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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/62

10:00 a.m., April 20, 1987

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
A. Abdallah	E. T. El Kogali
Dai Q.	Yang W., Temporary
C. H. Dallara	D. C. Templeman, Temporary
	H. G. Schneider
	E. Feldman
	R. Morales, Temporary
	T. Alhaimus
	B. Goos
J. E. Ismael	
	J. Hospedales,
	J. R. N. Almeida, Temporary
	M. Foot
	I. Puro, Temporary
	D. McCormack
	C. V. Santos
	I. A. Al-Assaf
G. Ortiz	V. J. Fernandez, Temporary
	S. de Forges
G. A. Posthumus	
C. R. Rye	
G. Salehkhou	O. Kabbaj
	L. E. N. Fernando
K. Yamazaki	
S. Zecchini	

J. W. Lang, Jr., Acting Secretary
R. S. Franklin, Assistant

Also Present
IBRD: N. L. Hicks, East Asia and Pacific Regional Office;
J. Harrison, Europe, Middle East, and North African Regional Office.
Asian Department: H. Neiss, Deputy Director; C. Cha, D. J. Goldsbrough,
E. Gurgen, A. Singh, W. A. Tilakaratna. European Department:
L. A. Whittome, Counsellor and Director; K. Bartholdy, A. G. G. Bennett,
L. J. Lipschitz, S. Mitra, H. O. Schmitt. Exchange and Trade Relations
Department: J. T. Boorman, E. H. Brau, P. M. Keller, D. A. Lipton,
E. J. Zervoudakis. Fiscal Affairs Department: T. Catsambas.
IMF Institute: M. Cvikl, Participant. Legal Department: P. L. Francotte,
A. O. Liuksila, J. M. Ogoola. Research Department: T. A. Wolf. Advisors
to Executive Directors: L. P. Ebrill, K. Murakami, I. Sliper. Assistants
to Executive Directors: F. E. R. Alfiler, R. Comotto, E. C. Demaestri,
W. N. Engert, S. K. Fayyad, J. M. Jones, S. King, K.-H. Kleine,
M. Lundsager, R. Manfredi Selvaggi, D. Saha, G. Seyler, H. van der Burg.

1. PHILIPPINES - REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the first review under the stand-by arrangement for the Philippines and a request for modification (EBS/87/65, 3/23/87; and Sup. 1, 4/13/87) together with a memorandum of understanding on economic policy relating to the review (EBS/87/59, 3/12/87).

The staff representative from the Asian Department observed that in recent weeks, external payments arrears had arisen as some private sector debtors in the Philippines had experienced difficulties in making foreign exchange payments to Paris Club creditors for maturing obligations. The situation had resulted from a circular issued by the central bank on April 6 that required private sector debtors to negotiate with Paris Club creditors in order to restructure the debt on terms comparable to those offered by the Paris Club for public or publicly guaranteed debt. The Philippine authorities had since confirmed that the circular had been based on a misunderstanding of a Paris Club Minute which excluded private sector debt from Paris Club rescheduling. The authorities had assured the staff that the matter was being resolved and that private sector debt would be serviced as envisaged in the Paris Club Minute. In the circumstances, the staff was proposing to amend paragraph 4 of the draft decision and to extend the waiver for the introduction of an exchange restriction. An amended version of the decision would be circulated to Directors.

Mr. Rye made the following statement:

> On behalf of my Philippine authorities, I should like to thank the staff for its well balanced, comprehensive, and fair first review of the stand-by arrangement for the Philippines. My authorities are in agreement with the staff appraisal and remain firmly committed to implementing the remaining components of the Fund program and the agreed structural adjustment measures. This will enable economic recovery to be attained and consolidated, and the gains made against inflation and external imbalance to be preserved.
>
> My Philippine authorities are eager to showcase the Philippines as a prime example of the "adjustment with growth" model espoused by the Fund, in line with the Baker plan. I am sure that the Fund staff would be in accord with this view.
>
> The latest information provided by my authorities confirms the continued absence of inflationary pressures. Over the year to February 1987, the CPI registered a decline of 0.6 percent. Meanwhile, recent indications point to the maintenance, and even acceleration, of the economic growth observed in the second half of 1986, following two years of rapid decline. For example, the index of manufacturing production was up 16 percent over the year to January, and that for electrical consumption was up by 5.9 percent. The return of confidence in the economy is indicated by the

rise over the past year by more than a factor of ten in the volume and value of transactions on the stock exchange. Meanwhile, the external account has continued to strengthen; international reserves are now equivalent to over five months of the imports projected for 1987.

On top of this, preliminary figures for the quantitative performance criteria for the first quarter of the year under the stand-by arrangement indicate adherence to the Fund program. The level of base money as of end-March was substantially below the ceiling, in contrast to the overshooting of the December limit. The level of net international reserves remains comfortably above the floor specified under the program.

As the staff has noted, substantial progress has also been made in the various structural reforms begun earlier, notwithstanding delays in the implementation of some of their components. The staff review provides a thorough assessment of this progress, and there is little that I can add. My authorities have enumerated four broad principles of their reform strategy: (1) a substantial reduction in government involvement in the economy; (2) re-establishment of a competitive market environment; (3) a renewed emphasis on rural development and on an equitable sharing of the benefits of a sustained recovery; and (4) development of a more competitive and outward looking economy through trade liberalization and flexible exchange rate policies.

I wish to highlight some of the early achievements of the reform strategy which my authorities see as central to their long-term objective of sustained growth. I mention these also because, in previous Board discussions of the Philippines, some Directors have expressed concerns about the slow pace of reform (which I have of course conveyed to my authorities).

Reform of nonfinancial public corporations reform

The studies embarked upon in 1986 resulted in the proposal to privatize 125 of the 291 public corporations and to retain in their present form only 37, the remainder being either abolished, consolidated, or converted to regular government status. It is intended that presidential approval of this public sector rationalization package, together with precise modalities of the privatization process, will be in place by June 30, 1987. My authorities have been able to secure from the World Bank an economic recovery loan package in support of this privatization scheme. In the power sector a new tariff structure will be introduced, also by June 30, 1987, guided by the principle of long-run marginal cost; this will enhance internal resources available for capital investment projects.

Government financial institutions (GFIs)

The World Bank loan mentioned above also includes a component to finance the reforms in the GFIs. Among other things, these reforms will effectively

-- reduce the share of government banks in the banking system by reducing the size and operational scope of these GFIs;

-- remove government guarantees on liabilities of these banks, and government equity infusion to cover losses; and

-- subject government banks to annual audit by external private auditors.

It will be recalled that the GFIs have been a major avenue of abuse in the past and that their losses have contributed greatly to the budgetary imbalance. The nonperforming assets of these GFIs have been transferred to the newly established Asset Privatization Trust. It is intended that, within five years, the Trust will dispose of these assets, even at substantial discounts.

Agricultural reform

The dismantling of agricultural trading monopolies, particularly in the sugar and coconut sectors, has already resulted in the strengthening of farmgate prices and significant diversification of sources of commodities for export. These improvements have a direct impact in the rural areas, where the incidence of poverty is high.

I might also mention that the administrative bottlenecks that have impeded both the speedy implementation of the tax reform package and the disbursement of fiscal expenditures to stimulate activity in the rural areas, have been resolved. These administrative bottlenecks resulted mainly from the absence of any transitional arrangements when the new Government was swept into office.

The value-added tax system is expected to be in place by January 1988. At the same time, the gross receipts tax on banking institutions will be abolished, reducing the cost of financial intermediation and paving the way for lower lending rates.

Trade liberalization, an essential aspect of my authorities' outward oriented strategy, is progressing as expected. Completion of the agreed schedule of liberalization is targeted for April 1988.

The incomes policy component of the economic recovery strategy involves the correction of a substantial imbalance between the compensation of national government employees and their private sector counterparts. The decade-long decline in the real wage of national government employees (particularly teachers and field soldiers) has resulted in a deterioration of the quality of public service in the areas of education and national security and has rendered it difficult for the Government to attract qualified people to the civil service.

These disparities in compensation are illustrated by the fact that even after the proposed adjustment, which will effectively raise personnel service payments by about 25 percent over 1986, half the employees of the national Government will remain below both private sector wage levels and a defined poverty line. Against this background, my authorities do not expect the increase to result in a general upward shift in wage rates.

Meanwhile, employment in the public sector will continue to be limited to its 1986 level, except in areas of chronic shortage.

Finally, I had hoped to highlight the successful debt rescheduling of a substantial portion of Philippine obligations as an important breakthrough in the expression of support by the international financial community for the "adjustment with growth" efforts of my Philippine authorities. This preliminary agreement was reached last month after long and arduous negotiations which began in October. Unfortunately, recent events have indicated that, as the Philippine Secretary of Finance has put it, the negotiations had proceeded under a "false premise" that "the Mexican rate of 13/16 was an aberration that would never be repeated, and proceeding on that premise, we agreed to 7/8." On this basis the Secretary of Finance is contemplating reopening the talks with the commercial banks to seek terms equally favorable with those gained by Argentina. Of course, it remains to be seen what the outcome of all this may be, but any such move would not appear to carry any adverse implications for progress under the stand-by arrangement.

All in all, the new Government of the Philippines is making outstanding progress with its wide-ranging program of reform and development which, in my opinion, deserves the full support of the Board.

Extending his remarks, Mr. Rye observed that, on the basis of information he had received over the weekend, he could inform Directors that the Philippine authorities had been in touch with the Advisory Group seeking additional information about the agreement recently reached between the commercial banks and Argentina. His authorities had indicated that, depending on the nature of that information, they might request a renegotiation of their own preliminary agreement with the banks. It should be noted that, contrary to some press reports on the matter, the Philippine authorties would not be taking unilateral action to change the terms of the agreement.

Mr. Hospedales made the following statement:

Given the deep-seated structural character of the economic problems in the Philippines, we were in no doubt when we endorsed the stand-by arrangement in October 1986 that evolution of the Philippine economy on a path of sustained growth would be difficult, arduous and--very importantly--of a long-term nature, particularly in the light of the downside risk inherent in reliance on a rapid private sector response to the envisaged fiscal consolidation process, notwithstanding the initial limited fiscal stimulus.

The restoration of public investment as well as the necessary pickup in business confidence was slower than expected. Nevertheless, the GNP growth of 2 percent recorded in the second half of 1986, against a projected 6 percent, is--under the conditions prevailing in the Philippines--encouraging, as was the rapid deceleration of the inflation rate to zero. Clearly, the process of igniting economic growth in the Philippines in the context of the deep internal and external imbalances, foreign exchange constraints, long-standing structural weaknesses and prolonged uncertainties will not be easy. The response lags and behavior of key economic variables will be subject to considerable error; and, it is reassuring in these circumstances that the authorities are firmly committed to the macroeconomic and structural policy framework of the program. The general uncertain climate, however, has induced a larger than programmed shift in currency demand, breaching in the process the performance criterion pertaining to the December 1986 ceiling on the monetary base. The nonobservance of this ceiling, in our view, does not jeopardize the objectives of the program, and we can support a request for its waiver as well as a modification of that criterion for March 1987. In that respect, we are pleased to note from Mr. Rye's informative statement that the March 1987 test has been met.

With increasing evidence of a resumption of economic growth and an improvement in the external position, the authorities have been well advised in this first review to strengthen the policy framework in areas where policies have not evolved consistently or sufficiently. The recently improving domestic and external environment for the Philippines--consolidation of the political situation combined with increasing business confidence and favorable terms of trade developments--will certainly facilitate this process and permit the economy to build further on an already sound economic footing. We believe that the new measures being implemented are important and timely. The institutional and financial aspects of public sector reform--including completion of the tax package, wage restructuring, and reorganization of the public sector financial and nonfinancial institutions--will extend further the fiscal consolidation process. However, the Philippine authorities are correct to pursue the needed rehabilitation of the public enterprises without further delay. We can support, therefore, the request for modification of the March 1987 performance criterion related to the public sector borrowing requirement to take account of the accelerated capital expenditure during 1987. Completion of the import liberalization program and the maintenance of a sufficiently flexible and competitive exchange rate will certainly improve the allocation of resources and enhance overall economic efficiency.

We would encourage the Philippines to adhere firmly to the implementation schedule for these policies which, if sustained, will have a significant impact on the behavior of key economic variables, with self-sustaining economic growth and employment in a setting of price stability and a reduction in the current account deficit. However, the impact will be significantly more powerful if the improved policy environment and economic variables, including stronger export performance, could trigger a restoration of spontaneous commercial lending and enhance investment activity. The Paris Club and commercial bank reschedulings are essential elements in this process; the resulting containment and gradual reduction in the external debt service ratio envisaged in the medium-term projections will ensure the Philippines' return to rapid financial and economic stability. We hope that the commercial banks will offer to the Philippines the same interest rates as in other recent agreements. We can support the proposed decision as amended.

Mr. Yamazaki made the following statement:

The purpose of the authorities' economic strategy is to achieve renewed economic growth and to make the necessary economic adjustments, especially by vigorously tackling the deep-rooted structural problems. In this context, the program puts emphasis on major structural reforms as well as the public sector consolidation and a cautious but growth-accommodating monetary policy.

In the belief that the Philippine authorities should pursue a more market-oriented, outward-looking economy with stable growth, we warmly supported the program in our discussion last October, and we continue to feel that this approach is appropriate.

