemented fully and in a timely fashion. Public investment will also have to play an important role in expanding and maintaining infrastructure, particularly in the energy and transport sectors where bottlenecks are already appearing. It is very important that the Government keeps its capital expenditure program on track in order to create an attractive environment for private investment. To achieve this objective, the authorities' efforts to increase tax revenues and control current expenditure will have to be successful. Reforms to reduce the pipeline of undisbursed foreign project assistance will also play an important role in this endeavor.

The growth of public savings is, rightly, a key element of the program, as a stronger revenue base is needed. While we support the authorities' efforts to improve tax administration and increase tax compliance, these efforts are not likely to be sufficient to reach the fiscal deficit targets. The probable need for new tax measures after 1989 is recognized, but the nature of these measures is not yet clear. In addition to raising revenue to less depressed levels, it will be important that new measures do not adversely affect income distribution and efficient resource allocation, or add to present inequities and distortions.

On the expenditure side, interest payments are a major burden, with such payments expected to represent approximately one third of national government expenditures and net lending in 1989. While this ratio is expected to fall to about 22 percent in 1992--despite continuing fiscal deficits--this seems to depend upon an assumed decline in domestic interest rates. Yet, it is not clear why interest rates should decline; we would welcome the staff's comments on this issue.

We are pleased to see that the efforts to privatize, reorganize, and make more efficient the financial and nonfinancial public enterprises figures prominently in the structural reform effort, with the World Bank playing the lead role. However, the goals of the privatization program are modest when viewed against the remaining size of total public corporation assets. In addition, we wonder why the deficit of the monitored corporations is expected to amount to about one percent of GNP throughout the program period.

Encouraging progress has been made over the past couple of years in expanding exports, the major depreciation of the peso in real effective terms in the period 1986-88 no doubt played a part. However, there has been a gradual appreciation of the peso against the currencies of some of the Philippines' major competitors--a development that needs to be reversed.

We welcome the trade liberalization that has occurred in the Philippines over the past few years. It is important that this trend continues. Unfortunately, the time schedule under which the Government will shift tariff items from quantitative restrictions to tariff-based protection seems too slow; for certain items, the time schedule has not even been specified. Also, we believe that the program should delineate goals for further rationalization of the Philippine tariff schedule and for reductions in average tariff levels. It is not enough to switch from quantitative restrictions to high and variable tariff rates; overall protection and variation in protection needs to be reduced.

According to the staff paper, the Government expects that, during the period 1989-92, the Philippine assistance program and Multilateral Assistance Initiative will provide the broad framework for increased flows from multilateral institutions, official and private bilateral sources, and foreign commercial banks. The report also states that "the need for exceptional external financing might well extend beyond the period of the proposed arrangement," and that financing gaps of about $1.1-1.7 billion a year are expected for the years 1993-95. We recall that a primary objective of the Multilateral Assistance Initiative is to decrease the dependence on foreign aid by promotion of the private sector, direct investment inflows, and greater national savings. Also, given that the Philippines has been a very prolonged user of Fund resources, this balance of payments outlook is very disappointing and raises serious questions as to whether relative economic priorities are being set correctly, and whether economic policy is adequately strong and properly focused on this key objective.

On a number of occasions in recent years, we have expressed concern about the prolonged use of Fund resources in the case of the Philippines; use has been almost continuous for the past 16 years. While the outstanding drawings of the Philippines from the Fund are high, they are lower than those of a number of countries in Latin America and Africa. We are not especially concerned about the willingness or ability of the Philippines to repay the Fund, but we would have liked to see a separate and more comprehensive section in the staff paper on this matter than is provided on pages 23 and 46 of Supplement 1 to EBS/89/59. We welcome the introduction in the program of semiannual monitoring with some quarterly benchmarks; the Philippines' record of performance qualifies it for such treatment.

Finally, this is only the second case of contingency financing under the compensatory and contingency financing facility, which has been presented to the Board for approval. The clarity and comprehensiveness of the presentation of the arrangement has improved considerably compared with the first case that was approved by the Board in January (EBM/89/4, 1/17/89). In particular, the coverage of current account transactions seems appropriate when one excludes the export and nonfactor service items, which are clearly not subject to exogenous shocks. We note the careful treatment of coconut oil prices, given the importance of that product for the Philippines in world trade; in addition, we observe the calculations of movements in some of the variables to show the point at which they might trigger activation of the financing. However, we wonder how the 15 percent threshold and the 50 percent of the net sum of deviations were decided on. Finally, while we recognize the current complex relationship between the authorities and the foreign commercial banks, we do believe that parallel contingency financing from the banks could be a part of the menu in an eventual financing package. We urge the authorities to give due consideration to this possibility.

Mr. Yamazaki made the following statement:

The Philippine economy made remarkable progress under the 1986-88 stand-by arrangement. The impressive economic growth of 6.7 percent in 1988 was led by robust private investment, which, undoubtedly, had a favorable effect on the supply side of the economy. The strong economic growth, coupled with the tax reform initiated in 1986, contributed to the decline of the public sector fiscal deficit. The external current account recorded a deficit of only 1 percent of GDP in 1988, because the increase in imports was largely offset by an accelerated growth of exports.

Despite these significant achievements, major challenges remain for the authorities. These challenges encompass sustaining strong growth, subduing the rekindled rate of inflation, attaining a better balance of payments position, and completing major structural reforms. As Mr. Evans has clearly stated, the authorities rightly recognize those challenges; therefore, we would support the proposed program, which has been formulated accordingly. However, the program is ambitious and requires persistence on the part of the authorities. It will be essential to sustain economic growth in order to increase domestic savings. Given the strong private consumption, the public sector should assume primary responsibility for improving the domestic national savings necessary for larger investment. Therefore, the authorities should assign priority to the sufficient reduction of the fiscal deficit.

On the revenue side, the major efforts to strengthen tax administration is already under way. However, the inefficiency of the tax administration seems to be deeply rooted, as illustrated by the relatively low tax revenue to GNP ratio. A determined effort by the authorities will be essential in order to attain the projected revenue; in this respect, we would like the staff to clarify Table 1 of the staff paper. The projected revenue for each of the measures shows significant declines or increases in 1989/90; we presume that some of the increases stem from the introduction of new measures during 1989. However, I note that while the broadening of the withholding tax was effective January 1, 1989, the revenue arising from this measure is projected to increase from P500 million in 1989 to P930 million in 1990--almost twice the amount of the previous year. In view of the long-standing poor tax administration, the authorities' intention to monitor closely the revenue developments and to implement additional measures are very welcome. Furthermore, the formulation of new revenue measures in 1990 is one of the most important tasks facing the authorities and should be completed as soon as possible.

It will be essential to contain the growth of current expenditure. Past experience shows that wage compensation added inflationary pressures to the economy; that should not be repeated. The envisaged transfer of the interest burden from the Central Bank to the Government would also constitute an important element of budgetary rehabilitation. The authorities are encouraged to complete the specific arrangements for this transfer as soon as possible.

The high inflation rate requires that the authorities take a prudent stance, although it partly reflects supply shocks. As to the structural area, we would encourage the authorities to intensify their efforts, particularly in trade policy reform. Although we recognize the sensitivities involved, the authorities should be encouraged to study the possibility of expediting the timetable. We attach great importance to the area of reform of government enterprises, because we believe that reform of public enterprises would not only enhance the efficiency of the economy, but would also promote private direct investment. We also attach great importance to external policies, in particular the repatriation of flight capital and the expansion of the debt/equity swap operations. The medium-term projection made by the staff does not envisage the attainment of external viability within the program period; the Philippines will have to rely on exceptional external financing until the mid-1990s. Thus, we believe that it is important for the authorities to formulate policy measures to expand debt/equity swap operations and to repatriate flight capital in order to attain external viability earlier than envisaged.

In conclusion, while we support the extended arrangement, we would like to emphasize that the authorities need to persevere with the program, because it constitutes the basis not only for further economic development, but also for the mobilization of external resources from creditors and donors--including the

Multilateral Assistance Initiative. The staff proposes to apply the Fund's new guidelines on the debt strategy in the case of the Philippines. We certainly recognize that the arrangement does not exactly fit these guidelines, because the program was formulated before the new guidelines had been approved. However, we are willing to support the proposed set-aside. We also support outright approval of the program, because judging from the continued good relationship between the bank advisory committee and the Philippines, and from the improving economic situation in the Philippines, we expect that the negotiations with commercial banks will be completed within a reasonable period of time.

However, we would request the authorities to commit themselves to three points. First, the authorities should reach an agreement with the staff on policy measures to expand debt/equity swap operations and repatriate flight capital, in order to attain external viability. Second, the authorities should formulate menu options for debt reduction and discuss those options with commercial banks as soon as possible. In this connection, we understand that a buy-back will not be the main menu item. Third, the authorities should, together with the staff, develop specific modalities of interest support. In this context, we would like to emphasize the need for a timely review of the program and the financial arrangement.

Finally, we support the proposed decisions.

Mr. Garcia made the following statement:

We note the impressive economic results of the Philippines' efforts to correct economic disequilibria and to improve resource allocation. The economic policies that have been implemented in the past two years have helped the country to recover from the economic and financial crisis that started at the beginning of the 1980s. The willingness and the efforts of the authorities are impressive and encouraging, as reflected in the policies of macroeconomic stabilization and structural reforms that have been intensified during the process of democratization, which began in 1986.

The program of the Philippines seems to be feasible in terms of a sustainable economic growth rate, balance of payments viability, and a low rate of inflation, although external financial support will be needed to reduce the financing gaps and the debt overhang.

As to fiscal policies, they should be aimed at increasing public savings, reducing the fiscal deficit, and concentrating investment in infrastructure that is needed to reduce fiscal bottlenecks. To avoid slippages in this area, tax revenues should be increased; I note that the ratio of tax revenue to GDP is relatively low by international standards.

In respect to trade policy, the decision to reduce some quantitative restrictions and substitute others for tariff-based protection seems appropriate. To avoid further pressures from the affected sectors and delays in the improvement of remaining import restrictions, the speed of adjustment should be clearly stated at the beginning of the program; that will also send a clear signal to the private investment market.