The Philippine authorities now have taken several steps toward this goal and are surely embarking in the right direction. The inflation rate was suppressed to -0.3 percent last year, and substantial progress has been achieved in some structural reform areas. In addition, favorable developments can be seen in the external area: the overall balance of payments deficit was less than programmed, and, in the area of export performance, some nontraditional goods are further penetrating existing markets and tapping new ones with the help of the flexible exchange rate policy.

On the other hand, there are also some points of concern, especially with respect to economic recovery. The restoration of public investment and maintenance expenditures seemed to be slower than programmed, and consequently real GNP growth stayed at the low level of 0.1 percent in 1986. As the recovery of economic growth is realized by a substantial initial increase in public investment, efforts by the authorites will be required to avoid further delays in implementing investment. In this connection, I am glad to find in Mr. Rye's most helpful statement that the administrative bottlenecks in this area have already been resolved.

On fiscal policy, in order to ensure that the private sector plays a greater role, it will be essential to review and reshape the public sector's role in the economy, and I note with satisfaction that substantial progress has been made toward this end. In particular, a major reform of the public nonfinancial sector has been specified in the memorandum on economic policies. Also welcome is the fact that the major restructuring of the two important government financial institutions of the Philippines National Bank and the Development Bank of the Philippines are already underway, and the next stage is expected to witness reform of the smaller institutions.

Regarding the public sector deficit, I welcome the authorities' observance of the public sector borrowing requirement (PSBR) performance criterion, although I know that this has been achieved partly through the delay in public investment. Recognizing the importance of the implementation of public investment, as mentioned above, however, I support the modification of the PSBR performance criterion for March 1987 and hope for steady implementation in this area. At the same time, I share the staff's view that the PSBR should be reduced in 1988, as programmed, to make room for private recovery. As regards the tax reform, I would simply like to say that the introduction of the value-added tax will be appropriate, and I am looking forward to the introduction of such a tax, scheduled for 1988.

In the area of monetary policy, I can understand that the nonobservance of the performance criterion with respect to the base money for end-December 1986 was due to the higher than expected currency demand in the face of the low currency holding cost and the renewed political uncertainties. Thus, I can support the waiver of the performance criterion pertaining to this period. I am also pleased to know from Mr. Rye's statement that the performance criterion for end-March 1987 has been observed, and I commend the authorities for this favorable development.

On structural reforms, I recall that at the previous discussion, this chair stressed the importance of the reform of the sugar and coconut sectors. I feel comfortable knowing that the reforms which are intended to widen the role of the private sector and improve farm incentives and efficiency have been or are being taken, and I commend the authorities for this progress.

With regard to external policies, I feel that favorable export performance is one of the key factors for the recovery of economic growth in the medium term. As the growth prospect of current export items is limited, export diversification will necessarily be pursued only with great effort. In this connection, I welcome the recent trade liberalization measures and flexible exchange rate policy, which will ensure and strengthen the international competitiveness of traded goods, and I hope the authorities continue these efforts.

Finally, I can warmly support the draft decision with the waiver and modification of some performance criteria as shown in the paper.

Mr. Feldman made the following statement:

The Philippine authorities have implemented a comprehensive plan, which basically seeks to stimulate a sustained noninflationary recovery of economic activity; at the same time, the program includes a vast and ambitious set of structural reforms with the objective of reorienting the role of the Government in the economy, as well as of enhancing competitiveness. It is clear from the staff analysis, from the memorandum on economic policy sent by the Philippine authorities, and from Mr. Rye's illustrative statement that the macroeconomic and structural policy framework of the program has been consistently designed. Also clear is the firm commitment of the Philippine Government to carry out major economic reforms. For all these reasons, the Philippine program deserves our support. We are broadly in agreement with the staff appraisal and will make only a few comments related to the implementation of the program for 1987, to the role of the Fund in this program and to the medium-term projections.

Central to the 1987 program is the objective of resuming a reasonable rate of economic growth. The cumulative decline of GNP per capita in the Philippines was 20 percent for the triennium 1984-86. The 6-7 percent growth target for 1987 may sound too high, unless account is taken of the deterioration in the level of the GNP per capita that has occurred in the past few years and of the very rapid rate of population growth of the country. The economic recovery during the second half of 1986 was well below the Government's objective; the GNP growth rate was 2 percent instead of the 6 percent rate targeted in the program. This sluggish recovery has been related, by both the staff and the Philippine authorities, to delays in initiating the public investment program and to the persistence of political uncertainties, which, in turn, have had a negative impact on business confidence. Without denying the importance of these factors, I would argue that monetary policy has been more restrictive than necessary in the Philippines during 1986, and that the same possible recessive bias may arise from the design of monetary policy for 1987. Staff comment on this point would be helpful. It is true that during 1986, base money grew faster than targeted, although it is apparent that there was a dramatic unexpected increase in the demand for money, which was reflected in a significant shift from deposits to currency holdings, especially in the second half of 1986 and early 1987. The increase in the demand for currency is strongly associated with the sharp deceleration in the rate of inflation that occurred during 1985 and intensified during 1986. It is very likely--and this can be supported by data--that the increase in the supply of liquidity was insufficient to accommodate the increase in the demand of money. This was reflected in a swing in real interest rates from around -10 percent in 1985 to +7 percent in 1986; and the stock of bank credit to the private sector declined by 6 percent between 1985 and 1986. In those circumstances, the overperformance of the Philippines' balance of payments and the poor investment and growth results were not surprising. For 1987, the program includes a clause to the effect that base money growth will be held below the targeted level if the currency deposit ratio declines more rapidly than predicted. This would be a reasonable clause if a symmetrical condition were stated for the case in which the currency deposit ratio went up, a possibility that should not be disregarded. Similarly, the quantitative limit imposed on the monetization allowed for net international reserves seems also very rigid and would prevent the transmission of the benefits arising from an eventual overperformance in the external sector (a fact already pointed out in Mr. Rye's statement) to domestic interest rates in the Philippines.

We believe that the Philippine program is a reasonable one. The Philippine authorities have made a dramatic adjustment effort, and the time has come for giving top priority to growth. Our concern is related to those aspects of the program--particularly on the monetary side--which may become an obstacle to the economic recovery of the Philippines, depending on whether some provisions are or are not implemented. Fortunately, the figures provided by Mr. Rye on the performance of the industrial sector and on electrical consumption for the early part of 1987 are encouraging. We welcome the price stability achieved in the Philippines and feel that the viability of the program--and perhaps even the political stability of the democratic Government--depends basically on growth.

Finally, on the role of the Fund and on the medium-term projections, we feel that through March 1988, total credit outstanding will decline as scheduled, and repurchases will exceed purchases. This would be reasonable if international financial markets were operating normally and the Philippines was able to have access to voluntary financing. We have recently discussed the increasing reluctance of commercial banks to lend to indebted countries, either on a concerted or a voluntary basis. That is why we feel that the Philippines may encounter serious difficulties in meeting the financing requirements now estimated for 1988-92 in the medium-term projections. For this reason we believe, as has been stated in the recent report of the G-24 Working Group on "The Role of the IMF in Adjustment with Growth," that the principle of temporary use of Fund resources should be revised and adapted to the fact that growth-oriented adjustment programs needing structural changes take more time than traditional demand-management programs and also must be adapted to the unfavorable framework resulting from the present commercial bank lending behavior. Finally, we strongly support the economic program.

Mr. Schneider made the following statement:

We have followed with great interest the developments that have taken place in the Philippines, and we therefore welcome this opportunity to review the situation as it has evolved in recent months. It seems that progress achieved so far in consolidating the political situation has created an environment in which economic reforms can take place. So far, however, the recovery has been very slow, and much remains to be done. I believe the cornerstone of the economic reform will be increasing confidence in the authorities' economic strategy. To illustrate its importance, let me quote the Minister of Political Affairs, Aquilino Pimentel, who recently stated that "the richest 10 percent of Philippine households reap 43 percent of the annual national income, while the poorest 40 percent--roughly 22 million Filipinos--must get by on less than one tenth of the national income. About two thirds of the population live below the poverty line of $116 per month for a family of six."

These inequalities have made land reform a most sensitive topic, and we welcome the steps already taken or planned toward such reform. The authorities' decision to abolish agricultural monopolies in some agricultural sectors has already greatly improved the living conditions of the rural population, and efforts to increase agricultural production should continue to receive priority, not so much in order to increase exports as to satisfy the basic needs of the Philippine population. Along the same lines, we support the planned salary adjustments in the public sector, for we believe that the Government's campaign against corruption can succeed only if civil servants are adequately paid.

While we are in broad agreement with the staff paper, we wish nonetheless to stress several areas of concern. First, we find it worrisome that real GNP growth was almost zero in 1986. Compared to a population growth rate of 2.7 percent, the 2 percent rate of GNP growth in the second half of 1986 could not halt the decline in per capita income of the Filipino people.

Second, in the light of slow world economic growth, and taking into account the Philippines' past growth record, we have some doubt that the projected 1987 GNP growth target can be achieved. Consequently, the relative external debt will probably exceed forecasts. In addition, it is worrisome that despite the sluggishness of the economy and little investment activity, the ratio of debt to GNP is 10 percentage points above the forecast. Some information from the staff about the currency structure of the Philippines' debt and the impact on it of the recent dollar decline would be helpful.

In view of the foregoing, we wonder whether the projected debt level of 67 percent of GNP for 1992 is still realistic. The relief expected from the debt conversion scheme is likely to be small in view of the amounts involved at present. It is also questionable whether the creditors will be very keen to convert their claims into equity, since the conversion fees seem rather high. We would appreciate some information from the staff on the present discount rate for Philippine debt in the secondary market.

On the positive side, we note with satisfaction that inflation has come down dramatically. It is further encouraging that the public sector deficit has been considerably below the program level and that a small current account surplus is anticipated for 1987.

With respect to monetary policy, we have no problem with the stronger than expected growth of base money, since the velocity of money has slowed. The whole financial system should be strengthened by the restructuring of the Government Financial Institutions (GFIs), and the reduction in the costs of financial intermediation will help to boost economic activity.

In the area of the public service companies, we strongly encourage the authorities to implement the investment plan without delay in order to reinforce the general infrastructure which is to support the economic recovery. We note here with regret that the decision of the previous Government to build a nuclear power plant in an earthquake region will impose a heavy financial burden on the taxpayers in the years ahead.

We are fully aware of the challenge facing the authorities, and we wish them luck with their difficult inheritance. It is clear that much will depend on the confidence the new Government is able to inspire in the private sector and on the support the Philippines receives from the international community. Finally, I can go along with the amended decision.

Mr. Ortiz made the following statement:

At the outset, let me express our support for the decision contained in the staff report on the first review under the stand-by arrangement for the Philippines (EBS/87/67), including the request for waiver and for modification of performance criteria. It is clear that the noncompliance of the end-December base money performance criterion does not reflect overly expansionary policies on the part of the authorities; paradoxically, the opposite appears to be true.

In that regard, I am puzzled by the explanation given in the staff report to the effect that the currency deposit ratio turned out to be different from what had been expected, which, in turn, caused the noncompliance with the base money ceiling for end-December. One usually perceives a different order of causality in which the modification of the currency deposit ratio affects the multiplier and the fractional reserve system, tending to reduce the multiplier. This would then affect the growth of monetary aggregates, not the monetary base. The fact that money grew on target and the base grew at a higher rate would, as Mr. Feldman has indicated, seem to signal an increase in the demand for money which was not satisfied through the provision of base creation within the context of the program.

Performance so far under the stand-by arrangement has been somewhat disappointing to the extent that one of the basic objectives of the economic program was the achievement of a sustainable reactivation of economic activity, and this did not materialize in the second half of 1986. Yet, as Mr. Rye notes, continued progress has been made in the area of structural reform; inflation has drastically abated; and the balance of payments remains in a relatively strong position.

The strategy outlined at the time the program was approved was a two-pronged approach based on the gains made in stabilizing prices and on a relatively favorable balance of payments outlook. The medium-term growth prospects were to be reinforced by a series of structural reforms aimed at reducing or eliminating distortions, facilitating the growth of markets and, in general, stimulating private activity and investment. The initial stimulus to recovery was to be given by a boost of public investment expenditures, leading to a resumption of private investment. The fiscal stimulus was expected to be withdrawn in 1987, when private activity should have gathered enough momentum to sustain the recovery. In the event, the fiscal stimulus did not take place, and the recovery failed to materialize.

The staff points out that the reasons the strategy had been somewhat poorly timed included the risk inherent in the reliance on a rapid response by the private sector and the problems encountered in effectively implementing the public investment program. One should note that expecting a reactivation of private activity in the midst of a fiscal reform--which, even if it removed distortions and provided some stimulus to investment, had the effect of extracting real resources from the private sector in order to reduce the fiscal deficit--was a bit too optimistic. On the other hand, doubt about the capacity of the economy to service on commercial terms the large external debt must be a factor which discourages new investment, as it is obvious that the economy remains extremely vulnerable to external shocks. In this respect, we hope that a prompt arrangement with commercial banks will be achieved and that future misunderstandings will be avoided.

I agree with the staff's view that it will be essential to ensure an effective implementation of the public investment program and to continue with the structural reforms which have been described in detail both in the staff report and in Mr. Rye's useful statement. Given the very positive gains made so far in stabilizing the economy, priority should be given to the areas of public investment and the different aspects of reform of public sector enterprises and financial institutions; in sum, as Mr. Feldman stated, priority should be given to economic growth. On the other hand, the reduction of the public sector borrowing requirement should be continued on a gradual basis only if it allows simultaneously for the implementation of the investment program and the structural reforms envisaged. In addition, care should be taken to ensure that monetary restraint does not hinder economic recovery.

Mr. Ismael made the following statement:

I can fully support the staff's recommendation that the Board accede to the Philippine authorities' request for a modification of the March 1987 ceilings on base money and the public sector borrowing requirement, and their request for a purchase of SDR 58 million under the stand-by arrangement upon the completion of this review.

I note with satisfaction that most of the performance criteria under the stand-by arrangement were met by the authorities. I am particularly impressed with the determination shown by the authorities in adhering steadfastly to the structural reform program, especially under such an adverse environment of political uncertainty and economic difficulty.

I regret to note that the authorities were not able to make the third purchase under the stand-by arrangement, simply because the December 1986 ceiling on base money had been exceeded. This is really an unfortunate situation arising from our placing too much emphasis on the target of base money--as alluded to by Mr. Feldman and Mr. Ortiz--and our having too much faith in the stability of the money demand function and the money multiplier. I would like to draw the Board's attention to the fact that even in several industrial countries, which enjoy highly monetized and mature economies, monetary targets have not been met in the past few years because of a shift in parameters. The problem is worse for the developing countries, whose economies are much less monetized and in which monetary relationships have not been stable. In the Philippines case, it is clear that there would be a shift in preference to currency holding because of the prevailing political uncertainty. This, together with the fact that the growth of M3 had been right on target, should have led to the conclusion that the monetary growth target was generally met. I would, therefore, like to urge the Board and the staff to show more flexibility in selecting and setting monetary targets, especially for the developing countries.

I reiterate my appreciation to the Philippine authorities for their determination in implementing such wide-ranging reform in the public sector, as well as in the banking and agricultural sectors. With the emergence of a more stabilized political situation and a gradual resumption of private sector confidence, I am optimistic that the authorities will be able to effectively implement the economic program and put the growth of the economy on a much firmer footing. These expected favorable developments could lead to a resumption of spontaneous commercial bank lending. In the circumstances, I urge the Board to give the Philippine authorities full support in their effort toward economic restructuring so as to help them succeed in the implementation of the debt strategy. In conclusion, I can register my support for the proposed amended decision.

Mr. de Forges made the following statement:

This first review under the stand-by arrangement leads me to consider that, on the whole, the Philippine program is broadly on track. Of course, one waiver and two modifications of performance criteria are requested, but the initial thrust of the adjustment policy does not seem to be called into question. Consequently, we have no difficulties supporting the modifications proposed by the staff. In this connection, even though I am aware of the various statistical considerations which have led to the selection of the base money as a performance criterion, I cannot help but ask the staff about the practicability of monitoring such a sensitive variable. Given the unpredictability of the demand for currency holdings, which was further evidenced at the end of March, I wonder whether the staff has envisaged shifting to a broader and more stable measure of money.

From a wider perspective, the stabilizing effect of the stand-by arrangement appears indisputable: public finances under control; a very low inflation rate; and a substantial current account surplus. But a negative byproduct of this macroeconomic adjustment effort is the stagnation of economic activity after several years of severe recession.

Even in 1986, when the arrangment with the Philippines was approved, the risk of a cautious reaction from the private sector--which could be a drag on the expected economic recovery--was alluded to.

A rapid and strong resumption of economic growth appears to be required if the reshaping of the economy is to prove viable in the medium term. This fundamental concern helps explain the modifications introduced in the economic program for this year. The strong stimulus stemming from a larger central government deficit and an even more ambitious investment program for the nonfinancial public corporations can be justified on these grounds. But one must keep in mind that such heavy reliance on the public sector can run against the declared will to restore a climate of confidence within the private sector and, as such, can jeopardize the longer-term objective of scaling down the role of government in the economy.

However, so far, the ambitious public sector investment program has been implemented at a very slow pace, thus contributing to a low level of activity. On this latter point I would appreciate any comments on the responsibility that can be attributed either to the negative side effects of ongoing structural reforms or to the delay of external creditors in disbursing already committed financial resources.

The overriding objective of reviving the economy can also be perceived in the rather accommodating stance of monetary policy. I have no strong reservations about this initial stance, since the policy is monitored closely by the authorities, with a view to holding down the growing liquidity overhang. However, continued close control must be exercised.

Similarly, the new compensation policy being implemented in the public service raises some questions. Even if the recent pay raise were warranted, in light of substantial pay differences with the private sector, it could send a wrong signal on the role that the public sector is prepared to play in the future. Furthermore, it is to be hoped that such a substantial increase will not trigger widespread wage claims outside the Central Government. Otherwise, it will be difficult to keep inflation under control.

Let me close by turning to the longer-term outlook. The projections prepared by the staff give an unequivocal picture of the pressing financing needs that the Philippines will experience over the medium term. In this respect, it is reassuring to see that the authorities have been able to reach, within a reasonable period of time, agreements with all the categories of creditors, even if some uncertainties are perceivable today. It is also noteworthy that an interesting innovation, namely the Philippines Investment Notes, has been introduced in the agreement with the commercial banks. With the consolidation of the political conditions in the Philippines one can expect that a climate of confidence will be rapidly restored.

Mr. Salehkhou made the following statement:

The Philippines' economic and financial performance under the 1986 stand-by arrangement with the Fund has been mixed and generally below what was expected at the adoption of the financial program. It is clear, however, that this first review of the program coincides with a considerable improvement in the prospects for a turnaround in the economy's performance and a successful implementation of the country's overall economic strategy.

Although real GNP growth recovered in 1986 from the severe recession of the previous two years, it was contained to about 2 percent in the second half of 1986, as compared with a 6 percent target in the financial program. This lower rate was in spite of the implementation of many reforms aimed at improving the business environment. Such performance reflected the delays incurred in restoring an adequate level of public investment and in negotiating the restructuring of the Philippines' external debt. More important, it reflected the considerable political uncertainties, which, through 1986, have undermined the efforts to build business confidence. Such uncertainties have also contributed to the shift from deposits to currency holdings, which led to the nonobservance of the performance criterion on base money for December 1986.

Performance in other areas was, however, encouraging, particularly with regard to inflation--which declined more sharply than targeted under the financial program--and to the current account position, which shifted from approximate balance in 1985 to the equivalent of 3.3 percent of GNP in 1986. The strengthening of the external accounts was not entirely due to the sluggish economic activity and the further decline in imports; it also reflected relatively good export performance.

Public finance developments have also been on target, in spite of shortfalls in both revenues and expenditures. Performance in this area, however, appears to be less satisfactory, as the shortfalls were to a large extent induced by delays in implementing elements of the tax reform package and putting in place the expenditure and control procedures necessary to the fiscal stimulus envisaged under the program.

These developments notwithstanding, as underlined in both the staff report and Mr. Rye's comprehensive statement, it is clear that recent developments and additional measures implemented by the authorities have significantly improved the prospects for a strong performance in the remaining period of the program. I note in this regard that the new memorandum on economic policies has confirmed the original objectives of the financial program and aims in particular at a further reduction in the consolidated public sector deficit and the maintenance of the momentum of structural reforms. More important, the consolidation of the political situation and the strong expressions of international support have considerably improved private sector confidence and should facilitate the expected recovery in total investment. Such recovery should also benefit from the further decline in interest rates, the provision of adequate private sector credit in the financial program and the authorities' efforts to promote foreign investment.

I note that while the acceleration of growth and the needed restocking of inventories, as well as the liberalization of the trade system, should lead to a significant rebound in total imports, the current account is projected to remain in surplus in 1987. The successful implementation of the financial program should also permit a further strengthening of gross official reserves.

Over the medium term, however, projections indicate financing gaps and the need for exceptional financing through 1992. Taking into account reschedulings, there will remain a residual financing gap, which the staff expects to be covered by a resumption of spontaneous lending. While such resumption is dependent on the strengthening of the economy and the effectiveness of ongoing structural reforms, it should be noted that inadequate external financing could in turn upset growth and adjustment efforts in the Philippines. The economy's performance with respect to real growth, employment and alleviation of poverty is crucial to the maintenance over the medium term of a favorable political and business environment. Cooperation and flexibility on the part of the country's creditors, including the Fund and the World Bank, are therefore essential for an orderly solution to the Philippines' development and debt problems. As to the information provided by Mr. Rye this morning on the commercial bank rescheduling, I would appreciate hearing whether the terms sheets relating to such an agreement have been signed by the two parties. Finally, I wish to endorse the proposed decison as modified by the staff, including the request for waiver and modification.

Mr. Al-Assaf made the following statement:

Let me state at the outset that I support the proposed decision with the requested waiver and modification. It seems clear that, despite the somewhat fitful start toward the current economic recovery in the Philippines, the program's overall objectives are now quite firmly established. The requested waiver and modification are due more to the fact that the behavioral conditions turned out to be different from those forecast than to any basic policy slippage. Indeed, the rate of inflation is lower, and the balance of payments stronger, than originally programmed. Further, as detailed in Mr. Rye's comprehensive statement, the Philippine authorities are now embarked on an extensive program of adjustment and reform. Specifically, they are in the process of reforming agricultural policies and of restructuring the nonfinancial public corporations and the government financial institutions. I therefore commend them for all they have achieved, as well as for their apparent success in rescheduling their commercial debt. I would only like to make a few brief observations.

First, I note that monetary policy is being conducted against a background of rapid change. Inflation has declined dramatically, implying that there will be a stock shift in the demand for money. I therefore believe that, in general, the 15 percent increase projected for M3 in 1987 is reasonable. However, the dynamic nature of the changes being experienced by the Philippine economy suggest that this situation should be monitored carefully. I am encouraged by the authorities' stated intention to do precisely this.

Second, on fiscal policy, I again commend the authorities for the bold program of fiscal and structural reform they have initiated. The attempt to make the tax system both more efficient and more equitable is especially noteworthy. In this connection, I welcome their intention to proceed with the introduction of a value-added tax. However, it is important that the authorities adopt a flexible attitude so as to ensure that revenue projections from this tax are met. I raise this concern since there is growing evidence, in both the Philippines and in other countries, to suggest that the revenue implication of major tax changes tend to be overestimated. On a related matter, I wonder whether the staff or Mr. Rye can update us on whether the tax reforms to be introduced in March and April have in fact been implemented.

Third, the Philippine authorities' decision to implement a debt-equity conversion program should help their debt-management policy. I wonder whether, with the introduction of Philippines Investment Notes, the scale of the scheme is anticipated to increase? Staff comment on this would be appreciated. Finally, I again commend the authorities for their determined adjustment efforts and wish them well.

Mr. Puro made the following statement:

During the Article IV consultations in October 1986, emphasis was placed on the significant risks inherent in the Philippine authorities' economic strategy. In particular, it was doubted whether fiscal stimulus could be strong enough to initiate economic recovery based on a revival of private activity.

Unfortunately, those reservations were well founded, and economic recovery has been considerably weaker than anticipated. Notably, fiscal stimulus has remained below the targeted level; some of the structural reforms are lagging behind schedule; and, most crucial of all, business confidence has not been restored.

Although the rather ambitious Philippine program is not generally "off track," it is obvious that developments in the second half of 1986 imply a serious threat to the entire strategy. Therefore, there is an urgent need to strengthen policy performance and to thoroughly fulfill the targets of the 1987 program. This year's program--detailed in the annex of the staff paper--seems reasonable with respect to the targets set and the previous policy record.

At the core of the program are public sector reforms that would, among other things, reduce the uncertainty over key parts of the environment in which the private sector must operate. A good number of the intended reforms have already been undertaken, as is elaborated in Mr. Rye's very helpful statement. There is now a need for a prompt and comprehensive implementation of the rest of the measures planned. The residual elements of the tax reform that would increase the elasticity of the tax system and improve incentives for investment and exports should be implemented. The long overdue reforms in the sugar and coconut sectors are necessary to improve supply and foster growth. The institutional reforms in the public financial and nonfinancial sectors are of great importance for the viability of the financial system, for the improvement in the efficiency of resource use, and for a reduction in the burden the institutions impose on the national government budget. Obviously, their prompt implementation is essential for the credibility of the entire economic program and will have a positive effect on the investor confidence needed to revive private activity.

The reduction in the public sector deficit, an area where slippages must absolutely be avoided, would make room for private sector financing. The financial policies formulated to accommodate the anticipated recovery have to be monitored closely in order to avoid any re-emergence of inflationary pressures. This is most important, given the uncertainty created by experience with the recent behavioral changes in the public's demand for currency.

On other aspects of monetary policy, I endorse the authorities' attempts to reduce the costs of financial intermediation. This is one important way of increasing the competitiveness of the Philippine economy.

The performance of the external sector will be crucial for the Philippine economy in the medium term. Rapid export growth is needed to regain an orderly servicing of external debt. New export products have to be developed, and efforts to remain competitive with the traditional products must be intensified. It is vital that economic policies and a competitive exchange rate provide incentives for the development of a more diversified export base. Also, other incentives should be shifted to favor exports and more efficient import substitution. I encourage the authorities to continue with their trade liberalization and tariff reform efforts.

In concluding, I want to comment briefly on the issue of the national government compensation policy. Although I can see the reasons for the intended wage adjustment for certain civil servants, such as teachers, the planned increases for 1987 seem to be surprisingly high. In general, I would be inclined to think that it would be preferable if the necessary shifts in the level of compensation were implemented gradually over a number of years. Increases in productivity could then absorb, at least partly, any inflationary effects of the wage adjustment. One can only hope that the authorities are correct in their assessment that the public sector wage policy will not result in a general upward shift in wage rates in the private sector. If a wage spiral were to emerge, this could have very detrimental effects on the success of the entire economic strategy. Finally, I support the proposed decision.