The most important consideration should be given to the balance of payments projection. We agree with the authorities and the staff that the Philippines is an appropriate case for debt reduction operations, not only because the country has adopted stabilization policies and structural reforms to improve economic efficiency and resource allocation, but also because the program itself would not be sufficient to overcome the external financial constraints the country faces. However, we note that exports are expected to continue to increase at a considerable rate. The buildup of official reserves at appropriate levels and the increase in investment needed for sustainable growth will require important amounts of external financing, as evidenced by the financing gaps that will remain beyond the program period. The sensitivity analysis made by the staff shows the external sector's vulnerability to some factors that could further widen the financing gaps. In addition, permanent rescheduling will be required, which may add uncertainty and instability to the situation and could dampen the increase observed in private investment in the past two years. Enhancement of the debt strategy will be necessary in the case of the Philippines in order to avoid a deterioration of the debt overhang and to reduce the burden imposed by the sizable level of debt service; I note, however, that the structural reforms have been designed with the intention of increasing the competitiveness of the economy.

Contingency financing under the compensatory and contingency financing facility will help to protect the external sector from possible external shocks. We fully support the authorities' request for possible access to contingency financing, as it will help to give a more certain scope of economic stability in the Philippines. As to the medium-term outlook of the Philippines' balance of payments position, the country should have no difficulties in meeting the financial obligations to be acquired under the program; in addition, the Philippines has an excellent track record. Finally, the Fund's strengthened debt strategy will help the Philippines to close its financing gaps and find a lasting solution to its external debt problem. We support the proposed decisions, including the set-aside of 25 percent of each purchase under the arrangement, as well as an augmentation of the amount of the extended arrangement by up to 40 percent of the Philippines' quota.

Mr. Enoch made the following statement:

The staff papers on the Philippines raise several important questions. The first issue is whether the proposed extended arrangement is well directed at the main challenges confronting the Philippines over the medium term, and is it likely to lead to the attainment of a viable balance of payments position over this period? Is the associated compensatory and contingency financing arrangement appropriate? Another issue relates to how the program ties in with the strengthened debt strategy. The program was designed before the Board considered the modalities of Fund support for debt reduction operations; therefore, to what extent will the program need to be adapted? As to the financing of the program, there is a substantial financing gap for 1989, and the Board will need to decide--on the basis of the new guidelines on Fund involvement in the debt strategy approved at EBM/89/61 (5/23/89)--whether the Fund should disburse into this financing gap or whether instead it should approve the program only in principle. As we emphasized at EBM/89/58 (5/19/89), once guidelines have been agreed, they must be adhered to firmly.

It is clear that the authorities deserve considerable credit for their efforts to secure a broadly based political and social consensus behind the continuing reform process. These efforts, together with the growth orientation of the program and its focus on land reform, poverty alleviation, and protection of the environment, provide assurance that the program will be implemented fully and that the very strong economic recovery in the Philippines since 1986 will prove to be sustainable.

The proposed extended arrangement has two broad macroeconomic objectives; first, to ensure a continuation of strong economic growth; and second, to strengthen the country's external payments position. These two objectives will require the full implementation of thoroughgoing measures designed to raise the rate of domestic and foreign direct investment, to increase domestic savings--primarily through greater fiscal consolidation--and to raise exports by maintaining external competitiveness.

As to investment, the program targets a substantial increase in public sector investment, designed to ease capacity constraints in the energy and transportation sectors. Over the past few years, the level of public investment has fallen well short of target, and it is clear that measures to improve implementation capacity will be very important. I note with some concern that in the first quarter of 1989, there appears to have been a shortfall in public sector capital spending. Does this shortfall imply that the expected streamlined procedures for the review and approval of large contracts have not yet been established?

The 1989-92 program also envisages a considerable increase in private sector investment and continuing strong direct investment from overseas. It is somewhat difficult to gauge the realism of these assumptions, as they are dependent on perceived responses of economic agents to such intangible factors as the so-called improved policy environment or increased political stability. Nevertheless, I was slightly surprised about the absence of any specific structural measures in the program to promote further investment. It is possible that a more vigorous trade liberalization program over the next year or so, combined with an acceleration of the privatization program, might provide a further spur to efficient private investment over the medium term.

As to foreign investment, including the return of flight capital, the main specific measure in the program is the plan to introduce a new debt conversion scheme. This approach is welcome, although it is not clear from the staff papers how the authorities intend to avoid the potential inflationary effects of such a scheme, which was the cause of the previous scheme's suspension in 1988. I would be interested in learning whether any other specific measures to increase foreign direct investment are under contemplation; for example, when does the Philippines expect to be able to ratify the Multilateral Investment Guarantee Agency?

The program envisages a gradual reduction in the consolidated public sector deficit, with increased capital spending more than offset by increased savings--particularly in 1990. While the measures being implemented to strengthen tax administration seem well directed and are included as indicative targets under the program, it is disturbing that specific measures designed to increase the level of public savings in 1990 have not yet been identified. Clearly, we will need to return to this issue at the time of the first review.

With respect to the external position, the underlying pattern over the program period is somewhat obscured by the impact on import demand of the targeted surge in capital spending. As a result of this factor, no improvement in the current account is projected over the program period. However, the program counts on a substantial increase in foreign exchange reserves to a more comfortable level of three months' coverage of imports. The major doubt about achieving external viability under the program concerns the projected substantial financing gaps until the mid-1990s. These projections imply that a return to normal market access could lie well beyond the program period; this, in turn, suggests that the staff would need to provide a more extensive assessment of the Philippines' ability to remain current in its payment obligations to the Fund over the medium term.

The uncertain prospects for the attainment of external viability underline the importance to be attached to the maintenance of a competitive exchange rate throughout the program period. In this respect, I was surprised that so little emphasis was placed on this issue in the staff papers. In 1988, the real appreciation of the peso against the currencies of major regional competitors was a very unhelpful development, and it is disturbing to learn that this trend continued in the first quarter of 1989. In practice, the authorities have not always used exchange rate policy flexibly to support their reserve targets. Occasionally, the reverse policy has been pursued.

As to the possible access to contingency financing under the compensatory and contingency financing facility, the staff and the authorities are to be congratulated on the detailed specification and broad coverage under the contingency element. However, I note that the baseline oil price projections seem to be a little on the low side. I also note that in this case it has not proved possible to specify at the outset what policy adjustments would be taken if the minimum threshold were exceeded.

An issue the Board needs to examine is how the new guidelines on Fund involvement in debt reduction operations might apply in the case of the Philippines. Since the program was designed before our recent discussions on the strengthened debt strategy, only passing reference was made to this issue in the staff paper, although Mr. Evans makes it clear that his authorities are hoping to receive additional resources for debt reduction operations. In this context, it is clear that the Board will need to establish whether the Philippines meets the eligibility criteria agreed at EBM/89/61. The agreed criterion of cost effectiveness implies a requirement for a staff analysis, demonstrating that it would be more efficient for the Philippines to use its scarce resources to finance debt reduction operations than, for example, to increase public investment or to liberalize imports. This requirement is by no means self-evident in the case of the Philippines, and certainly cannot be established by assertions such as that made in the staff paper that "voluntary debt reduction could quicken the return to normal market relationships."

If some proportion of the Philippines' resources, including up to 25 percent of the resources to be made available under the extended arrangement, are to be set aside to finance debt reduction, this will no doubt affect the overall financing of the program. In the absence of additional financing from other sources, this might imply the need for some additional adjustment in the short term. The degree of front-loading of disbursements of the set-aside needs further analysis. It is far from clear that the full upfront disbursement of three years cumulative access to the set-aside is consistent with the sense of the Board on this issue. The Board will need a staff paper analyzing the possible impact of alternative debt reduction scenarios on the Philippines' prospects and on the financing of the program.

As to the financing of the program in the absence of clear debt reduction proposals from the authorities, the main issue is whether it would be appropriate for the Fund, in the light of its new guidelines on debt reduction operations, to disburse into the very substantial financing gap that currently exists for 1989.

My authorities are concerned that the staff has not made any attempt to draw out the implications of the external financing assumptions for burden sharing between official and private creditors. According to calculations done by my authorities, the Paris Club's share of the external financing burden in the 1989-92 program appears to be about 50 percent more than could be justified by the Paris Club's share of end-1988 exposure. Therefore, my authorities are informing the Paris Club that they can agree only to the rescheduling of 100 percent of principal. They cannot agree to the rescheduling of interest, as assumed in the Fund staff's projections.

As to the financing gap, it is very important that our decision in the case of the Philippines conforms strictly to the approved guidelines on Fund involvement in the strengthened debt strategy. To breach these guidelines in their infancy would risk bringing the whole policy into disrepute and would make it more difficult to hold the line in future--to the possible detriment of the Fund's financial integrity. Having carefully assessed the proposed program against the Fund's new guidelines, my authorities' strong preference is to approve the program only in principle, because full approval, together with a disbursement of Fund resources, would be inconsistent with the Fund's new guidelines.

It is not clear that full approval of the program at this stage is essential for its successful implementation. At the end of April 1989, gross reserves amounted to $1.6 billion, a relatively comfortable level in relation to the first quarter current account deficit of less than $100 million, and a substantial figure in relation to the size of the Fund's first disbursement of SDR 94 million. It is far from clear that a delay of several months in making this disbursement would jeopardize the program--particularly if this delay were used to expedite negotiations with commercial banks. Such a delay would also give the staff the opportunity to analyze the role that debt reduction operations, supported by Fund resources, might play in strengthening the program.

Another condition for Fund disbursement while a financing gap remains is that it can be expected that a financing package consistent with medium-term balance of payments viability will be agreed within a reasonable period of time; however, there are as yet no clear indications of the shape of the financing package. Indeed, this fact is not surprising, because the negotiations between the authorities and the banks have up to now only been exploratory, which suggests the need for a further staff paper incorporating alternative financing assumptions, based on different debt reduction scenarios. Furthermore, a condition for Fund disbursement into a financing gap is that management would consult with Executive Directors at an early stage; evidently, this was not done in the case of the Philippines.

An additional condition is that arrears to the official sector cannot be tolerated; however, the Board is being asked to approve arrears to the Paris Club until, perhaps, the end of 1989. A further important point is that a comprehensive review of progress in the negotiations on financing between the authorities and the banks would be scheduled prior to the second disbursement; no such review is mentioned in the staff papers. Clearly, a first review under the extended arrangement is envisaged, but the remit of this review contains no reference to the financing of the program. As currently defined, the end-September performance criteria might actually be met even in the absence of an agreement with the commercial banks, because the reserve target is to be adjusted downward if the financing of the program falls below assumed levels. I wonder whether sufficient thought has been given to this fact, as it implies that if the banks decide to negotiate "tough," the main impact will be felt by the official creditors--including the Fund--in the form of an increase in risk through the lower level of reserves. This implication cannot have been the intention of the staff.

The Board has agreed that performance criteria should be quarterly, if negotiations with creditors are continuing, but this is not the case with the Philippine program--the performance criteria are six-monthly. I assume that the criteria cannot be changed without the agreement of the authorities.

In sum, there are significant grounds for doubting whether the current program falls within the Fund's new guidelines. In view of this concern, and in light of the fact that the program may need to be redesigned somewhat to take into account the possible scope for Fund-supported debt reduction, I would urge the Board to approve the program only in principle at this stage. This judgment is based on the Fund's guidelines and not on the content of the program itself. Subject to the points I have raised, the structure and objectives of the proposed extended arrangement appear commensurate with the challenges facing the authorities at the present juncture.

Mr. Nimatallah made the following statement:

The Philippine authorities have established a good track record by staging a remarkable recovery that provides a good foundation for further reform and growth. I am impressed by their performance and, therefore, I support their requests for an extended arrangement and contingency financing under the compensatory and contingency financing facility. I am in general agreement with the objectives of the economic program. I am also in general agreement with the staff's assessment of the probability of success of this program.

However, the authorities should make no compromise on bringing down the rate of inflation; they will have to control nonproductive current government expenditure, particularly personnel expenditure. Furthermore, the public sector has to increase the level of savings; by improving the efficiency of the public sector, the authorities will be pleasantly surprised to see how much can be saved. There should also be unlimited efforts made to enhance public investment expenditure--the basic element for encouraging private investment and strengthening growth.

As to the objective of controlling the rate of inflation, I wonder whether the authorities will be able to avoid a depreciation of the exchange rate of the peso, vis-à-vis their major competitors. In this regard, I disagree with the staff, at least on the timing of the reversal of the present real effective appreciation of the peso. The authorities should study the net impact on controlling the rate of inflation of avoiding a depreciation of the peso, as well as the possible loss of competitiveness. If the authorities believe that the peso has depreciated enough, and further depreciation can be postponed until there is convincing evidence that the rate of inflation is under control, I think that the Fund should support their efforts. The case of the Philippines might disprove the global misperception that the Fund always insists on immediate currency devaluation, and show that it is possible to improve the efficiency of the productive system and public finances without necessarily resorting to deep or repeated national currency depreciation.

I would like to advise the authorities to be flexible on the assumed real growth rates. Experience has shown that insisting on the realization of a certain real growth rate could lead, at times, to acceleration of the rate of inflation. It might be better to adopt a range of real growth rates say, of from 5 percent to 10 percent. In the meantime, I advise the authorities to pay special attention to structural reforms and their sequencing, in order to avoid bottlenecks and rigidities on the supply side. To encourage investment, especially in the private sector, it is important to continuously improve the quantity and quality of the factors of production. Retraining labor, improving regulations, and easing imports of needed equipment and materials would help the authorities to realize even faster real growth rates. I would not be surprised if, in a few years, the Philippine economy--like those of Thailand and Korea--were to grow at a rate closer to 10 percent a year. Therefore, it is important to continuously improve the efficiency of the economy. I am encouraged by Mr. Evans's statement that the elimination of inefficiencies is, to his authorities, an important prerequisite to the achievement of their longer-run objective of allowing the market pricing mechanism to reflect the true scarcity value of factor inputs.

Finally, I hope that the authorities will attain the appropriate financing package for this program, including debt reduction and parallel financing from Japan. I am confident that the Fund will find the Philippines eligible for debt and debt service reduction operations. I support the proposed decisions.

Mr. Feldman made the following statement:

The Philippines has successfully completed the first phase of stabilization and recovery. The authorities intend to take additional measures to remove the remaining economic and social problems, namely, poverty and the burden of external debt; these efforts deserve the prompt support of the international financial community. We support the authorities' request for an extended arrangement and possible access to contingency financing under the compensatory and contingency financing facility. In particular, we observe the modified version of the proposed decision on the extended arrangement, which notes the authorities' intention to request an augmentation of the amount of the arrangement.

We welcome the consideration of six-month quantitative performance criteria in the program. The six-month period should help to reduce uncertainties and provide the authorities with more flexibility in implementing the program. However, the establishment of quarterly benchmarks for the external and domestic sector variables, and indicative targets for net domestic assets, tax revenues, and capital expenditure put the mentioned flexibility into question. The staff intends to monitor short-term developments under the program, as well as progress in the strengthening of tax administration and public sector corporate reform. We realize that these indicators will be useful for the authorities, but we do not see how the indicative targets and benchmarks will operate within the program supported by the Fund, or what the consequences of any deviations from the targets might be. Explicit inclusion of these targets and benchmarks in the Fund-supported program does not seem necessary, especially as that could be misinterpreted to imply that the program has quarterly performance criteria, but only biannual disbursements. Furthermore, since the biannual disbursements depend on the compliance of the six-month performance criteria and on the satisfactory completion of reviews, the quarterly targets and benchmarks appear to be redundant.

On the external projections for foreign investment, debt conversions, and capital reflows, we have difficulties in reconciling the projected high level of foreign investment, given the suspension of the debt/equity swap program in 1988. The medium-term projections assume that direct foreign investment will remain close to the very high level of 1988, but since most of the direct foreign investment flows were fueled by debt conversions in 1988, we see difficulties in projecting such high levels for the medium term, given the change in the institutional framework. We do not see how an increase in the share of traditional foreign investment, financed through additional foreign exchange inflows, will be enough to make up for the decline in direct foreign investment financed through debt conversions. I would also like to learn about the projected amounts of flight capital compared with the figures of the past couple of years.

Debt reduction operations could help the Philippine economy to achieve external viability more promptly and ensure a faster rate of economic growth. We realize that the authorities are exploring concrete procedures for these operations, and that they have been waiting for the Fund and the World Bank to finalize the modalities of their support for debt reduction operations before continuing the negotiations with commercial banks. The guidelines on Fund involvement in the debt strategy have now been set, and the authorities and the creditor banks should resume their negotiations. An early agreement between the two parties would be important in order to avoid an interruption of the implementation of the program. Given the uncertainties concerning the timing and results of the negotiations, the Fund-supported program should be flexible enough to avoid adverse consequences stemming from delays in the negotiations, and should permit the incorporation of debt reduction operations without affecting the normal implementation of the program.

As to the possible access to contingency financing, the high proportion of import, export, and current account transactions covered under the contingency element is a positive feature. I note that the staff suggests an activation of the contingency mechanism when the net sum of deviations exceeds the baseline projection by the equivalent of 15 percent of quota; a threshold of 10 percent of quota was not advisable, since frequent activation of the contingency mechanism could occur on account of relatively small deviations. However, we would have favored a threshold of 10 percent of quota, because we do not consider that that amount is a small deviation, especially given the low level of the country's net international reserves. In addition, a threshold of 10 percent of quota would have allowed the authorities more flexibility in dealing with unfavorable external developments.

We urge the authorities and commercial banks to include parallel contingency financing from commercial banks in the new financing package. However, we, like the authorities, are concerned that parallel contingency financing could result in a reduction of other forms of financing from the banks. Appropriate and prompt financial support from the banks is essential; we attach considerable importance to obtaining new money from creditor banks to close the projected financing gap. Also, we believe that debt and debt service reduction operations and parallel lending from the Export-Import Bank of Japan might provide the needed financial help.

Finally, we support the proposed decisions.

Mr. Fogelholm made the following statement:

The Nordic countries find themselves in a difficult position with respect to the request by the Philippines for an extended arrangement and possible access to contingency financing under the compensatory and contingency financing facility, as well as the accompanying debt reduction proposals.

On the one hand, we acknowledge that the Philippine economy has experienced positive developments in recent years, inter alia, with the help of a Fund stand-by arrangement, which was completed in a satisfactory manner. During the period of the stand-by arrangement, substantial progress was made not only to curb macroeconomic imbalances, but also to implement reforms designed to reduce government intervention, remove distortions, and increase the efficiency of the economy. The program for 1989-92 is aimed at a continuation of the comprehensive structural adjustments, while maintaining strong growth. We are also pleased to find that due attention has been paid to the question of poverty alleviation.

On the other hand, the program raises a number of serious concerns and, as the program was negotiated before the completion of the guidelines on Fund involvement in the strengthened debt strategy, it contains features that are not compatible with these guidelines. It is of particular concern that despite staff projections of favorable economic developments, the program is not leading to medium-term viability in the external accounts; it seems that this program is more concerned about growth and less about adjustment. It appears that one of the major reasons for formulating the program is to become eligible for debt reduction and interest rate support. Indeed, if this is the case, we believe that more emphasis should have been placed on adjustment in order to fulfill the requirements for debt reduction operations, namely, substantial adjustment efforts and the notion of an exceptionally strong program.

In addition, we wonder whether the Philippines is in fact in need of Fund resources. The financing gap is not much bigger than the yearly increase in net international reserves. Furthermore, it is noteworthy that direct investment, including capital repatriation, is not even projected to increase in nominal terms during the program period. This forecast appears highly conservative, in light of the projected economic growth rate. Certainly, one would assume that after several years of high growth rates, a considerable amount of flight capital could be expected. Or, is the staff not convinced that the program is strong enough to induce such capital reflows?

As to the Philippines' relationship with the Paris Club, it is most regrettable that the country is allowing arrears to accumulate despite the fact that the terms are comparable with previous rescheduling agreements, and that the country has reasonable payment capabilities compared with many other developing countries. In its calculations, the staff has used these same terms as well; it appears that it should, at the least, have made some sensitivity analysis to illustrate the effects of other apportionments on interest and amortization payments, in order to give the Paris Club more flexibility.