Mr. Templeman made the following statement:

On balance, we believe that Philippine economic policy implementation and economic performance in the past year was quite good, that the stand-by program remains basically on track, and that the overall economic strategy remains valid. In fact, with the minor exception of an overshooting of the monetary base ceiling, both monetary and fiscal performance were satisfactory in 1986, while progress continued on a variety of important structural reforms.

That being said, there were some delays in completing implementation of the 1986 tax reform, and import liberalization has been moving at a much slower pace than originally envisaged. We would strongly urge the authorities to maintain the momentum of their structural reform efforts, so that the necessary favorable environment will be created for a revival of private investment, the achievement of sustainable economic growth, and the alleviation of the Philippines' still heavy debt burden. Close cooperation with the World Bank on some of these structural reforms, and careful Bank assessment of the Philippines' public investment plans, are particularly welcome and crucial to the success of this economic strategy.

The most comprehensive and complex structural reforms are in the fiscal area, with the near completion of the 1986 tax reform, the introduction of a value-added tax at the beginning of 1988, the restructuring in 1987 of the system of public salaries, the modification of fiscal responsibilities within the public sector to provide more transparency, and the initiation of the reforms both of the financial and nonfinancial public enterprises. We understand the need for reform of the public salary structure, in light of the past decade of declines in real incomes, particularly with regard to teachers' salaries. But we hope that the macroeconomic impact of the proposed reforms can be contained. We also very much welcome the effort to increase the transparency of financial transactions within the consolidated public sector. Greater clarity in the data, a more arm's length relationship among public entities, and a clearer delineation of the responsibilities of the various elements of the public sector should emerge from this exercise. In particular, we are pleased that the quasi-fiscal operations of the central bank will be reduced, hidden subsidies will be replaced by direct appropriations, and financial and nonfinancial public enterprises will be made responsible for paying a return on the financial assistance which they receive from the Government. Finally, while the deficit of the consolidated public sector is expected to continue to decline this year and next, deficits exceeding 5 percent of GNP each year would still be very substantial.

For the nonfinancial public enterprises, we are pleased to see in Mr. Rye's statement that presidential approval of the rationalization package and of privatization modalities will be in place by June 30. We stress the importance of the reformed institutions promptly expanding their ability to generate internal financing, especially through realistic pricing policy and cost control, so that they can tap the financial markets and end their dependence on the Government for financial support.

In the monetary field, we agree with the staff that the overshooting of the monetary base ceiling at the end of 1986 does not give cause for concern, and we are pleased that the monetary base was below the end-March ceiling. For 1987, we support a rate of credit expansion which is sufficient to accommodate the expected recovery of real economic activity. But, it is worth recalling that as recently as 1984, inflation exceeded 50 percent, and experience in other countries demonstrates how quickly inflation can turn around. Given the considerable uncertainty about the strength of recovery of private investment this year, and the still large public sector deficit, the conduct of monetary policy will need to be kept under close review.

As to reforms of the government financial enterprises, especially the Philippines National Bank and the Development Bank of the Philippines, the transfer to the national Government of a large part of their liabilities makes sense, provided that the basic principles of the Government Financial Institutions (GFI) reforms which were adopted last December are pursued successfully. This includes restoration of the financial viability of the Philippines National Bank and its subsequent privatization, and the reduction in the scope of activity of the Development Bank of the Philippines. We also view with interest the creation of the Asset Privatization Trust.

In the external accounts, the stronger than expected current account outcome in 1986 was particularly welcome, insofar as it reflected higher than expected receipts from merchandise exports, services, and transfers. The contribution made by lower than expected import levels was a less positive factor, since it reflected the disappointing rate of recovery of economic activity. In any case, the Philippines' strengthened external position at the beginning of 1987 does provide a margin of flexibility, which should permit a considerable recovery of imports this year in line with a progressive recovery of economic activity.

Strong export growth will remain a key factor for success both this year and over the medium term. The substantial real effective depreciation of the peso, which by late 1986 had almost reached the previous low point in late 1983, should help to maintain the Philippines' international competitive position. However, the very interesting chart on page 8a of the staff paper shows that the peso is still substantially appreciated in real effective terms against six Pacific region economies, compared to the 1983-84 period.

We welcome the current review of foreign investment policy. But, in light of the important role which investment can play in both enhancing growth and strengthening the external balance, we urge the authorities to give high priority to effective implementation of a liberalized investment code. We also welcome the renewed commitment to complete the import liberalization program that was originally expected to have been completed by end-June

1987. But it does seem to us that the postponement of the liberalization deadline for 132 out of 293 of the remaining import items until end-April 1988, when the current stand-by arrangement terminates, represents a rather slow pace for increasing the openness of the Philippine economy to foreign competition.

The staff projection of the medium-term balance of payments and foreign debt outlook continues to show a rather tight position. Given the assumption of $1 billion annually in new voluntary lending, there would have to be very substantial progress in structural adjustment of the economy, for the support of which a major share of the financing would presumably be provided. The scenario does suggest a fairly large decline in the ratio of foreign debt to GNP from a peak of 95 percent in 1986 to 67 percent in 1992 and in the debt service ratio from 33 percent to 26 percent over the same period. However, both figures would still be quite high. Also, the current account deficit would still be about 3 percent of GNP and moving on a slightly upward trend. Furthermore, the alternative medium-term scenario, which assumes a very rapid 6 1/2 percent rate of GNP growth, would add perceptibly to the size of the current account deficit, to the uncertainty about the adequacy of external financing, and to the debt ratios. Clearly caution is called for in this area.

In conclusion, a good basis has been laid--both with regard to macroeconomic policy and in terms of the initial structural reform effort--for considerably improved economic performance this year and in coming years. But, the success of the Philippines's economic strategy will depend considerably upon the carrying to completion of a variety of complex structural reforms, as well as the prudent management of macroeconomic policies. We hope that the Philippine authorities will pursue this strategy with vigor and determination.

Mr. Goos made the following statement:

At the outset, I should like to congratulate the Philippine authorities on the recent rescheduling agreement reached with the consultative group of creditor banks. This agreement is most welcome because it confirms the effectiveness of the existing debt strategy. Moreover, despite assertions to the contrary, I feel that it also attests to the confidence of the financial community in the adjustment strategy of the country. I will refrain from commenting in any detail on the authorities' announcement to consider reopening the rescheduling talks with commercial banks, because I feel that this issue has to be resolved in the first instance between the two parties that are directly involved. I would merely express the hope that this matter is going to be addressed by the authorities and the banks in a constructive spirit so as to avoid a total unraveling of the agreement. Such an outcome could not only entail substantial delays in the eventual closing of the external financing gap; it might even render more difficult the effort to achieve international cooperation between debtors and creditors.

Turning now to the program review, I feel that the critical policy issues are adequately addressed in the staff appraisal. Therefore, and in view of both the good progress made so far and the authorities' commendable policy undertakings for the period ahead, I will restrict myself to a few general remarks.

First, the observation in Mr. Rye's statement that his "Philippine authorities are eager to showcase the Philippines as a prime example of the 'adjustment with growth' model espoused by the Fund, in line with the Baker plan" gives me no particular difficulty. However, it reminds me of the concerns I had expressed at our previous Board meeting on the Philippines about the initial stance of fiscal policy programmed under the arrangement--a policy stance which, contrary to Mr. Puro's assessment, I had perceived at that time as unduly stimulatory and rather risky, inasmuch as it involved a considerable degree of fine tuning. I, therefore, would like to re-emphasize that the realization of the growth component of the authorities' adjustment strategy can hardly be obtained by force, i.e., by fiscal or monetary stimulation, especially if the resumption of growth is to be sustainable beyond the short term. This objective, as we all know, can be achieved only if growth is carried in the main by autonomous market forces and a satisfactory performance in the tradeables sector. Against this background, I am pleased to note that fiscal policy is now following a much more even pattern than originally envisaged for 1986 and this year. The staff, to be sure, is probably right in blaming part of the shortfall in growth performance on the relatively weak fiscal expansion. But even more important--at least in a longer-term perspective--is the staff's finding that the resumption of growth has also been delayed by prolonged political uncertainties and difficulties in the implementation of structural reforms. Accordingly, in order to be successful, the economic strategy must continue to focus as a matter of priority on the removal of the remaining constraints in those areas, while financial policies have to be kept sufficiently tight.

Having said that, I feel greatly encouraged by the laudable objectives pursued by the authorities in the area of structural reform, where further progress in reducing government involvement in the economy and in the implementation of the tax reform appears particularly essential, as has been stressed by previous speakers.

In the same vein, I should also emphasize the importance of the ongoing efforts to further shift the structure of incentives toward exports, to push ahead with trade liberalization and tariff reform, to reduce the costs of financial intermediation, and to keep a close eye on external competitiveness and the adequacy of monetary expansion.

While in general it appears that the program remains on a promising track, I am somewhat worried about the rather ambitious growth target set for 1987, a target which I hope is only indicative in nature. Economic recovery, to be sure, is already under way. And I acknowledge that higher growth is certainly badly needed to make good on the recent losses in per capita incomes and to stabilize the political situation. But I think one cannot exclude that full recovery might continue to lag behind the authorities' expectations. If such were the case, a relaxation of the present course of financial discipline might become quite tempting, particularly in view of the currently rather comfortable external financial position. However, such a shift in the policy stance would undoubtedly be shortsighted and eventually counterproductive to the objective of sustainable economic growth.

With these remarks, I would like to conclude by endorsing the staff appraisal and the proposed decision and to express the hope that the matter of private sector arrears to the Paris Club creditors will be resolved soon.

Mr. McCormack stated that in October 1986, when the Board discussed the request for a stand-by arrangement for the Philippines, his chair had noted in its statement that the economy was quite fragile, with a narrow economic base badly in need of restructuring. The main thrust of the statement was that the authorities needed to move ahead with resolution in tackling the economy's deep-seated structural problems, although it endorsed the authorities' program generally, emphasizing in particular the importance of tax reform, import liberalization, and reform of agricultural policy. The Philippine authorities were to be commended for their broad-ranging policy undertakings and for the success they had achieved so far. Progress on a number of fronts had been impressive and, like the staff, he believed that the basis was being laid for a significant improvement in the prospects for the Philippine economy.

Like other speakers, Mr. McCormack said that he wished to stress the importance of the timely implementation of the various reform measures, in particular the continued improvement in the tax regime and in the regulatory structure of the sugar and coconut sectors. Delays in implementing the public investment program in the past year were particularly unfortunate, as they had postponed the necessary economic recovery. It was heartening, therefore, to learn from Annex V of the staff paper that the World Bank considered that an expanded investment program in 1987 was easily within the country's implementation capacity. Also, he wanted to stress the importance of adhering to the financial policies embodied in the adjustment program, while noting that the considerable uncertainties with respect to monetary policy called for close monitoring and flexibility in policy response as the year progressed. Continued progress in all of those areas was desirable on a number of grounds, not the least of which was the need to sustain and enhance the credibility of the adjustment effort, which in turn would lead to continuing broad support and improved investor confidence. In closing, Mr. McCormack said that he agreed with the staff's appraisal, and supported the proposed decision as amended.

Mr. Yang recalled that since the new Government came to power some 14 months previously, the performance of the Philippine economy had been encouraging. Substantial progress had been made in laying the foundation for the revival of the economy, and a significant turnaround in economic growth was taking place. Meanwhile, inflationary pressures had remained absent, and the external account had continued to strengthen. The return of confidence in the economy was progressively evident, both inside and outside the country. Most notably, as indicated in Mr. Rye's statement, all the quantitative performance criteria for the first quarter of the year under the stand-by arrangement were observed. In sum, the strength of the authorities' wide-ranging economic reform program was evident in the revival of the economy and, as a result, the program did indeed deserve full support.

As the staff appraisal has provided a comprehensive and sober analysis of existing policy issues, and since many important views have been voiced by previous speakers, he would only touch upon a few points, Mr. Yang said.

First, as the staff had pointed out, the principal factor that led to the overshooting of the base money ceiling at end-December 1986 was the unexpected shift of demand from deposit to currency holdings, Mr. Yang continued. The political uncertainties as well as the reduced opportunity cost of holding currency due to lower inflation and interest rates might have concurrently contributed to the higher than expected currency demand. The problem was that the weight of the two factors in effecting behavioral changes was unclear. At present, the political uncertainties had abated considerably, whereas the cost of holding currency had remained low. In the circumstances, would high currency demand and low velocity of money circulation persist? Mr. Rye had informed the Board that the level of base money as of end-March was substantially below the ceiling. What, then, were the factors which caused the most recent decline in base money? He would welcome the staff's comments on that matter.

Second, he had noted that the authorities had a clear recognition of the great importance of land reform in relieving rural poverty and invigorating agriculture, Mr. Yang concluded. He welcome their intention to expand and accelerate land reform as a major policy objective. He hoped that the reform will be carried out smoothly and successfully, and supported the proposed decision as amended.

Mr. Zecchini made the following statement:

Positive results have characterized the implementation of the Philippines's stand-by program so far: inflation has been reduced; the current account has improved; and structural reforms are going ahead in the agricultural sector. Although an early recovery of economic activity was an essential part of the program adopted last October, this recovery has failed to materialize. In this respect, we share the staff's contention that "judged by the standard of achieving this early recovery, the strategy has been less than fully successful." The main causes of this outcome were the difficulties in achieving the targeted levels of public investment expenditures and the slow expansion of private sector economic activities due to political uncertainties and to delays in implementing some of the structural policies envisaged in the program.

As we consider the original framework of the program still broadly appropriate, we welcome the authorities' renewed commitment to the macroeconomic objectives agreed upon in October 1986, as indicated in the Government's memorandum on economic policy. We also commend the adoption of appropriate measures in the 1987 plan in order to cope with the problems that have emerged recently. Therefore, we can also endorse the proposed decision that appears on pages 44-45 of EBS/87/65.

Looking at the 1987 program in detail, we would like to make a few comments on fiscal, monetary and external policies, as well as on structural policies. On fiscal policy, we praise the authorities' commitment to further reduce the consolidated public sector deficit to 5.4 percent of GDP in 1987 and to about 5 percent of GNP in 1988. A tight monitoring of expenditure dynamics is crucial in our opinion in order to ensure that the fiscal stimulus envisaged on the expenditure side will not cause a crowding out of private sector expenditure. Therefore, tax reform measures and restructuring of the expenditure side of the budget, in order to enhance capital investment and prospects for economic growth, should be given the highest priority in the implementation of fiscal reforms.

In the monetary area, we would like to stress that monetary policy will have to support investment activity by aiming at an appropriate level of interest rates. Interest rates in nominal terms were reduced in 1986, but real rates have tended to increase significantly because of the declining trend in inflation. In this context, we welcome the authorities' efforts to reduce the lending rates by lowering the costs of financial intermediation. In setting the monetary policy targets, we understand that there are some problems due to the uncertainty surrounding the stability of the money demand function as a result of recent large shifts in money velocity and in liquidity preference. Again, as in the October discussion, we wish to emphasize that such considerations call for more effort to restore confidence in the public about the viability of the financial system as well as to improve the monetary policy approach. In this respect, we wonder whether, in view of the instability of the currency/deposit ratio, a monetary aggregate broader than the monetary base would have been preferable as a performance criterion.

On the external side, the prospects for 1987 are rather favorable, as the current account will remain in surplus in spite of the large increase in oil imports. Export values will expand, and this will reflect, among other factors, the improved performance of the nontraditional export sectors and the increased penetration in the external market. In order to provide adequate support to the growth and diversification of exports, a liberal trade policy and a coherent exchange rate policy will be necessary. In this respect, we commend the authorities for announcing new schedules for completing the liberalization program. The general criteria, indicated in the paper, that have guided the conduct of exchange rate policy since 1984 seem broadly appropriate. Several improvements in the external debt situation of the country have also occurred. The debt service ratio in 1986 turned out to be lower than expected, and it will continue to fall in 1987 and 1988. Moreover, as a result of the rescheduling agreement concluded on March 27, the debt service ratio is expected to improve until 1992. As to the approach to the repayment of external debt, it is important for the authorities to develop their initiative aimed at introducing investment notes for funding interest payments. These notes can be utilized for debt-equity conversions. We wonder whether any indication of the banks' response to such initiative is already available.

Structural policies and reforms must play a crucial role in the present development strategy. Some significant structural improvements have occurred, especially in the agricultural sector, but the introduction of reforms in the sectors of government financial institutions and public nonfinancial corporations is still pending. At the time of the approval of the stand-by arrangement, it was indicated that plans for reorganizing the nonfinancial corporations were to be approved by the end of 1986, and timetables for their adoption were to be incorporated in the first program review. However, we understand that the reform plan is now expected to be approved by the Cabinet and the President by mid-1987, but no specific timetable is yet available. Although we are aware of the difficulties of working out the details of such broad reform plans (and the length of time needed to achieve the objective), we wish to reiterate the importance of a more precise commitment in this area to strengthen the credibility of the whole strategy of adjustment with growth. Therefore, we urge the authorities to deploy more efforts to speed up the implementation of such essential reform plans.

Mr. Fernando made the following statement:

It is worth recalling that not so long ago the Philippines underwent a traumatic period of political and social tension, with inevitable adverse repercussions on economic growth and development. It is one thing to have an economic program which mandates a massive government retreat from economic involvement and activity to a role very much secondary to market forces; it is quite a different thing to negotiate and implement, by and large successfully so far, that program of reduced government intervention in the wake of two years of negative growth. Recognizing the courageous stance of the Philippine authorities--a stance that might be perceived as suicidal by many a government--it is only fair that we should reinforce our support for the stand-by program to enable the Philippines to become what Mr. Rye has labeled the prime example of "adjustment with growth."

The structural adjustment of the Philippine economy can be seen to have been facilitated by two favorable recent developments. First, while this country has historically experienced high levels of inflation, it can boast of near perfect price stability over the past two years. Second, the balance of payments has strengthened, with the current account deficit sharply down, the debt profile greatly improved, the debt service ratio down significantly, and reserves comfortable. Admittedly, the import compression that brought about the favorable outturn was not the best technique for strengthening the balance of payments. The authorities should thus persevere in accelerating public investment. Equally important, they should reinforce the environment that induces enhanced private investment. In this respect, I join Mr. Templeman in urging the authorities to be steadfast in their resolve to speed up investment through further progress in import liberalization, restructuring public nonfinancial corporations, including privatization, and attracting private direct investment.

The first two areas I mentioned are very delicate ones, and slippages are easy. These are areas where there are strong vested interests and pressure to delete certain aspects of the reform, or at least delay the necessary measures for prolonged periods. We wish the authorities well in their endeavors. Hence, we have no objection to the modification requested for the public sector borrowing requirement (PSBR), as we have noted that this is essentially to accommodate revised projections for the National Government. It is yet another sign of growing international acceptance of the intent of the Philippine authorities that the bulk of the PSBR will be met from external financing. Similarly, we have no serious reservations in concurring with the increased limits for base money. However, this should be carefully monitored, especially in the light of the statement that increased demand for currency still reflects a certain lack of public confidence in the system. I say this because, judging by the relative success of the authorities in renegotiating external debt and the contribution of tourist traffic to the balance of payments, the confidence of the foreign community in the system appears to have been restored much sooner than it might otherwise have been. I wonder whether Mr. Rye or the staff would comment on this.

Clearly, the commitment of the Philippine authorities to this very substantial series of structural reforms deserves the full support of the international financial community. We appreciate the great collaboration between the Fund and the World Bank--with the World Bank providing strong inputs to rearrange and monitor the investment program, the rationalization of the nonfinancial public corporations, and privatization. Similarly, in the matter of rescheduling of external debt, the Philippines deserves terms no less favorable than what have been seen in other debt agreements so far. It is hoped that donor countries will provide, through their intensified support, an added impetus to the Philippine effort.

On the exchange rate, it is of vital importance for the authorities to maintain and improve competitiveness. Certainly, the inflation record and the program targets in this respect would help. Equally important, the authorities should not become complacent in managing the exchange rate, in the context of the favorable balance of payments, strong reserves position, or the currently favorable terms of trade. The longer-term perspective requires a diversification of the commodity composition of exports.

Inevitably, when the national authorities of a country wish to embark on a comprehensive reform of economic policy and management, there is likely to result hardship to some groups of people. In this light, we fully understand the desire of the Philippine authorities to accelerate and expand the land reform program so as to relieve rural poverty. The objective, besides the social one, is to improve productivity. However, this is an area where a great deal of caution should be exercised. There are many countries that have followed this path only to find that, while some amount of benefit did accrue to the rural population, the economy suffered disproportionately. Perhaps we should flag this subject as another one to be implemented in close coordination with the World Bank.

With respect to reform of the government financial institutions (GFIs), I noticed that the Development Bank of Philippines is to be restructured. After shedding the nonperforming part of its portfolio, it is to concentrate on agriculture and small- and medium-sized industry to attain viability. By definition, these areas of lending entail high costs for credit delivery, monitoring and recovery. I would like to know something about the basis for such expectations. A good profit record will, of course, greatly facilitate the eventual privatization of this bank.

With respect to public corporations, especially the ones supplying public utilities like electricity, waterworks and the sewerage system, viability is sought through appropriate pricing, collection of arrears and efficient billing and collection. These are tricky areas. Is there any assurance that arrears due from the retailer (as in the case of electricity) are due to noncollection of arrears from final customers? The task can be quite complicated if the final customers have paid but the retailing organization has mismanaged the collections. I mention this detail not with a view to picking a hole in the program--it remains our conviction that it is excellent--but only to reflect a sense of pragmatism. In any event, we wish the authorities well in their endeavors, and we hope Mr. Rye will convey out best wishes to the authorities.

Finally, this chair supports the proposed decision on pages 44-45 of EBS/87/65 with paragraph 4 revised as in the circulated attachment.

Mr. Foot agreed with previous speakers that significant progress had been achieved under the stand-by arrangement approved in October 1986, despite the fact that growth had not picked up as quickly as the authorities had hoped. He tended toward the view of those who felt that even the most appropriate economic policies might not have hastened the pace of growth. For the period ahead, the authorities should remain committed to their import liberalization plans and he would welcome a progress report on the liberalization process in future staff papers. For example, Table 6 of the latest paper contained extensive information broken down by the number of items to be liberalized. But such information was of little value unless one had some idea of the relative importance of the categories concerned.

Like other speakers, he was concerned about the substantial increase in wages in the public sector, Mr. Foot continued. Unrealistically low wages could of course lead to inefficiencies of varying sorts; but too rapid an attempt to remedy long established inequities brought certain risks, and close monitoring would be required to ensure that more efficient work practices and streamlining of staff were promoted in return for the extra money to be spent.

He could strongly endorse the staff's emphasis on the need for caution in the stance of policy should growth again prove weaker than expected, Mr. Foot said. Where growth was being restrained by uncertainties, not wholly economic in form, it would typically be difficult to judge the appropriate stance of monetary policy. In the short term, a rapid buildup of liquidity might be willingly held and might thus lead to little or no price pressures. Such a situation could potentially unwind very rapidly, however, once confidence improved. Those factors might help to explain some of the recent unexpected trends in velocity, and careful monitoring of the situation was required.

Finally, on the proposed revisions in the draft decision, Mr. Foot observed that revised paragraph 4 made no reference to the elimination of the exchange restriction, a deletion he found disappointing. He could go along with the wording of the decision, provided that it was clearly understood that the restriction was based on a misunderstanding.

The staff representative from the Asian Department observed that broad money growth in 1986 had been about 13 percent, as projected in the program, although GNP growth had been lower. The staff did not believe that supply factors had limited the satisfaction of the demand for money and credit in 1986. Thus, commercial banks had been willing to satisfy the demand for credit, although they had been far more selective in meeting that demand. Moreover, real interest rates had remained high in 1986, in part because of the fairly high public sector deficit and because of lingering inflationary expectations. The program for 1987 anticipated a decline in real interest rates, which would encourage a pickup of private demand for credit as well as the emergence of the kind of demand the banks were prepared to satisfy. The program projected M3 growth of approximately 15 percent in 1987, a rate that would allow for a significant fall in velocity. For precautionary purposes, the staff had assumed that the currency/deposit ratio would remain at a fairly high level throughout the year, and the staff had built in flexibility with respect to monetary policy through the continuation of an additional margin for overperformance in net international reserves.

The reason the base money ceiling for December was being waived was that the central bank had been forced to expand base money faster than projected because the currency/deposit ratio had been higher than expected, the staff representative continued. As to whether it continued to be relevant or appropriate to use base money as a control variable in the program, Directors might recall that some years earlier, the staff had shifted from credit aggregates to base money precisely because, at the time, base money had appeared to be more closely related to developments in inflation and because developments in broad money had become rather unstable. Since that time, control of base money had significantly helped control of inflation, which, as Directors had noted, had declined to nearly zero. Moreover, the authorities had acquired some expertise in controlling base money, and they apparently found it a control variable of convenience. Of course, the staff would be flexible in monitoring base money and would not exclude consideration in future reviews of whether it was more appropriate to continue with a base money program or return to some other variable. In response to a related question from Mr. Yang, he noted that while base money had declined in the first quarter, that should perhaps be seen as a seasonal decline. If adjusted for the seasonal decline, base money would be seen to have performed as projected in the program.

Several questions had been raised on the public sector in the Philippines, the staff representative recalled. In particular, some had wondered whether the wage increase for civil servants would not stimulate competing demands in the rest of the economy. The authorities had argued that an upward adjustment had been long overdue; and even after the adjustment, a large proportion of national government employees remained below the poverty line and well below compensation levels in the private sector. In that respect, there was no fear of stimulating higher private sector demands.

On the matter of tax reform in the Philippines, the staff had received indications from the authorities that the remaining reform measures were being implemented broadly as envisaged, the staff representative commented. Some minor delays would affect the implementation of the measure changing the customs valuation base and the measure determining the ceiling on deductions for income taxes; but even those were expected to be in place no later than end-April. And the complex process of preparing for a value-added tax in January 1988 remained on track.

Commenting on the potential profitability of the Development Bank of the Philippines (DBP), the staff representative observed that the problems of the DBP in the past had risen mainly because the bank had been forced to extend credit to activities and projects yielding less than optimum returns. The Philippines did not have a broad-based industrial bank, and there was no reason why the DBP could not make a profit. Indeed, the tentative cash flow projections for 1987-88 showed the bank making a small profit on its operations after the transfer of its nonperforming assets and liabilities to other institutions.

On the external side, the staff representative recalled several questions on the debt-equity scheme and the discount in the secondary market. To the best of his knowledge, the discount for Philippine debt instruments was roughly 27-30 percent. On the currency composition of debt, 80 percent was denominated in U.S. dollars, while 16 percent was denominated in yen. In 1986, much of the increase in the debt/GNP ratio reflected simply a revaluation, which took into account exchange rate realignments in 1986 and in previous years when the debt had not been appropriately revalued. In that respect, more than half the increase in the ratio in 1986 was due to a revaluation.