The financing of the program is most uncertain. In addition, it has been impossible to assess the effects of any debt reduction operations, because concrete and detailed information to this effect has not been available. However, we do find that the implementation of the 1989-92 program, including debt reduction operations, is not compatible with the guidelines on Fund involvement in the strengthened debt strategy; Mr. Enoch has stated these concerns adequately. Clearly, it is not acceptable that the proposed monitoring procedures in the program are weaker than in the approved guidelines for debt reduction. Also, we maintain that there should be adequate financing assurances before the Philippines makes the second drawing of the extended arrangement. We would also appreciate some information on the possibility that the Philippines will receive additional resources from other sources than the Fund.

As to the contingency element, the calculations appear extremely complicated; therefore, my authorities have found it difficult to assess whether the exogenous variables to be covered under the element have been realistically evaluated. We would have welcomed some more background information on how these variables were chosen. In this context, we agree with the staff on the need to include parallel contingency financing from commercial banks in the new financing package.

Obviously, my authorities are not pleased with many aspects of the proposed program. At the least, they believe that the program should be amended in such a way that it becomes compatible with the Fund's new guidelines on debt reduction and debt service reduction. Furthermore, in light of the need to modify the program, the fact that no medium-term viability is in sight, and given the lack of adequate financing assurances, we believe that only an approval in principle would be appropriate today.

Mr. Marcel made the following statement:

At the outset, I want to stress that we are very pleased that an agreement has been reached between the Fund and the Philippine authorities. Given the specific needs of this country, as well as its good track record, an extended arrangement appears particularly well suited in this case. Sound macroeconomic policies, combined with major structural reforms over the past years, have resulted in a remarkable economic performance; growth has been strong, sustained by buoyant private investment, and despite moderate slippages in the targets of inflation and public deficit, the current account deficit was limited to 1 percent of GDP.

The medium-term program formulated by the Government seems to adequately meet the country's requirements, and its main objectives are broadly appropriate. However, it is an ambitious program. Therefore, to be successful, strong determination on the part of the Philippine authorities, as well as strong external support, will be required over the whole period. Furthermore, the implementation of the program will also need the full support of the population.

Achieving the growth objective of 6.5 percent a year will require a substantial increase in investment, both private and public, which makes the mobilization and allocation of domestic savings a primary condition for success. Fiscal policies will be crucial in this area, and we are somewhat worried about the fiscal slippages experienced in 1988; a deficit of that size can undermine the whole stabilization process. The share of current expenditure has increased considerably and is constraining the implementation of the public sector investment program. Given the necessity to increase public investment, I would appreciate the staff's comments on the feasibility of the high increase envisaged in the program. In this connection, it is of the utmost importance to maintain a tight control of current expenditures, particularly personal costs.

The implementation of the tax reform seems rather slow, as underlined by the declining ratio of tax revenues to GDP. We welcome the proposed major strengthening of tax administration--a key priority of the program. However, I note that the increase in tax revenue/GDP ratio is significant and perhaps too optimistic. We fully agree with the staff that further revenue measures are needed.

As to the central bank deficit, we approve the measures taken by the authorities, as well as the planned transfer of the interest burden from the Central Bank to the central government, which will make the true fiscal deficit apparent. Fiscal developments can complicate the implementation of monetary policy. Although it is important that monetary conditions remain sufficiently tight to curb demand pressure and speculative capital outflow and to mobilize domestic savings, the interest rate level should remain compatible with the sustained growth of investment and a realistic exchange rate policy. This balance will certainly be difficult to achieve; I would appreciate further comments by the staff on this matter.

A flexible exchange rate policy should continue to prevail in order to ensure an adequate level of external competitiveness; this is crucial to support the projected export and import targets, as shown in Annex VIII of the staff paper, which demonstrates the sensitivity of the financing gap to the export volume.

Structural policies are of the utmost importance. The reform of public nonfinancial corporations is welcome, as it will help the fiscal adjustment process. The financial sector reform will help diminish high intermediation costs and support a better allocation of resources. On trade policy, we urge the authorities to speed up the liberalization of imports, because it is important not to induce investments in noncompetitive activities.

Foreign direct investment has a key role to play, not only in helping to finance the balance of payments, but also in stimulating the efficiency and competitiveness of the economy. I note that recent developments in this area are most welcome. Are the authorities contemplating taking specific measures to encourage further investment? Furthermore, is there any evidence that the debt conversion scheme had, in the past, some crowding out effect on traditional foreign investment inflows financed through additional foreign exchange inflows? Measures to reduce poverty are important parts of the program and should help the Government to obtain the support of the population, which will be crucial to the success of the program.

As to the authorities' request for possible access to contingency financing, I have no difficulties with the basic approach followed by the staff. The variables covered under the contingency element seem appropriate and provide a large coverage of merchandise exports and imports. The safeguards provided by the threshold of 15 percent of quota and the proportion of deviations to be financed seem appropriate. The introduction of a specific limitation on interest rate deviation seems warranted, as well as the fact that favorable deviations will be used to increase the amount of net international reserves. Finally, we welcome the fact that purchases under the contingency mechanism can take place only after the completion of a review by the Board.

It is clear that an agreement between the banks and the authorities is far from within reach. However, despite this concern, we are prepared to go along with the proposed decision. Indeed, given the good track record of the Philippines, as well as the quality of the program, we believe that the country deserves the Fund's support before adequate financing assurances have been secured. This approach will help to maintain the political consensus about the program; in addition, to approve the arrangement outright should facilitate the resumption of official credit flows from the Paris Club. The medium-term economic program should help to catalyze international financial support in the framework of the Multilateral Aid Initiative. We welcome the establishment of an ad hoc council to the Government, entrusted with the coordination of measures and mobilization of resources, aimed at creating a good environment for private investment.

As to the strengthened debt strategy, we hope that the Philippines will benefit from the Fund's new guidelines in this area, and that discussions with banks resume rapidly and come to positive results. We are well aware that considerable uncertainties with respect to the debt strategy remain; therefore, the Board will need to be closely informed of further developments in this area.

In conclusion, the Philippine authorities will have to demonstrate a strong determination during the whole period of the program, because the international financial community will certainly pay close attention to the adequacy of its implementation.

Mr. Grosche made the following statement:

I agree with the staff that the 1989-92 economic program is ambitious. Its targets seem to be attainable only if a number of additional measures will be undertaken. At this stage, the program does not convey the impression that a reasonable balance has been struck between the objectives of the program and the policies needed to attain these objectives. Most importantly, the pursuit of an ambitious growth target without strong measures in place to increase public savings might compromise too much the inflation objectives and balance of payments viability in the medium term.

I understand and endorse the Philippines' desire for strong economic growth. Considering the country's reconstruction and development needs, I can accept an increase in current account deficits during the program period. However, one would expect more than vague indications as to how the financing gaps will be filled. Outright approval of the program under such conditions does not seem to be fully consistent with the new guidelines on Fund involvement in the debt strategy. Indications on the commercial banks' willingness to provide contribution for the closing of the financing gap are scarce. It would not be wise for the Fund to go ahead with its financial support, in the hope that the banks will be favorably impressed and pledge their support at a later stage.

Accordingly, only an approval in principle seems to be in order; this should be sufficient for the Philippines' discussions with the Paris Club on a rescheduling arrangement. I wonder, however, whether the staff's and Mr. Evans's indications of a Multilateral Assistance Initiative and parallel lending from Japan's Export-Import Bank may provide additional assurances about a closing of the remaining gaps. It would be interesting to receive some additional information as regards the volume of expected capital inflows under the assistance program and the Multilateral Assistance Initiative, respectively. An approval in principle would provide the staff with the opportunity to inform the Board about these programs, and to analyze whether the envisaged debt reduction operations conform with the Fund's new guidelines.

The success of the program depends to a large degree on higher national savings. Most importantly, the program envisages an increase in public savings, stemming primarily from a better revenue performance at the level of the Central Government.

In 1988, however, despite strong economic activity, the tax revenue/GDP ratio actually declined. Given the long-standing problems with respect to tax collection and the untaxed activities in the parallel economy, it remains to be seen whether the target of 1989--although only slightly higher than the outcome in 1987--can be reached. I am encouraged by the staff's opening statement, reporting an increase in tax revenue close to the program target during the first four months of 1989. Nonetheless, uncertainties remain in the area of fiscal policy--an area where slippage occurred under the past stand-by arrangement. The consolidated public sector deficit actually widened from 2.7 percent of GNP in 1987 to about 3.4 percent in 1988.

The increase in the rate of inflation is most worrisome, and I question the desirability of aiming at an inflation rate of 5-6 percent. In this area, the program does not seem to be ambitious enough. Monetary policy needs to be fairly restrictive. I was not pleased to see that broad money growth continued to increase in the first quarter of 1989 at a rate above the target.

I note that during the past four years actual implementation of the public investment program has not been encouraging; there have been considerable shortfalls in implementation. Thus, it is not entirely clear whether the planned increase in productive investment will materialize. With respect to private investment, less reliance on bureaucratic procedures and more forceful action to dismantle quantitative trade restrictions would be helpful. The nonremoval of quantitative import protection for some industries entails the danger that scarce resources are being channeled into nonproductive investments. Complicated bureaucratic procedures also seem to hamper foreign direct investment, which in other Asian nations appears to make a more significant contribution to economic development than is the case in the Philippines.

The envisaged export growth appears to be on the high side. It will require the adoption of aggressive export policies, as well as easing of supply constraints, which in turn will require the pursuit of an adequately flexible exchange rate policy. In that respect, the authorities should follow the staff's advice to reverse the recent real effective appreciation of the peso vis-à-vis trading partners and regional competitors. The improvement in the terms of trade has been largely due to the oil price developments. I would be interested in learning whether the oil price assumptions underlying the program are still in line with the current price levels. As regards the agrarian reform program, financing should primarily be sought from sources within the Philippines.

I can approve the authorities' request for possible access to contingency financing. I agree with the staff that the contingency mechanism should be activated only when the net sum of deviations exceeds the equivalent of 15 percent of quota. I also agree on the need for parallel contingency financing from commercial banks, if the Fund would be requested to finance unanticipated deviations in net interest payments. The description of the proposed contingency mechanism under the program confirms my concern that the new instrument is not easy to operate and does not make the staff's workload lighter. The new facility implies that the Fund staff makes assumptions about such sensitive issues as interest rates, which is not welcome at all. We anticipated such difficulties when creating this mechanism; we are now interested in learning how the mechanism actually works.