Turning to other more specific questions, the staff representative noted, first, that the terms sheet agreement between the Philippines and the commercial banks had not yet formally been signed by the Philippine authorities. Second, on the question of whether delays in the growth of private sector activity had been due to delays in negotiating external financing arrangements, because the financing arrangements did not include new money, those arrangements in themselves had probably not affected private sector activity, although they had certainly played a part in the overall level of confidence, which was important to the growth of private sector activity. Finally, as to whether the new Philippine Investment Notes would substantially help the reflow of investment to the Philippines, it was too early to be able to identify the response of the banks to the investment notes or the debt-equity conversion scheme. The crucial issue was the discounted value, and the Philippine Investment Notes had one advantage in that equity investments through those notes would not carry charges in the form of fees. Hence, it was expected that the discount applicable to the Philippine Investment Notes would be smaller than the discount applicable to other debt-equity instruments.

The staff representative from the Exchange and Trade Relations Department, recalling Mr. Foot's concerns about the proposed revisions in the draft decision concerning the exchange restriction, observed that no time limitation on the extension of approval had been proposed. As had been indicated to Directors, the arrears had arisen because of a misunderstanding by the Philippine authorities, and the staff had been assured that the authorities were in the process of issuing the instructions required to clear those arrears. In that respect, it had not been felt necessary to set a limitation on the period of approval.

Mr. Rye reiterated the view he had expressed in his opening statement that the Philippine program itself was a strong one aimed at tackling the wide-ranging structural problems as well as the macroeconomic distortions in the economy. Moreover, he was impressed by the vigor with which the Government, in the face of many difficulties, was pursuing the restoration of the Philippine economy. In that respect, he had found one or two Directors overly pessimistic in their assessment of growth performance thus far. It should be stressed that the 2 percent growth rate in the second half of 1986 must be perceived as an annual rate of about 4 percent, which he found not a bad achievement in the circumstances. Moreover, there had been other indications of good performance in the early months of 1987, including data--such as the high level of cement production--showing that private investment might be rebounding.

The extremely difficult circumstances facing the new Government in the Philippines must not be underestimated, Mr. Rye continued. Perhaps a less exciting transfer of power might have provided a better basis for the long haul that the new Government undoubtedly faced. It must deal with an economy that had been plundered to serve private ends, a run-down and demoralized public sector, and a continuing situation of political doubt and fears as well as a massive insurgency problem in many of the outer provinces. Given those difficulties, he saw the progress in the economy as nothing short of outstanding. Of course, much depended on political developments from now on; but political consolidation had been greatly helped by the results of the referendum, and in recent months, there had been encouraging signs that the President was taking the reins of power firmly in hand. Of course, a further test of that observation would be the forthcoming election. Finally, he would pass the comments of his colleagues on to his Philippine authorities, who were looking forward with interest to the results of the Board discussion and views of Directors.

The Executive Board then took the following decision:

1. The Philippines has consulted with the Fund in accordance with paragraph 4(c) of the stand-by arrangement for the Philippines (EBS/86/222, Sup. 2, 10/28/86) and the second paragraph of the letter dated September 18, 1986 from the Minister of Finance and the Governor of the Central Bank of the Philippines, in order to review the progress in implementing the program supported by the stand-by arrangement and establish suitable performance criteria.

2. The letter dated March 10, 1987 from the Minister of Finance and the Governor of the Central Bank with annexed Memorandum on Economic Policy will be attached to the stand-by arrangement and the letter dated September 18, 1986 with annexed memorandum shall be read as supplemented and modified by the letter dated March 10, 1987 with annexed memorandum.

3. Accordingly,

(i) the limit on the public sector borrowing requirement referred to in paragraph 4(a)(i) of the stand-by arrangement shall be as specified in paragraph 7 and Table 2 of the Memorandum on Economic Policy annexed to the letter dated March 10, 1987;

(ii) the limit on base money referred to in paragraph 4(a)(ii) of the stand-by arrangement shall be as specified in paragraph 10 and Table 2 of the same Memorandum;

(iii) the limit on net international reserves of the monetary authority referred to in paragraph 4(a)(iv) of the stand-by arrangement shall be as specified in paragraph 15 and Table 3 of the same Memorandum;

(iv) the limit on the approval of nonconcessional external loans referred to in paragraph 4(b)(i) of the stand-by arrangement shall be as specified in paragraph 18 and Table 3 of the same Memorandum; and

(v) the limit on short-term debt referred to in paragraph 4(b)(ii) of the stand-by arrangement shall be as specified in paragraph 18 and Table 3 of the same Memorandum.

4. The Fund decides that the review contemplated in paragraph 4(c) of the stand-by arrangement is completed and that, notwithstanding the introduction of an exchange restriction giving rise to external payments arrears, the Philippines may proceed to make purchases under the arrangement. Moreover, the Philippines may proceed through June 15, 1987 to make purchases that shall not

cause purchases under the arrangement to exceed the equivalent of SDR 58 million, notwithstanding paragraphs 4(a) and (b) of the arrangement.

Decision No. 8567-(87/62), adopted
April 20, 1987

2. YUGOSLAVIA - ENHANCED SURVEILLANCE - ASSESSMENT OF RECENT POLICIES AND DEVELOPMENTS; AND EXCHANGE RESTRICTION - EXTENSION OF APPROVAL

The Executive Directors considered a staff paper (EBS/87/79, 4/13/87) assessing--in the context of enhanced surveillance by the Fund--recent policies and developments in Yugoslavia as described in a presentation by the Federal Secretary for Finance of Yugoslavia at the Paris Club meeting of March 30, 1987. They also had before them a paper containing a proposed decision extending the Board's approval of an exchange restriction until "the next interim review with Yugoslavia under enhanced surveillance, or September 14, 1987, whichever is earlier." (EBD/87/111, 4/17/87).

The Director of the European Department observed that Directors were meeting on short notice, despite a full discussion of Yugoslavia in the Board as recently as March 13, in response to a request made under the enhanced monitoring arrangement as applied to Yugoslavia. The Paris Club creditors had met on March 30 and had considered the recent staff report on Yugoslavia and the Chairman's summing up of the discussion at the conclusion of the Article IV consultation. They had also considered a statement by the Federal Secretary for Finance of Yugoslavia on recent economic developments and policies. At the March 30 meeting, the creditors had agreed on the proportion of debt that would be subject to rescheduling, but they had stated that the rescheduling would only become effective following their consideration of a further assessment by the Managing Director of the Fund of the measures described in the statement put forward by the Federal Secretary for Finance of Yugoslavia and attached to EBS/87/79. The Yugoslav authorities, for their part, had stressed that they were most anxious for the further assessment to be provided as soon as possible; after the meeting, the views of Directors, as expressed in the Chairman's summing up, would be conveyed to the Yugoslav authorities and, through them, to the Chairman of the Paris Club.

Mr. Posthumus made the following statement:

First, I would like to thank the Board for agreeing to consider the staff's assessment of the statement delivered by Minister Rikanovic at the Paris Club meeting only one week after the staff paper was circulated to the Board. My Yugoslav authorities hope and expect that this will contribute to an early conclusion of the discussions in the Paris Club and prevent further delays in the decisions to be taken by the commercial banks regarding the second stage of the multiyear rescheduling.

I would like to make one or two other remarks because this discussion offers me an unexpected opportunity to say a few words about two of the issues we discussed here on March 13, when the Article IV discussions took place in the Board. At that time, some Executive Directors had observed that in the past, intended policies had not always been fully implemented. They had regarded the date of April 1 especially important because on that date, the new real interest rate policy was expected to lead to an increase in nominal interest rates by more than 20 percentage points, from about 60 percent to more than 80 percent. I myself had acknowledged that the April 1 date was indeed an opportunity for the outside world to judge the determination of the authorities. I should like to point out that the intended increase in nominal interest rates was indeed carried out on that date. In fact, the measures taken went a step further.

This leads me to a second issue--the effectiveness of enhanced monitoring arrangements--on which some Executive Directors made comments during our March 13 discussion. As the Chairman's summing up indicates, enhanced monitoring depends in large part on the authorities paying heed in a flexible manner to the conclusions of the Board. I commented in my reaction that enhanced monitoring is not the same as the conditionality of a stand-by arrangement, which of course does not mean that the authorities should pay no heed to the conclusions of the Board.

I will not now make a formal link between the Board's conclusions and the measures the Yugoslav authorities took, e.g., with regard to real interest rates. But it is noteworthy that on April 1, not only the 12-month deposit rates but also the 6-month deposit rates were brought to positive real levels. In other words, there was a further tightening of policies, especially in the form of more positive real interest rates, by accelerating a measure originally planned for implementation January 1, 1988. Needless to say my Yugoslav authorities are firmly determined to implement the policies described in Minister Rikanovic's statement, which, considering the short-term economic and political difficulties encountered so far, requires, in my opinion, quite an effort.

Mr. Almeida noted that the Board was discussing Yugoslavia again, little more than one month from the time of the most recent Article IV consultation, basically at the insistence of official creditors. The official creditors and the Paris Club should be able to arrive at their own conclusions, given the elements available to them at the time of their discussions. In addition the problem was of a general nature, which would better be addressed on another occasion.

He was satisfied that the authorities had shown flexibility in their actions and had moved in the right direction on the basis of comments made in the last Board meeting on the matter, Mr. Almeida said. He was particularly happy to see that they had implemented legislation to control exaggerated growth in nominal wages; they had also raised the interest rates on 6-month deposits to the level of the discount rate, a very important step toward making all interest rates positive.

It was very encouraging to note the significant reduction of the trade deficit with the convertible currency area in the first quarter of the current year, Mr. Almeida considered. He did not expect the improvement to be sustainable through the year, but it was a good sign to see that the authorities had the courage and determination to change policies in the face of unexpected economic developments. Finally, he agreed with the extension of approval of the exchange restriction.

Mr. Foot considered that the staff paper (EBS/87/79) presented a clear and balanced assessment of the current situation in Yugoslavia, which was little different from that which had been apparent at the March 13 discussion of the Article IV consultation. The views of his chair presented at that time also had not changed.

Urgent action seemed necessary in a number of areas if the authorities were to restore confidence and deal with the widening financing gap that faced them, Mr. Foot continued. First, while nominal interest rates had risen on April 1, the value of the increase had been vitiated by the authorities' stated inability to apply the interest rate formula to deposits of less than six months. Thus, as the staff had noted, short-term interest rates remained highly negative in real terms. The 3-month rate had risen by a mere 2 percentage points--from 46 percent to 48 percent--and the result had been a sharp yield curve over the period. The reason given by the authorities for their action was that "a part of the long-term loan portfolio of the banking system continues to bear contractually fixed rates." While the argument was a reasonable one, he would welcome further details about how much of the banks' portfolio was in that form, at what rates business had been transacted, and how soon the loans would run out or could be converted to a more realistic basis. If it was not possible for the authorities to return to positive real rates at present because of the adverse effect on the profitability of the banking system, such information as he was requesting should at least help them to establish a timetable for achieving positive real rates.

Second, in the area of wages, Mr. Foot expressed the hope that the Yugoslav authorities would be able to indicate whether they would renew or extend the present intervention law when it expired later in 1987. It should be noted that one of the intervention laws passed in February had a rather odd feature, in that it linked changes in wages to changes in revenue per worker. Surely such a linkage was only an incentive for enterprises to push up prices as fast as the rules would allow; it was therefore ill designed for the purposes of wage restraint.

Third, it would be useful to know what the authorities intended to do following the current price freeze, including how they intended to remove the present distortions in relative prices, Mr. Foot commented. More generally, it would be helpful if the staff could offer a further opinion on whether current fiscal and monetary policy provided a sufficiently firm underpinning to ensure that the temporary benefits of the current wage and price restrictions were not dissipated as soon as the restrictions were lifted.

Fourth, the mechanism for foreign exchange allocation remained badly flawed in his view, Mr. Foot remarked. Appropriate changes would seem to be called for over a relatively short time span, and he would welcome staff comments on what changes might meet those requirements. Fifth, his authorities felt that there was a case for arguing that the dinar remained overvalued. If so, a timetable could usefully be established for its appropriate adjustment. Finally, he was happy to go along with the extension of the approval of the exchange restriction agreed to six weeks previously.

Mr. Schneider stated that he welcomed the recent progress with respect to the activation of Yugoslavia's rescheduling agreement with its official creditors as well as the demonstrated willingness of the authorities to implement additional measures in order to support that agreement. The recent legislative measures to reinforce the financial discipline of the enterprise sector and the progress made in adopting a structure of real interest rates were certainly going in the right direction. On the whole, however, he still had some doubts whether those measures would suffice to curb inflationary pressures in a lasting manner. In his view, they went only part of the way toward an appropriate interest rate structure, and, more generally, they were likely to increase the excessive official intervention in the process of price formation and economic decision making. He was therefore concerned that the effect of the measures on inflation might be short-lived and fail to lead to progress toward the achievement of a better allocation of domestic resources from which a durable dissipation of inflationary pressures could be expected.

In conclusion, Mr. Schneider said that he shared some of the staff's uneasiness about Yugoslavia's wider economic prospects, and that he hoped that the authorities would take the opportunity to use the time which they have gained for themselves with the present measures to prepare more comprehensive policies from which a lasting internal and external stabilization of their economy could be expected. Finally, he could support the proposed draft decision on the extension of exchange restrictions.