Mr. McCormack made the following statement:

We commend the authorities for the adjustment measures taken in the past three years and the evident success that has been achieved in restoring strong economic growth without engendering excessive inflationary pressures. The measures contained in the 1989-92 program build on these past achievements and will help to ensure that the good performance will continue; in this regard, the focus of the program on structural adjustment measures is appropriate. In particular, privatization of public nonfinancial corporations, land reform, financial reform, and trade liberalization can be expected to help to increase economic efficiency and ensure a better allocation of scarce resources. In addition, the stance of fiscal and monetary policies appears broadly consistent with the objectives of the program.

However, we have some concern that the program is perhaps too ambitious with respect to growth and, therefore, may need to be strengthened over the program period. It may be difficult to maintain a real growth rate of 6.5 percent a year over the medium term in an environment of a declining rate of inflation--particularly given the strong increase in consumption factored into the program. While the rate of inflation may decline toward the end of the program period, reflecting the elimination of bottlenecks in line with planned infrastructure investment, inflationary pressures will likely remain significant and may even intensify in the interim. We would urge the authorities to remain vigilant and be prepared to take additional restraining measures, if the rate of inflation does not subside as anticipated in the program. In addition, to achieve growth rates of the order projected, a greater domestic savings effort is called for; this point is reinforced by the widening of the current account deficit in 1989/90. As the Philippines is seeking possible access to contingency financing under the compensatory and contingency financing facility, my authorities feel that more far-reaching efforts to narrow external imbalances would have been appropriate.

It will be essential that a competitive exchange rate be maintained. We note that the authorities have committed themselves to continue a flexible exchange rate policy and aim at ensuring an adequate level of international competitiveness. Nevertheless, it would appear that the Philippines lost some competitive ground vis-à-vis its major competitors in the Pacific region in 1988. Moreover, the staff indicates that this trend has not only continued in 1989, but the peso has also appreciated vis-à-vis the currencies of its major trading partners. Are the authorities considering any action on the exchange rate in the near future?

On the fiscal front, we note that the Philippines has a very low revenue to GNP ratio by international standards. Therefore, many efforts have yet to be taken to widen the tax base and improve tax administration. In this connection, we strongly support the revenue measures proposed and would urge that they be implemented as quickly as possible.

My authorities are concerned about the deficit of the Oil Price Stabilization Fund (OPSF). While there are plans to raise domestic oil prices to levels commensurate with those of the rest of the world, this will not be achieved until the end of 1989. This lack of progress will have cost implications and impact on the government deficit. The staff notes that any negative net balance incurred by OPSF will be offset by additional asset sales and privatization. However, it is not clear that such sales would not have occurred in any event under the privatization program that is already under way. The provision of this subsidy is not consistent with the goal of increasing domestic savings--particularly public savings--that are necessary to finance the ambitious infrastructure investment program. We also note that the OPSF is not considered part of the consolidated public sector; we wonder why this is so, and what the implications would be for the consolidated public sector deficit if it were included. This issue also raises a question about what other government operations are off balance sheet; in addition, we wonder what government operations would, if included in the official figures, enlarge the size of the consolidated public sector deficit.

A large number of the public investment programs were to be financed by increased concessional external assistance. Have the authorities considered an alternative strategy or alternative measures, in the event the external assistance would be delayed or not materialize at all? I note that such delays are not unusual. A number of reforms, including the agrarian reform, should be a top priority of the Government and need to be protected. In order to secure the financing of these priority projects, and therefore ensure timely implementation, every possible effort should be made to finance them from domestic sources; this argues for building a high rate of public savings into the program.

As to external financing, my authorities feel that although the Philippines' debt burden is clearly large and imposes a burden on the economy, the case has not been convincingly made that there is such a problem of debt overhang that debt reduction is absolutely necessary or appropriate. The economy, led by buoyant private investment, is operating close to capacity restraints--a development not consistent with a so-called classical debt overhang problem. Moreover, even in the absence of officially supported debt reduction operations, the debt service ratio and the amount of external debt as a proportion of GNP are projected to fall significantly over the medium term

The balance of the strategy should, perhaps, involve a stronger adjustment effort, combined with a financing package that consists of mainly debt restructuring and new money, and a relatively smaller reliance on debt reduction. Moreover, there remains considerable scope to reduce the debt through further debt/equity swap operations, although their possible inflationary effects need to be contained.

Nevertheless, we are willing to support the program despite the fact that the negotiations between the authorities and the commercial banks are in the early stages. The staff suggests that, given the low level of reserves, delay in approval of the program could entail serious cash flow problems. More important, Fund approval could catalyze other forms of financing. It is essential to retain the confidence of foreign and domestic investors; any delay in approving a Fund program could increase the overall sense of uncertainty, which could lead to capital flows in the wrong direction. Moreover, the international donor community is a significant source of financing that provides resources to finance some fundamental structural reforms. The Fund's approval of a program would facilitate the continuation of these transfers. Also, it seems that the Paris Club may be becoming more reluctant to reschedule countries' debt on the basis of approval in principle; if this is correct, it is another reason to approve the program outright.

We note that as of yet there are no concrete debt and debt servicing reduction proposals. Moreover, we do not think that the Philippines is necessarily an ideal candidate for debt reduction. If the banks are of a similar opinion, a request to them for debt reduction may actually complicate matters, and the Philippines may well have difficulties concluding a financing package. In sum, concrete requests for debt reduction in circumstances that are not entirely appropriate may prove to be expensive to the debtor, and will need to be considered carefully.

While wishing that the contingency element were a less complicated instrument, we can approve the request for possible access to contingency financing under the compensatory and contingency financing facility.

Mr. Kiriwat noted the Philippine authorities' perseverance in implementing economic reform since early 1986. The reforms, particularly in the areas of agriculture, public finances, and trade, had resulted in the removal of the main distortions in the economy. The turnaround of the economy in mid-1986, and the subsequent recovery since that time, had been impressive. He agreed with the authorities that much more remained to be done if the country's development goals of strong and sustainable economic growth, alleviation of poverty, and creation of employment opportunities for its rapidly expanding population were to be achieved. Therefore, he welcomed the Government's proposed three-year economic program, as it would strengthen and extend the policies implemented in the past three years. He could support the Government's request for an extended arrangement and possible access to contingency financing under the compensatory and contingency financing facility. He was in broad agreement with the staff appraisal.

He urged the authorities to implement the program with determination and perseverance, because only through appropriate macroeconomic policies and economic reforms could a debtor country overcome its debt problems, Mr. Kiriwat commented. As was the case in most developing countries, the Philippines continued to face the problems of a weak tax administration and poor tax compliance. Accordingly, the program had provided for the implementation of measures to strengthen tax administration and for a review to formulate additional administrative measures. Those measures, together with new revenue measures to be introduced in 1990, should be implemented by the authorities without delay; increased revenue would contribute importantly to higher public savings. Slippages in that area would constrain public investment, crowd out private investment, or put pressure on the balance of payments. The 25 percent increase in tax revenues in the first four months of 1989 was indeed encouraging.

Strong export growth would be vital to the achievement of strong economic growth for the Philippines, Mr. Kiriwat observed. Therefore, an appropriate exchange rate would be important in order to ensure a sufficient level of international competitiveness. The Philippines should follow their neighboring countries in using the exchange rate as a major policy variable in promoting growth and external viability. It was not surprising that the program required a sizable amount of external financing. Despite a large increase in foreign official assistance, a rescheduling of most principal payments to commercial banks, and an estimated

$2.1 billion of debt conversion, the external financing gap would amount to a total of $1.7 billion in 1989-90. He urged official creditors, as well as foreign commercial banks, to play an appropriate role in the financing of the economic program. Moreover, the authorities should undertake strong efforts to encourage the return of flight capital and to attract foreign direct investment.

He could approve the extended arrangement, despite the fact that an agreement between the authorities and the commercial banks had not yet been reached, Mr. Kiriwat said. In addition, the proposal to set aside for debt reduction 25 percent of each purchase under the arrangement should be favorably considered.

Mr. Obame made the following statement:

> I note the remarkable economic performance achieved by the authorities under successive adjustment programs supported by the Fund. I note also that economic growth has been sustained since 1986, the rate of inflation has remained under control, and substantial progress has been made in the implementation of structural reforms in key areas of the economy--particularly in the trade, financial, and public enterprise sectors. While commending the authorities for the efforts made, we encourage them to maintain the thrust of these efforts also in the medium term, so as to build on the success already achieved, thus keeping the economy on a sustainable growth path.
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> I am in broad agreement with the staff appraisal, and with the thrust and objectives of the authorities' medium-term economic program.
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> We support the authorities' focus on undertaking adjustment with growth. In this context, the objective of a growth rate of 6.5 percent a year seems appropriate, as it will restore real per capita income to the level prevailing before the economic crisis in 1983. However, this objective is ambitious and will require the authorities' strong and determined implementation of demand management policies, as well as supply-side measures. A large increase in investment is needed, and should be concentrated chiefly on productive activities. Furthermore, a large share of public investment should be directed at improving basic infrastructure facilities that can ensure economic growth. Much of the investment needed to support growth will be financed by increased domestic savings, from both the private and the public sectors; this is an important challenge, and I encourage the authorities to implement the stated measures designed to improve the public sector's resource mobilization. However, the availability of external financing will also be crucial in order to complement domestic resources, so as to achieve the growth target over the medium term.

The achievement of the program's medium-term objectives is predicated on the continuation of strong structural reform efforts by the authorities in four main areas, namely, the public enterprise sector, the trade system, the financial sector, and the agrarian system. The authorities' objective aimed at strengthening the economic and financial performance of public and nonfinancial corporations is appropriate. Therefore, the privatization process under way for most of the public enterprises, as well as the measures contemplated under the program, or already introduced for enhancing their efficiency, are steps in the right direction.

The substantial impediments to the smooth functioning of the financial sector need to be removed, particularly those related to the high costs of intermediation and the lack of long-term funds to finance the industry. I encourage the authorities to fully implement the reform program in this sector with the assistance of the World Bank. I note the authorities' intensified efforts to liberalize international trade during the program period. This liberalization process should be aimed at increasing the competitiveness of the industrial sector and stimulating growth of nontraditional exports, while encouraging greater foreign direct investment inflows, particularly in support of the economic growth objective.

I find appropriate the authorities' intention to undertake a comprehensive agrarian reform program over the next three years. This reform is timely and should not be delayed, as the distribution of land to the population is one way of alleviating poverty in the Philippines. It is indeed striking that about 60 percent of Philippine households, particularly in the rural sector, have incomes below the poverty level, which is equivalent to about $160 a month. In this connection, I note that the Government intends to develop a comprehensive strategy that will focus on improving the quality of life in the rural areas through increased education, rationalization of taxation, and a wide distribution of lands to peasants. These are encouraging steps, and I urge the authorities to implement this strategy and commit the necessary financial resources to this endeavor.

The economic program designed by the authorities is on a solid ground, and we can support it. We believe that the Fund's financial assistance is suitable in light of the structural problems facing the Philippine economy. However, to be successful, this program will need international financial support, particularly in the form of debt reduction and new money. In this context, I support the authorities' efforts to negotiate a debt reduction package with private creditors. I can also support the use of part of the Fund's resources for debt reduction. However, we will be expecting, at the time of the next review, more detailed information on the status of the negotiations with the commercial banks.

Finally, the Philippines' adjustment program is strong and the country needs a substantial amount of financial resources for debt repayment and economic growth. I agree with Mr. Evans that approval of the extended arrangement will provide the authorities with the necessary support to mobilize further resources. Accordingly, I support the proposed decisions.

Mr. Hubloue said that he wished to emphasize the strength of the Philippines' recent adjustment record and that he supported the thrust of the 1989-92 economic program. Three main elements would be important in order to extend the successes of the past two years into the 1990s, and to lay the foundation for a broadly based development in which all areas of the society could participate fully. First, to promote a durable and orderly expansion of private sector activity, a public investment program should be implemented; second, to ensure that the investment program and the social needs of the country could be accommodated without undue pressures on the budget, sufficient public savings should be mobilized; and third, to promote an efficient allocation of the envisaged increase in total imports, a rapid liberalization of the trade system would be needed.

He was reassured to learn from Mr. Evans that the authorities would give high priority to the implementation of the investment program, Mr. Hubloue remarked. He welcomed the introduction of indicative targets that would monitor the progress of the program. However, he was somewhat concerned about the authorities' planned policies in other areas. Despite the envisaged measures to improve the administration of tax collection, the level of public revenue would still be very low at the end of the program period. Such a low level of public savings was, indeed, undesirable, as it would complicate the Government's task to accommodate the large social and infrastructural needs of a rapidly developing nation, and because it might discourage the mobilization of foreign savings. Therefore, additional revenue enhancing measures would be welcome during the program period.

As to trade policy reform, he was concerned about the somewhat slow pace of import liberalization, Mr. Hubloue said. Not only was the persistence of quantitative import restrictions likely to affect the efficiency of future investment, but it was also likely to discourage the foreign creditors who could finance the country's current account deficits in the medium term. The need to assure creditors that all external financing would be put to optimal use was especially important in the case of the Philippines, as the current account deficit was expected to increase in the next couple of years.

The authorities should consider completion of the trade policy reform by the end of the program period instead of by the mid-1990s, Mr. Hubloue commented. Given that the medium-term economic program had been established for a period of three years, the authorities should aim at accelerating certain reform measures during the course of the program, as that would improve the market's perception that extended arrangements provided the framework for acceleration--not delay--of the implementation of key reform measures, thus reinforcing the credibility of the external financing facility.

He supported the Philippines' intention to set aside 25 percent of each purchase under the extended arrangement for debt reduction, and its intention to request an augmentation of the amount of the arrangement by up to 40 percent of quota, as well as its request for possible access to contingency financing under the compensatory and contingency financing facility, Mr. Hubloue said. In that context, it would be important to include parallel contingency financing from commercial banks in the new financing package. He fully supported the arguments presented by Mr. Enoch with respect to an approval in principle; he would await the staff's comments on those arguments before approving the program. At the current stage, an approval in principle seemed to be the preferable course of action, because it was not clear whether immediate disbursement by the Fund would be essential for the implementation of the program. In addition, an approval in principle was normally sufficient to pave the way for agreements with the Paris Club.

Mr. Vasudevan said that he supported the requests of the Philippines for an extended arrangement and possible access to contingency financing under the compensatory and contingency financing facility. He noted the excellent turnaround in output, the sharp rise in real domestic investment, and the slowdown in the public sector deficit. At the current stage, the Fund's support would give a clear signal to the international community, and would help to mobilize support from other official and commercial creditors.

The program targets seemed achievable, Mr. Vasudevan noted. The success of the program would be dependent on the measures undertaken by the authorities, but also on the external environment--in particular developments in the terms of trade, the openness of foreign markets, and inflows of capital, including direct foreign investment. The program targets were ambitious; for example, gross domestic investments were to increase from 18.2 percent in 1988 to about 25 percent in 1992. A very substantial increase in domestic savings within a short period of time would be required to achieve the target in gross domestic investment. He hoped that the feasibility of the underlying assumptions in that area and other important areas had been closely examined in order to avoid disappointment.

The 1989-92 program did not assume any debt reduction operations to take place aside from debt conversions in an amount equivalent to $2.1 billion, Mr. Vasudevan noted. The program also postulated high inflows of medium- and long-term loans and sizable reschedulings by the Paris Club and commercial banks. In the event that those expectations did not materialize, the exceptional financing requirements would increase substantially. The program contained a large number of performance criteria. It might have been more appropriate, however, to place greater reliance on only two or three crucial variables, which were directly related to the Government's policies and could be monitored with confidence; it was clear that monitoring of a large number of variables would overburden the Administration during the entire period of the arrangement. In that context, he noted that the contingency element would cover as many as six variables--accounting for more than one half of current account transactions--which could complicate the arrangement and make it extremely difficult to understand and manage.

Finally, he supported the proposed decisions, Mr. Vasudevan commented.

Mr. Almeida remarked that the extended arrangement contained several innovations, which were particularly welcome, as they improved some of the key characteristics of Fund programs. The targeted growth rate of 6.5 percent a year during the three-year program was a satisfactory rate even for a country with a high rate of population growth, such as the Philippines, and constituted a significant departure from the moderate growth rates contained in most previous Fund programs. He welcomed the emphasis placed on poverty alleviation in the program, not only through reducing the rate of inflation, but also through distributing more equitably the burden of taxation and reorienting public expenditures to the benefit of the poorer segments of the population. Performance criteria and reviews were scheduled every six months, which was an important departure from the staff's previous emphasis on quarterly performance criteria for programs heavily concentrated on structural elements, as in the case of extended arrangements.

The authorities had made tremendous efforts to create favorable conditions to increase private and public savings, and improve overall economic conditions to induce foreign direct investment and repatriation of capital, Mr. Almeida noted. Nevertheless, the program was in need of a substantial amount of external financing. For the program to succeed, the Board should approve the arrangement outright, as that would facilitate negotiations with the Paris Club and prevent the unraveling of the political consensus in the Philippines.

Exchange rate and interest rate policies should be market oriented, Mr. Almeida commented. There was no reason for changing the exchange rate policy, particularly when the value of exports had increased by 18 percent in 1987 and 24 percent in 1988, and since similar growth rates were estimated for the duration of the program. The closing of the financing gap of US$1.7 billion in 1989/90 was particularly important for the success of the program, as it was sensitive to changes in exogenous variables. The authorities were making efforts to reduce domestic absorption through a vigorous increase in tax revenues. The targeted increase of tax revenue of 3 percentage points of GDP during the program was impressive.

Finally, he, like Mr. Warner, welcomed the set-aside of 25 percent of the access available under the arrangement for debt reduction, Mr. Almeida said. He supported the proposed decisions.

Mr. Zhang remarked that the Philippine economy had continued to grow rapidly following the significant turnaround in 1987. According to the staff, economic developments in recent months had also been in line with performance criteria. Undoubtedly, it was the authorities' adjustment efforts that had brought about those satisfactory achievements. He was very impressed by the authorities' determination to continue their adjustment efforts, as indicated by the objectives of the Government's medium-term economic program for 1989-92.

The program was growth oriented, which was desirable for a heavily indebted country like the Philippines, Mr. Zhang said. However, the success of the program was constrained by the availability of financial resources. Most of the growth in domestic savings would come from an improvement in public savings. Therefore, fiscal policy would play a key role, as it should facilitate a reduction in the public sector deficit, while allowing for greater public investment in support of necessary infrastructural development. A gradual reduction in the fiscal deficit seemed realistic; however, a financing gap in the public sector would remain unless new revenue measures were taken.

Higher than targeted increases in private savings might be possible, or, at the least, the level of private savings should not decrease, Mr. Zhang noted. However, to achieve that target, sacrifices would be required with respect to the level of private consumption, which would usually induce unfavorable social consequences. He noted also that reliance on foreign savings would remain strong in the presence of constraints on domestic savings and a heavy debt service burden.

The success of the comprehensive program would largely depend on the authorities' achievements in the alleviation of financial constraints, Mr. Zhang said. Both new money and debt reduction would be critical in order for the country to gain from its adjustment efforts. Since the authorities had already made substantial adjustment efforts and were fully committed to continue those efforts, he believed that a certain degree of debt reduction could provide incentives for even greater efforts. Therefore, the Philippines appeared to be an appropriate case for debt reduction operations. The authorities placed great hope on the Fund's support of their adjustment efforts. The role of the Fund's financial support had two roles to play: first, to provide incentives to the country to continue its adjustment efforts; and, second, to catalyze additional financing from the international financial community in support of the Philippines' efforts. In conclusion, he supported the proposed decisions.

Mr. Filosa made the following statement:

After two years of substantial improvements in the domestic economic situation, the Philippines is planning a major adjustment program, aimed at marking the second phase of its continuous stabilization effort. The objectives of the program are ambitious, but appear to be within reach. I believe that the success of the program will be determined by the achievements in the area of fiscal adjustment. However, it is important to note that fiscal adjustment will affect the possibility of achieving the targets of structural policies, as virtually all the envisaged structural measures have a strong fiscal content, either direct or indirect.