Mr. McCormack made the following statement:

> As I understand it, the purpose of this meeting is to comment on the statement of the head of the Yugoslav delegation to the Paris Club and to evaluate the extent to which this statement

significantly qualifies the Managing Director's summing up at the conclusion of the Article IV consultation with Yugoslavia in March of this year.

At the time of the Article IV consultation, this chair focused on monetary issues, and, in particular, on the need to adjust interest rates in Yugoslavia with a view to making them positive in real terms. The statement before us today suggests that some progress has been made in this direction. However, the adjustment is far from complete; in particular, interest rates on three-month deposits are significantly negative in real terms. I understand that the history of bank lending policy, and the constraints placed on bank interest rates in the past, have led to a situation in which precipitate adjustment could lead to bank losses. But this is a matter of degree only. Upward revision of interest rates on six-month and longer-term deposits will of itself tend to raise the average cost of funding to the banks. Funds held in the form of lower yielding three-month deposits will over time tend to move into the longer-term and higher-yielding categories. I wonder, therefore whether the magnitude of the problem involved in raising the rate on three-month deposits may have been overestimated by the authorities, insofar as they would seem to neglect the substitution possibilities between the various deposit terms. Also, the banks' capacity to absorb higher interest rates or term deposits is affected by the fact that a substantial volume of sight deposits attracts extremely low rates of interest. Over time, there will also be compensation on the lending side as new loans are negotiated at more realistic interest rates. More generally, the banks may be expected to benefit from a process of reintermediation as rates are allowed to approach market-clearing levels. On this point, it would seem that the authorities may be thinking in unduly static terms. I make this point not in a carping spirit but rather to encourage the Yugoslav authorities to move even further along the path they have chosen.

The staff's assessment makes clear that there is in concrete terms relatively little additional policy content in the recent statement of the Yugoslav authorities. Indeed, it would be unrealistic to expect there to be, given the short time which has elapsed since the Article IV discussion. However, the statement does give a very strong indication of the Government's determination to implement the policies required for creditworthiness to be fully restored, notwithstanding their short-run economic and political consequences. We note, in this context, that the staff's analysis points to a tension between competing balance of payments and growth objectives this year, making continued determination of the authorities both welcome and necessary.

On balance, I see the recent statement of the Yugoslav authorities as qualifying in a positive, but necessarily marginal, way the overall assessment which was reached at the conclusion of the Article IV consultation and which has been embodied in the summing up which was passed to the Paris Club. What we have learned subsequently does not call into question the fundamental soundness of that assessment.

Finally, I can agree to the proposed extension of approval of exchange restrictions concerning travel until completion of the next midyear review of policies.

Mr. de Forges said that since the previous meeting on Yugoslavia had taken place only five weeks previously, it was the orientation of policy rather than its results that must be considered. Tangible economic results often required more than 40 days to materialize. In his opinion, the most recent decisions by the Yugoslav authorities were generally headed in a positive direction. Nevertheless, as clearly recalled by previous speakers, much remained to be decided on and implemented. Without dwelling on the various relevant issues, which his chair had covered on March 13, he requested that the text of his chair's statement at EBM/87/44 be included in the minutes of the meeting (see Annex). He would recall only that his authorities considered it essential to implement the policies that the Yugoslav authorities recognized as necessary, all the more so since the uncertainties remained considerable, as clearly demonstrated--and in a favorable direction--by the surprising recent change in the trade balance vis-à-vis the convertible currency area.

The Yugoslav authorities must thus deepen their efforts to ensure that some temporary measures, such as the price freeze, will not render impossible the necessary move toward a firm reliance on market-oriented policies, Mr. de Forges observed. They will also have to demonstrate that the short-term difficulties, despite their magnitude, will not weaken the strength of their commitment. In that respect, his authorities were appreciative of the strength of the commitment expressed on March 30 by the Yugoslav representative in the Paris Club. An important part of that commitment had been clearly put into action by the decision on interest rates applied the following day, even if that decision was in his opinion only a partial one, as stressed by Mr. Foot and Mr. McCormack. He viewed the decision as a forerunner of other decisions, the adoption of which would be welcome.

Mr. Goos made the following statement:

I continue to feel that the Yugoslav authorities are pursuing quite commendable economic targets and that, in doing so, they have taken a number of encouraging steps in both the macroeconomic and microeconomic policy area. This overall impression, together with the underlying commitment to adjustment, has been reconfirmed by the statement presented by the head of the Yugoslav delegation to the Paris Club. And it has been reinforced, I believe, in important aspects by the adoption of new measures since our last Board meeting.

Nevertheless, I agree with the staff and previous speakers that economic prospects for Yugoslavia remain subject to considerable uncertainties that are related both to the specific policy mix currently pursued by the authorities and their ability to successfully implement those policies. I can refrain from elaborating in detail on those uncertainties because they are adequately covered in the staff appraisal. The recent change in the interest rate formulas undoubtedly constitutes a most welcome step in the right direction, and this certainly also applied to the continued efforts to contain wage and price pressures and to strengthen financial discipline in the enterprise sector. But it appears that the present policy stance continues to lack a certain degree of comprehensiveness and consistency with regard to the declared intention to "build an efficient market-oriented economy." I appreciate of course the economic and political difficulties the authorities are facing in the process of reform. But perseverance in that process and--wherever possible--its strengthening would certainly be in the best interest of the country.

In this regard, I feel that the statement of the authorities contains a number of encouraging elements, including their acknowledgment of the desirability of introducing positive real interest rates on short-term deposits and their intention to move toward a more indirect and, hence, more efficient global system of money and credit control. It is to be hoped that before long they will also be able to replace the existing administrative regime in the areas of price and wage policy and in the allocation of foreign exchange with more market-oriented procedures, which, of course, would have to be supported by the pursuit of sufficiently restrictive financial policies. Finally, I support the proposed extension of the approval of exchange restrictions.

Mr. Zecchini made the following statement:

The most recent economic measures announced by Minister Rikanovic do not introduce elements that are significantly different from those that characterized the orientation of Yugoslavia's economic policies at the time of the previous Board meeting on Yugoslavia. Minister Rikanovic's statement is, however, important to the extent that it reaffirms the willingness of the authorities to go ahead with the implementation of the adjustment measures previously announced and adds the indication of new, cautious steps in the direction advocated by the Fund.

We understand that political and social difficulties surround the introduction of austerity measures. Therefore, beyond the declarations of intentions, it is essential for us to see whether the country actually moves in the right direction consistently over time. In this respect, the latest declarations of Yugoslavia are encouraging, since they indicate that the authorities are gradually moving in the right direction. Of course, in the case of Yugoslavia as in all the other cases, the speed of adjustment and economic reform has been attuned to the political reality of the movement. This is possible only if such speed is also in line with the availability of foreign exchange. If external financing from both official and private resources is not easily available because of doubts about the medium-term viability of the external position as well as the country's economic policies, then the country has no other choice but to strengthen its adjustment efforts in order to upgrade its external creditworthiness.

In the case under discussion, such an upgrading does not seem clear in the light of Yugoslavia's latest declarations concerning monetary and wage-price policies. On monetary policy, the recent increase in the six-month deposit rate does not appear fully adequate to reverse the ongoing tendency toward banking disintermediation. In fact, real levels of interest rates for deposits of less than six months remain negative. This does not help to achieve a better control of monetary aggregates, since it constitutes an incentive to the persistence of a wide market for deposits among nonfinancial enterprises and, consequently, tends to undermine the effectiveness of the credit ceilings.

As to wage-price policy, the authorities should bear in mind that the price freeze will provide only short-lived results if it is not supported by a tightening of monetary policy. Moreover, if this freeze is going to be retained for many months, it will tend to accentuate distortions in resource allocation.

On wage policy, the authorities' newly proposed controls on wage dynamics are welcome to the extent that they are part of a wider strategy of aggregate demand management which is aimed at controlling inflation without endangering the development and investment prospects of the economy.

Unfortunately, such a wider strategy lacks consistency in some of its elements. For instance, on the fiscal side, the containment of public expenditure growth in relation to revenue expansion is still limited to half of the accounts of the public sector, leaving unchecked the expansion of items like pension and defense expenses. At the same time, a containment of public investment is envisaged. As to the overall stance of fiscal policy, it is doubtful whether these initiatives will be able to reverse the trend projected last March of an increasing ratio of public expenditure to GDP.

In conclusion, we welcome the latest statements of the Yugoslav authorities since they show some determination in pursuing the adjustment program, even at the cost of adopting unpopular measures. Nevertheless, the most recent measures are not sufficient to dispel some of the doubts we expressed last March about the adequacy of present policies in bringing about a balanced, and therefore sustainable, growth of the economy in the years ahead.

Mr. Rye made two points. First, he was a little uneasy to be having the discussion at all so soon after giving full consideration to Yugoslavia's economy and its economic policies. Of course, he accepted the staff's opening comments, but he would not like to think that any precedent was being set whereby the Paris Club might come to regard the Fund at its beck and call. He hoped that some such reservation might be conveyed to the Paris Club through one channel or another.

Second, on the merits of the matter at hand, while having every sympathy with the Yugoslav authorities, Mr. Rye added, he was bound to say that the scale of their response did not yet seem commensurate with the scale of their economic problems. Certainly, as the staff report said, "it is helpful to have in the statement a strong confirmation of the Government's determination to implement these policies despite the short-run economic and political difficulties foreseen." But he also agreed that "on the factual information available to date...uneasiness about Yugoslavia's economic prospects cannot yet be adequately dispelled." That last phrase was an understatement at best.

In short, Mr. Rye considered that the Chairman's summing up at the conclusion of the March 13 meeting needed very little amendment or qualification. Finally, he supported the extension of approval of Yugoslavia's exchange rate restriction.

Mr. Dai made the following statement:

I need not repeat the views I expressed a month ago during the discussion of the Article IV consultation with Yugoslavia. The problem before us today is to make a further assessment of policies and developments in order to expedite the activation of the rescheduling agreement already agreed upon, in principle, between Yugoslavia and its creditors. In my view, on the basis of the statement by the head of the Yugoslav delegation at the recent Paris Club meeting on March 30 on current economic developments and the stance of policies, and on the basis of the latest information provided to us by the staff, a considerably positive, favorable, well-balanced assessment by the Fund is appropriate and desirable so as to facilitate the rescheduling and help the Yugoslav Government overcome its financing difficulties and resume its accelerated economic reform and stabilization program.

The measures which have been taken, and are to be taken, by the Yugoslav authorities are quite comprehensive and tough, despite the possible social trauma and political difficulties that are foreseen in their implementation. This explicitly shows and confirms the strong determination of the Yugoslav authorities to implement the policies and their willingness to cooperate with the Fund.

Since the problem of excessive investment and overconsumption, with the resultant high inflation and external imbalance, seems rather serious and complex, and given the very recent date of the adoption of many policy measures, some time must pass before the economic adjustment and the stabilization program of the Yugoslav Government can be fully and effectively carried out. It is understandable that some measures have to be carried out step by step. The specific situation in Yugoslavia should be fully taken into consideration when making an assessment and proposals.

In view of the orderly payment of its foreign debt by the Yugoslav Government in the past few years, a positive and favorable assessment would be a signal of encouragement and would strengthen the confidence of the financial markets at a time when many commercial banks have been reluctant to become involved in new lending, which was a cause of serious concern in the recent Interim Committee Meeting, and every effort should be made to restore the confidence of the international banking community. Finally, I agree with the proposed decision on extension of approval of exchange restrictions.

Mr. Salehkhou began by expressing his support for the draft decision regarding the extension of the approval of Yugoslavia's exchange restrictions. The authorities' commitment to implement various measures to correct the economic imbalances, as elaborated in the statement of the head of Yugoslavia's delegation at the Paris Club meeting and in the staff paper before us, was welcome. The staff appeared overly cautious in its assessment of Yugoslavia's economic situation and of the sufficiency of the courageous measures adopted by the authorities. However, such caution appeared to stem mostly from past performance of the economy rather than the adequacy of the adopted measures. For his part, he was encouraged by Mr. Rikanovic's statement as well as Mr. Posthumus's opening remarks, and he wished the authorities every success in their endeavors.

Mr. Yamazaki said that as they had at the time of the discussion on Yugoslavia in March, his authorities commended the Yugoslav authorities for their adjustment efforts to date. They welcomed, at the present time, the confirmation of the Yugoslav authorities' determination to implement adjustment policies as outlined in the statement delivered at the Paris Club meeting. However, they noted from the staff paper that many of the measures described in the statement were already announced or in train at the time of the Article IV consultation with Yugoslavia in March; for that reason, they believed that the main thrust of the Managing Director's summing up of the Board meeting at that time remained valid. Therefore, his authorities continued to urge the Yugoslav authorities to strengthen further their adjustment efforts along the lines suggested in the Managing Director's summing up. Finally, he supported the proposed decision.

Mr. Dallara made the following statement:

The May 1986 Agreed Minute between the official creditors and Yugoslavia made the entry into effect of a second stage of official debt rescheduling dependent upon a positive assessment by the creditors that Yugoslavia is implementing a comprehensive and satisfactory economic program. In light of the rather critical report produced by the staff and, in effect, endorsed by the Board on Yugoslavia's economic performance under the enhanced surveillance arrangement, which had been reviewed in this Board on March 13, I believe that it is perhaps not surprising that the creditors sought some further views from the Fund regarding Yugoslavia's economic policies and prospects.