Accordingly, slippages in the fiscal area of the program should be avoided, not only because of their macroeconomic consequences, but also because the occurrence of fiscal slippages would imply that the structural objectives of the program would not be met either. In this connection, I agree with the staff that the strengthening of tax administration, as well as new tax measures, are of paramount importance. I note that the ratio of tax revenue to GNP continues to be small despite the increased level of taxation expected over the program period. Without such measures it could prove to be impossible to implement the large public investment program envisaged under the program period, thus adversely affecting the supply side of the economy. Furthermore, I believe that additional fiscal measures should be put in place before the actual transfer from the Central Bank to the Central Government of some liabilities, because such a transfer will cause a sizable deterioration in the consolidated public sector deficit.

Structural reforms constitute important parts of the program. In addition to the agrarian reform, whose social importance is apparent, two other reforms will have a crucial importance: first, the financial sector reform; and, second, the trade policy reform. In fact, the legacies of unhealthy political interference in these areas are resulting in heavy losses in terms of both efficiency and equity of the economic system.

The proposed reforms in the financial sector will help to reduce the intermediation costs and the allocation efficiency of the whole system, as well as improve the climate for increasing remittances from Filipinos working abroad and the return of flight capital. However, I am less convinced that the maintenance of restrictions on imports is a viable long-term solution to promote industrial development. Therefore, I agree with the staff that the granting of open-ended protection should be avoided and the shift to tariff-based protection should be accelerated.

With respect to the external financing of the program, the existence of financing gaps is somewhat disturbing. However, the increase in net international reserves envisaged for 1989-92 is larger than the residual financing gaps. Therefore, small deficiencies in external financing could be accommodated by sacrificing partially the objective of increasing gross official reserves. According to the staff, a new commercial bank package and Paris Club rescheduling will be able to close the financing gaps in 1989/90. It is disappointing to notice that the Philippines' arrears to the Paris Club have accumulated since September 1988. Therefore, I urge the authorities to clear those arrears, as they might complicate the forthcoming negotiations. The persistence of large financing gaps from 1991 and beyond suggests that the authorities should actively seek debt reduction. In addition, the Fund's financial support should be accompanied by similar efforts from multilateral institutions and official sources. I encourage the authorities to explore the possibilities offered by debt reduction schemes in their negotiations with the commercial banks. In particular, it seems necessary to include in the program strong measures aimed at attracting foreign capital.

In his statement, Mr. Enoch illustrated a number of features of the Philippines' program that do not correspond with the guidelines on Fund involvement in the strengthened debt strategy. Semiannual performance criteria are not in line with the Fund's performance criteria, and arrears to official creditors should not be permitted. Furthermore, the negotiations between the authorities and the commercial banks are in a very early stage; it is not likely that an agreement will be reached in a reasonable period of time. Accordingly, an approval in principle seems to be appropriate in this case. In addition, an early disbursement of Fund resources do not appear essential to ensure the financial viability of the program.

The Chairman remarked that he was somewhat surprised by Mr. Filosa's remarks. It was his understanding that Mr. Filosa considered that the objectives and the structure of the Philippines' extended arrangement were appropriate, yet he was apparently not willing to approve the arrangement because it might not be fully consistent with the Fund's new guidelines on the strengthened debt strategy. However, approval in principle could send the wrong signal to the authorities, the international financial community, and the commercial banks, as it might appear that the Fund was not convinced about the strength of the authorities' program. The authorities had made tremendous efforts to put together the program, and they deserved the Fund's full support.

Mr. Yamazaki said that he stood fully behind the remarks by the Chairman. He was not convinced that the extended arrangement was not fully consistent with the new guidelines on Fund involvement in the debt strategy. Although noting that the Philippines was the second application of the strengthened debt strategy, the Fund's treatment of the country should be consistent with the previous treatment of other member countries in similar situations. Furthermore, an approval in principle might increase the overall sense of uncertainty, which could jeopardize the implementation of needed reforms.

Mr. Filosa agreed with the Chairman that the structure of the extended arrangement seemed appropriate. However, that was not sufficient, given that the arrangement also had to be consistent with the new guidelines on Fund involvement in the debt strategy. One condition for Fund disbursement while a financing gap remained was that it would be expected that a financing package consistent with external viability would be agreed within a reasonable period of time; however, there was no clear indication of the shape of the financing package in the case of the Philippines. It was important to give a clear signal to the financial community of the Fund's commitment to its new guidelines on the strengthened debt strategy.

The Chairman said that he could understand that some Directors were concerned about adopting an arrangement that was inconsistent with the Fund's new guidelines. However, as in the case of Costa Rica (EBM/89/62, 5/23/89), Directors could approve outright the Philippines' extended arrangement, while, at the same time, being assured that an augmentation could only take place in the event that financing arrangements were concluded with commercial bank creditors for debt service reduction, and upon determination by the Fund that such an arrangement was consistent with the Fund's new guidelines.

Mr. Enoch remarked that approval in principle of a program was as strong an endorsement as an outright approval. However, an approval in principle was more appropriate in the particular case of the Philippines, owing to the lack of a clear indication of the shape of the financing package. Once the financing was in place, there would be an outright disbursement without any further review, which demonstrated that Directors would not have suggested an approval in principle unless they believed that the objectives of the extended arrangement were satisfactory. Although he recognized that the international financial community would prefer the Fund's outright approval of the program, he was convinced that it would realize that, in the case of an approval in principle, there would be an outright disbursement as soon as the financing package was in place. As he had emphasized earlier, once guidelines had been agreed, they must be adhered to firmly; it was important to convey that point to the international financial community as well. According to the summing up on the guidelines on Fund involvement in the debt strategy at EBM/89/61, the practice of seeking a critical mass, as well as the possibility of approving an arrangement in principle, would remain valid. Therefore, an approval in principle would be fully consistent with the Fund's new guidelines. In contrast to the case of the Philippines, there had been significant progress in the negotiations between the Costa Rican authorities and the commercial banks; therefore, an outright approval of the stand-by arrangement had seemed appropriate in that case.

The Chairman said that he disagreed with Mr. Enoch's comment that an approval in principle was as strong an endorsement as an outright approval of a program. In addition, Directors would have an opportunity to return to the question on financing assurances before the Philippines made the second drawing under the extended arrangement. Accordingly, there was no risk that the Fund's guidelines would not be adhered to firmly.

Mr. Nimatallah said that an approval in principle would not convey the same message to the international financial community as an outright approval. More importantly, the Fund's outright approval could help to catalyze other forms of financing. In addition, the structure of the extended arrangement was appropriate; therefore the Fund should give the authorities its full support. Besides, the Fund could suspend any further drawings under the extended arrangement, if the financing package were not yet in place.

Mr. Warner said that he supported fully the remarks made by the Chairman and Mr. Nimatallah.

Mr. Grosche said that he stood fully behind Mr. Enoch's comments. He had recommended an approval in principle, given that the Fund's new guidelines implied that such an approval would be appropriate if there were no clear indications of the shape of the financing package; evidently, that was the case of the Philippines.

Mr. Hogeweg said that the Philippines might, indeed, be a good candidate for a debt reduction program in the context of a Fund program. Certainly, there was a clear willingness to take adjustment measures on the part of the authorities, and they had shown adequate commitment under previous programs. The large financing gap was evidently related to the large stock of debt that the authorities had to service; the gap would remain throughout the program period and beyond.

The program was ambitious, especially with respect to the growth target, Mr. Hogeweg commented. He noted that the improvement in the current account was only very gradual. He regretted the projected slow improvement in government finances. In addition, a lot of adjustment measures in the staff papers had been referred to as "measures to be identified;" that, of course, was not a very firm way of describing measures. Since many of the measures to improve government finances had not yet been identified, in the meantime, there would also be additional expenditures, which had not been identified either. Nevertheless, he noted that although the program was ambitious, it was courageous on the part of the authorities.

There might be a risk of the financing gap being larger than projected, for example, in the event that the envisaged repatriation of flight capital would not materialize, or if export performance would not meet the projected level, Mr. Hogeweg remarked. In that connection, the contingency element would only partly cover unanticipated deviations from the program projections. Parallel contingency financing from commercial banks would be highly desirable in order to prevent--in the case of rising interest rates--use of contingency financing by the Fund for payments to the commercial banks.

The Fund had endorsed the new guidelines on Fund involvement in the debt strategy at the previous meeting and he believed that it would be inappropriate to deviate from those guidelines in the first applications of the debt strategy, Mr. Hogeweg noted. The guidelines not only related to the strengthened debt strategy, but also played a very important role with respect to the issue of financing assurances. If there had been no debt initiative by the U.S. Treasury, the Fund would still have been faced with the same program, the large financing gap, and the problems with respect to financing assurances. He, like Mr. Enoch, believed that an approval in principle was appropriate as the Board should ensure that the program coincided with the Fund's new guidelines. The importance of consistency did not only apply to the guidelines on additional access, but also, for example, to set-aside amounts, disbursement of resources, and monitoring of programs. Finally, he noted that there were no medium-term scenarios in the staff paper, depicting the way toward external payments viability including the envisaged debt reduction operations. In that context, he agreed with the remarks made by Mr. Enoch, Mr. Filosa, Mr. Fogelholm, and Mr. Grosche. To approve the program in principle seemed appropriate, while waiting for the staff to assess how the new guidelines would fit into the program of the Philippines.

Mr. Gorjestani said that he supported the proposed decision on the extended arrangement.

The staff representative from the Asian Department said that the Philippines' request for an extended arrangement deserved the support of the Fund. An approval in principle would imply that the program had started out on the wrong footing. Withholding the Fund's support would delay the envisaged response from other official sources and could entail cash flow problems. Gross official reserves had declined to about $1.6 billion at the end of April, equivalent to 1.5 months of imports, which was a low level by historical standards in the Philippines.

The authorities had made substantial efforts to come to an agreement with the commercial banks, the staff representative noted. However, the discussions with commercial banks on a new financing arrangement had so far only been exploratory, in part owing to the new element of the debt strategy. The authorities had indicated that they had been waiting for the World Bank and the Fund to finalize the modalities of their support for debt reduction operations before continuing negotiations on those issues with the advisory committee of the commercial banks. Those negotiations were expected to resume within the next few weeks. It was expected that the debt service obligations that had fallen due to the Paris Club creditors in September 1988, and that would fall due during the period of the extended arrangement, would be rescheduled on May 25, 1989. During the period of discussions between the authorities and the commercial bank creditors, the staff would closely monitor program developments and progress in the negotiations; any significant developments would be brought to the Executive Board's attention. In addition, there would be a review of financing assurances before the Philippines made the second drawing of the extended arrangement.

The Philippines had expressed strong interest in debt and debt service reduction operations, the staff representative said. Early Fund support of the authorities' intention to request an augmentation would likely help to facilitate the negotiations between the authorities and the commercial banks. If the authorities and the banks agreed on voluntary, market-based debt operations, the country would be more likely to achieve its objectives of investment growth and a return to more normal financial market access.

Since 1984, about 8 percent of total bank debt had been extinguished through debt conversions, the staff representative noted. The authorities were in the process of revising and improving the debt conversion scheme. The system of investment incentives in place was judged to be comparable with those of other countries in the region and should stimulate private capital inflows, including the reflow of flight capital. In that context, he noted that there was no evidence of capital flight at the moment. A large increase in capital repatriation was not to be expected, as much of the capital was held abroad for political, rather than economic reasons. In 1988, direct foreign investment had tripled to almost $1 billion. In the coming years, the share of direct investment financed through debt conversions was assumed to decline, while the share of traditional foreign investment financed through additional foreign exchange inflows was assumed to increase. However, although investment incentives were broadly appropriate, the unstable political situation had had a somewhat negative impact on foreign direct investment. In order to increase foreign investment further, the authorities were expecting to be able to obtain from Congress a ratification of the Multilateral Investment Guarantee Agency within a reasonable period of time.

Public investment as a share of GNP was targeted to rise from an estimated 3.4 percent in 1988 to 5.8 percent by 1992, the staff representative commented. The level of public investment had fallen short of target in the period 1986-88, owing to tight administrative control, procedural bottlenecks, changes in key management personnel, and a reappraisal of projects by the new Government.

To strengthen the tax system, a package of specific administrative measures had already been implemented, and was projected to yield revenue amounting to 0.6 percent of GNP in 1989, the staff representative remarked. However, the full effect of the administrative measures would not be felt until 1990, as those measures were being implemented step by step; revenue was projected to rise to 0.8 percent of GNP in 1990. The introduction of a value-added tax in 1988 had encountered some initial problems. Therefore, a key element in achieving the tax revenue target in the short run would be to strengthen tax administration; revenues would rise as leakages were steadily reduced.

As to exchange rate policy, the authorities aimed at ensuring an adequate level of international competitiveness, so as to support the projected export and import targets, the staff representative said. They were committed to continuing with the flexible exchange rate policy established in 1984.

Finally, a consultative group meeting was scheduled sometime in early July to discuss the Multilateral Assistance Initiative, the staff representative from the Asian Department noted.

The staff representative from the World Bank said that there had been a major restructuring of the investment program in the Philippines in recent years. A number of measures had already been taken to speed up implementation of investment projects. To track the progress of those measures, a monitoring system had been established in collaboration with the World Bank, which would report the size and composition of capital expenditures on a quarterly basis. In the first quarter of 1989, there had been an increase in domestic investment by about 20-25 percent of GDP in real terms. As to the National Power Corporation, there had been a slowdown in investment, largely because projected loans from Japan had not been disbursed, owing to the Philippines' arrears to Paris Club creditors.

A consultative group, chaired by the World Bank, would meet in early July to discuss the Multilateral Assistance Initiative, the staff representative from the World Bank said. The World Bank was preparing a policy framework paper that was very detailed in areas such as agriculture and telecommunication. The program would be fully consistent with the Fund's extended arrangement.

Mr. Evans commented that the Philippines' program was, indeed ambitious, especially with respect to the growth target. The program targets were nevertheless achievable. The program combined structural adjustment with prudent macroeconomic policy measures. To achieve significant structural adjustment, the growth target had to be set at an ambitious level, because structural change was not possible in a nongrowth environment.

As to the question of approving the program outright or in principle, there seemed to be an overwhelming majority in the Board for an outright approval, Mr. Evans said. He strongly disagreed with Mr. Enoch's comment that there was no substantial difference between an approval in principle and an outright approval. He recognized that, according to the new guidelines on Fund involvement in the strengthened debt strategy, "the possibility of approving an arrangement in principle would remain valid"; however, that wording was highly suggestive. An outright approval of the program could catalyze other forms of financing, facilitate the negotiations with the banks, and strengthen the authorities' ability to implement the program. The authorities had expressed interest in debt service reduction operations, but would not make such a request until financing arrangements had been concluded with commercial bank creditors for debt service reduction. In addition, the Fund would have to determine whether such arrangements were consistent with its new guidelines.

Mr. Yamazaki remarked that since the program had been designed before the approval of the new guidelines on Fund involvement in the debt strategy, there had not been much time to ensure that the program was fully consistent with the new guidelines. However, a review of the program could be scheduled before the second drawing under the extended arrangement. It was important to approve the program outright, given that similar cases would soon be presented to the Board--cases with possibly even larger financing gaps. The Fund had to ensure that it gave the same treatment to all members in similar situations.

Mr. Hubloue said that the staff's, the Chairman's, and Mr. Evans's comments had convinced him that an outright approval would convey the right message to the authorities and the international financial community. Therefore, he supported an outright approval of the program.

Mr. Enoch, Mr. Grosche, Mr. Hogeweg, and Mr. Filosa said that, as there was not a majority for approval in principle, they would abstain from voting.

Mr. Fogelholm commented that his constituency would abstain from voting. However, one country in his constituency believed that although the program had certain weaknesses, it could support the Philippines' request for the use of Fund resources under the extended financing facility, including the scheme for debt reduction, and possible access to contingency financing under the compensatory and contingency financing facility. The country had emphasized that the Philippines had completed its previous Fund-supported program in a satisfactory manner, but that the Philippines' debt service burden remained high. The Fund's support could have a catalytic effect, which was important in order to promote the level of investment growth that was necessary to achieve a sustainable balance of payments position.

The Executive Board then took the following decision:

Extended Arrangement and External Contingency Financing Under Compensatory and Contingency Financing Facility

1. The Philippines has requested

(a) an extended arrangement for a period of three years from May 23, 1989 in an amount equivalent to SDR 660.6 million; and

(b) a decision that, should adverse external contingencies occur during the period of the extended arrangement, the Fund will provide, in association with the extended arrangement, external contingency financing under the compensatory and contingency financing facility (Decision No. 8955-(88/126), adopted August 23, 1988), up to a maximum amount equivalent to SDR 286.3 million.

2. (a) The Fund approves the extended arrangement set forth in EBS/89/59, Supplement 3.

(b) The Fund decides that

(i) should adverse external contingencies occur during the period of the extended arrangement, the Fund will provide, in association with the extended arrangement, external contingency financing under Decision No. 8955-(88/126), up to a maximum amount equivalent to SDR 286.3 million, in accordance with the factors set out in the Annex to this decision, and

(ii) should favorable external contingencies occur during the period of the extended arrangement, adjustments of up to SDR 286.3 million will be made by the Fund at that time under paragraph 27 of Decision No. 8955-(88/126), in accordance with the factors set out in the same Annex.

3. Should the Philippines notify the Fund after the date of this decision that it no longer wishes to avail itself of the benefit under paragraph 2(b)(i) above in association with the extended arrangement, the provisions of paragraph 27 of Decision No. 8955-(88/126) shall continue to apply for the remainder of the baseline period during which such notice was received by the Fund.

4. The Fund notes the intention of the authorities of the Philippines to request augmentation of the amount of the extended arrangement as set forth in paragraph 1 above, by an amount up to the equivalent of forty (40) percent of the Philippines' quota of SDR 440.4 million. The Fund will be prepared to consider an augmentation in the event that the arrangements for the financing of the Philippines' program provide for appropriate debt service reduction and upon determination by the Fund that such arrangements are consistent with the guidelines on Fund involvement in the debt strategy, approved at EBM/89/61 (5/23/89).

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

Decision No. 9156-(89/62), adopted
May 23, 1989

Exchange System

The Fund approves the retention by the Philippines of the exchange restriction evidenced by arrears to Paris Club creditors and the exchange restriction that will remain pending the execution of the rescheduling or refinancing agreements with each Paris Club creditor until the completion of the first review contemplated in paragraph 4(c) of the extended arrangement or December 31, 1989, whichever is earlier.

Decision No. 9157-(89/62), adopted
May 23, 1989

APPROVED: December 26, 1989

CHRISTIAN BRACHET
Acting Secretary

External Contingency Financing

I. For duration of extended arrangement

1. External contingencies to be taken into account:

(i) the effects of changes in export prices of coconut oil;

(ii) the effects of changes in export prices of copper concentrate and copper metal;

(iii) the effects of changes in non-oil import volume of major trading partners on the export volume of nontraditional manufactured products net of imported inputs;

(iv) the effects of changes in prices of petroleum and petroleum products;

(v) the effects of changes in partner countries' non-oil export prices on prices of non-oil imports, net of imported inputs for manufactured exports and imports for foreign-financed projects;

(vi) the effects of changes in interest payments on net external debt at variable interest rates, provided that changes resulting from increases in interest rates over 2 percentage points will not be taken into account.

2. Maximum amount of external contingency financing in case of unfavorable external contingent deviations:

SDR 286.3 million (Fund financing with respect to deviations in net interest costs is limited to SDR 66.06 million).

3. Minimum threshold to be exceeded by net sum of deviations before financing is provided:

SDR 66.06 million (15 percent of present quota).

4. Proportion of financing of net sum of deviations:

In first semester in which threshold is exceeded: 50 percent of net sum of deviations; and

In next semester: 30 percent of the part of the net sum of deviations that does not exceed the net sum of deviations in the previous semester and 50 percent of the remainder.

5. Maximum amount of adjustment in case of favorable external contingent deviations: SDR 286.3 million.

II. For duration of initial baseline period

1. Duration of baseline period: April 1, 1989-March 31, 1990.

2. Maximum amount of external contingency financing: SDR 110.1 million.

3. Maximum amount of adjustment in case of favorable external deviations: SDR 110.1 million.