Like Mr. Rye and others, however, we wonder about the particular approach which has been requested by the Paris Club. It seems to us that it would have been more appropriate to request the Fund to actually conduct an accelerated consultation with the Yugoslav authorities under the provisions which created this possibility in the appropriate Agreed Minute, rather than to ask the staff and the Board to, in effect, conduct a further review and analysis of policies that were largely in place or at least announced at the time of our March discussion. As many Directors have noted, there have not been fundamental changes in policies or economic developments that the Board was unaware of at the time of that review, so it is not at all clear what this discussion can add or detract. Nonetheless, we are prepared to participate in this review, but we hope that in future, the Paris Club could focus on potentially more effective means of using the Fund's role in this enhanced surveillance process. This is because a repetition of this particular approach, without further consultations between the authorities and the Fund staff seems to us to run the risk of undermining the Fund's own credibility in enhanced surveillance.

Turning to policies and performance, I need not repeat the rather critical comments which I made at the March 13 meeting, since we consider them essentially valid today. This is true, in light of the fact that we had already fully taken into account the measures adopted by the authorities in December and February and had, to a degree, already anticipated the interest rate changes of April 1. There are a few aspects of the picture which are somewhat new, however. Let me comment briefly on those.

First, with regard to the balance of payments and financing outlook, substantial uncertainties would appear to remain, despite the reduction in the first quarter in the convertible currency trade deficit in relation to the comparable period last year. We wonder now whether the staff will be revising its trade estimates for the year in light of the first quarter results. We also wonder, as the staff seems to do, whether continuation of the sharp decline in imports in the first quarter is at all consistent with the growth projections of the authorities and the staff and with other economic parameters. Any further thoughts the staff or Mr. Posthumus may have on this would be helpful.

We welcome the move on April 1 toward positive real interest rates, including the shift in the reference rate from a 12-month to a 6-month rate. But, it is regrettable that the 3-month rate is not being used as the reference rate, since this would make a more effective contribution to keeping short-term enterprise liquidity within banking channels, avoiding a further buildup of the foreign currency component of the money supply, and avoiding capital flight. In addition, we remain somewhat less than fully persuaded that the new interest rates are truly positive in real terms in light of inflation in the first quarter, which was at an annualized rate of something approaching 130 percent.

On wage and price policy, we support attempts to reverse the large overshooting of wage targets last year. The resort to another partial price rollback, however understandable it may be on political grounds, does, in our view, represent a step backward in price deregulation, an area where the record has been quite erratic.

In concluding, we welcome the measures the authorities took in December, February, and April, and we join other members of the Board in welcoming the clear reaffirmation by the authorities to implement these measures forcefully. After all, in the past, concerns regarding Yugoslavia's economic performance were related not so much to announced policies; frequently, the difficulties were associated with the absence of full and complete implementation in a timely manner of these policies. Therefore, we welcome this reaffirmation. Nevertheless, we continue to have serious concerns about the adequacy of current policies and economic prospects. We share the uneasiness expressed by the staff and reiterate our hope that the authorities would implement announced policies as appropriate. In addition, we hope that they take additional steps along the lines of those suggested in the earlier staff report and alluded to again in the latest report, in order to strengthen their policies and their economic prospects.

Mr. Morales noted that as mentioned in the staff appraisal, it was helpful to have in the context of the Paris Club a strong confirmation of the Yugoslav Government's determination to implement the policies mentioned in the Board's discussion of March 13, 1987, in the circumstances of the Article IV consultation. In that connection, he welcomed the authorities' recent decision to raise the interest rates on 6-month deposits (which made available deposits at positive interest rates) and their commitment to continue to fight inflation, as reflected in the measures taken on wages. Within the limitations of the short period since the previous discussion, he believed that the implementation of policies was in the right direction and he encouraged the Yugoslav authorities to continue their efforts in that connection. Finally, he supported the proposed decision approving the extension of restrictions on travel.

Mr. Fernandez made the following statement:

> On the occasion of the Board meeting on Yugoslavia on March 13, 1987, this chair welcomed the economic measures announced by the Yugoslav Government described by Mr. Posthumus in his opening statement. We also pointed out some of the imbalances remaining--as shown by the recent economic performance--but gave the authorities the benefit of the doubt in recognizing their sincere efforts in dealing with the main macroeconomic and structural problems.
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> The statement made by the representative of Yugoslavia at the Paris Club meeting of March 30 reinforces our earlier views since, as the staff indicates, "much of the content of the authorities statement re-emphasizes policy intentions announced before the conclusion of the last Article IV consultation with Yugoslavia." Thus, once again, I would like to express my support for the efforts made by the Yugoslav authorities in facing the difficult economic challenges emerging from the present economic situation, and I encourage them to fully implement the policies outlined in the statement presented by the Yugoslav delegation to creditor countries.
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> We agree with the authorities that a basic policy objective for the Yugoslav economy should be the attainment of a position in which balance of payments needs and debt service are financed by means of normal capital inflows, without recourse to trade and exchange restrictions. Progress has already been made to enhance financial discipline of public enterprise, align interest rates, and moderate wage increases. Further progress should be made in deregulating prices and interest rates, but we acknowledge the authorities' explanations, regarding the timing of its application, to delay stronger measures in these fields.
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> We also value as positive developments the adoption of new accounting and real depreciation systems, the Rehabilitation and Bankruptcy Law, and prospective measures that would tend to enhance the authority and autonomy of the National Bank of Yugoslavia.

There is one point that was of concern to a number of Directors during our discussion one month ago, and that the staff does not mention in today's paper. I refer to the balance of payments financing gap estimated by the staff at about $900 million for 1987. The authorities strongly disagreed with this estimate. I would appreciate further comments by the staff on this important point.

Despite the so-called factual information available to date, the firm commitment of the Yugoslav authorities to adequately deal with present difficulties, both internal and external, is clear to us, and I would like to stress that our response to official creditors must be based on this point.

We believe that a positive assessment should be given of the measures in the statement by the head of the Yugoslav delegation to the official creditors' meeting in Paris on March 30, 1987. Finally, this chair agrees with the extension of approval of the foreign exchange restrictions as approved in the Executive Board's decision of March 13, 1987.

Mr. Puro said that he welcomed the opportunity to review the recent economic policies in Yugoslavia. He noted with satisfaction the discussions in the Paris Club, which would seem to provide the Yugoslav economy with some needed external financial relief.

The concise staff paper indicated that only minor improvement had taken place in the Yugoslav economy in recent months, Mr. Puro added. The reduction in the trade deficit with the convertible currency area was to be welcomed. However, as the staff indicated, it was difficult to expect the development to be sustained throughout the year.

The authorities have recently taken several measures intended to provide scope for improved economic development, Mr. Puro continued. Among them, the rise in interest rates was a step in the right direction, although only a partial one. Further measures had to be taken in order to reach and sustain positive rates.

In the area of wages, the authorities' policy relied heavily on the intervention laws, Mr. Puro remarked. He wondered whether that kind of rather rigid ruling could be successful in the long run. Although short-term gains might be reached, the risk for considerable wage increases could be substantial after the expiration of the intervention laws. A rather similar regulatory attitude applied also to prices. It was regrettable that market forces were not allowed to play a larger role in that area.

All in all, Mr. Puro said that he welcomed the authorities' determination to cope with the difficult economic problems. At the same time, the adoption of more market-oriented measures would increase confidence so that the economy could gradually reach a more balanced state. Finally, he supported the proposed decision.

The Director of the European Department agreed with those who felt that experience thus far with enhanced monitoring in the Yugoslav case raised a number of questions, which would no doubt have to be considered at another time. On the substance of the meeting at hand, it was understandable--given the short time between the Article IV consultation and the present meeting--that no major policy changes had been observed, and he could limit himself to responding to one or two specific questions on fiscal and monetary policy. In that regard, some 20 percent of bank loans were made at fixed interest rates, but that figure should be seen in light of the relatively large proportion of sight deposits available to the banking system. Those sight deposits carried an interest rate of approximately 5 percent, which was a negative rate in circumstances of inflation of over 100 percent.

On the adequacy of fiscal and monetary policy in Yugoslavia, the staff's views were essentially the same as those that had been expressed in the paper prepared for the March 13 discussion, the Director continued. The staff had not had time to assess the most recent data, although those suggested that public expenditures were running notably higher in 1987 than in 1986. Moreover, credit to the banking system was proceeding at a rate that would make it unlikely that the Yugoslav authorities would be able to keep within their self-imposed ceilings for the first quarter of 1987. As he saw it, the most important single action the Yugoslav authorities could be expected to take reasonably quickly in the circumstances was to move forward on interest rates to ensure, in particular, that the shorter deposits bore positive rates of interest. Positive real interest rates were especially important for the enterprise sector, and a tightening of monetary policy seemed the necessary precondition for any further action on the exchange rate or the foreign exchange allocation system; indeed, such a tightening was necessary even for the authorities to begin freeing up the wage and price system in Yugoslavia.

Remarking on the trade picture for Yugoslavia, the Director of the European Department commented that the first quarter reduction in the deficit was welcome, although the way in which the deficit had been reduced--primarily through a sharp fall in imports--underlined the inconsistency between growth targets and the balance of payments targets of the authorities under present policies. However, the staff was not in a position to revise its balance of payments targets for the year as a whole.

Mr. Posthumus said that he shared the uneasiness of those who had expressed concerns about holding a discussion on Yugoslavia so soon after an Article IV consultation discussion. Although he believed that the Fund could play a constructive role in the framework of enhanced surveillance--as it was being asked to do in the present case--he agreed that the matter should be taken up in a more general discussion at a later stage in the Board.

It was fair to say that many Executive Directors had accepted that the measures adopted by the Yugoslav authorities were in the right direction, even though a number of them had been announced earlier, Mr. Posthumus continued. As he understood it, however, the feeling of some Directors was that many of the measures were not sufficient and, more particularly, were not being viewed as elements in an overall adjustment strategy. He would convey those comments to his authorities.

The staff representative from the European Department, responding briefly to questions on interest rates in Yugoslavia, noted that during the period of the stand-by arrangement, the producer price index had been determined as the most appropriate basis on which to measure interest rates. During the most recent Article IV consultation, and in the course of the staff's subsequent discussions with the authorities, the staff had expressed concern that the producer price index might be a less adequate reflection of the underlying rate of inflation than the consumer price index, although that concern had not led to a recommendation that the system of measuring real interest rates should be changed. Rather, the recommendation had been that price controls should be eased. It was fair to state at present that if one wanted to correct the assessment of underlying inflation for price controls, the consumer price index might well be a better index than the producer price index. In any event, the fact was that as measured by the producer price index, interest rates of six months or longer were positive, while they were negative when measured by the consumer price or wholesale price indices.

The Acting Chairman made the following summing up:

> Directors noted that the Executive Board had had an opportunity to discuss Yugoslavia's policies while concluding the 1986 Article IV consultation on March 13, 1987. Subsequently, at a meeting in Paris on March 30, 1987, on the renegotiation of Yugoslavia's official debt, it had been agreed that the creditors would reschedule, but only after further consultations on the basis of an assessment by the Managing Director of the measures described in the statement by the head of the Yugoslav delegation at that meeting. It was observed that the Board discussion of that statement and the staff's analysis (EBS/87/79) was intended to facilitate further consideration of the rescheduling of Yugoslavia's official external debt.
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> Directors welcomed the policy measures described in the statement by the head of the Yugoslav delegation which they felt were a step in the right direction. They also welcomed the fact that the statement strongly underlined the Government's determination to continue to make the necessary adjustments. However, it was noted that the majority of the proposals had been known at the time of the previous Board meeting, and those that were new went only part of the way toward what Directors felt would be necessary to address the problems facing Yugoslavia. Of the new measures, Directors agreed on the importance of the decision to raise the interest rate on six-month deposits to that of the discount rate, noting that this action meant that deposits of six months and longer would now bear slightly positive real

interest rates when measured against the producer price index. Directors expressed their concern, however, that the authorities' action did not go far enough and that real interest rates on deposits of less than six months had become more negative, so that savers would continue to have little incentive to hold short-term dinar deposits in the banking system.

Many Directors were impressed by the resolve of the Yugoslav authorities to stem the rise in wages, but some were concerned about likely wage developments after the expiration of the intervention laws, and they expressed the hope that the authorities would soon outline their intentions in that regard. With respect to the renewal of price controls, Directors expressed concern that such controls would increase distortions and they regretted what they perceived as a move away from the goal of full price liberalization. It was thought that action was needed to increase the role of market forces in the Yugoslav economy, especially in the areas of price determination and the allocation of foreign exchange. It was also stressed that such liberalization would need to be supported by restrained fiscal and monetary policy in order to prevent an increase in inflation.

In general, Directors welcomed the determination of the Yugoslav authorities to address the economic problems facing Yugoslavia. They believed, however, that a lasting improvement in the economic situation would be contingent upon a further strengthening of the policies along the lines suggested in the previous staff report and as stressed by Directors during the most recent Article IV consultation and included in the Managing Director's summing up at that time.

The Executive Board then took the following decision:

The approval of Yugoslavia's exchange restriction under Executive Board Decision No. 8549-(87/45), adopted March 13, 1987, is extended until the completion of the next interim review with Yugoslavia under enhanced surveillance or September 14, 1987, whichever is earlier.

Decision No. 8568-(87/62), adopted
April 20, 1987

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/87/61 (4/17/87) and EBM/87/62 (4/20/87).

3. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/87/83 (4/16/87) is approved.

4. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director as set forth in EBAP/87/84 (4/17/87) is approved.

APPROVED: November 4, 1987

LEO VAN HOUTVEN
Secretary

Statement by Mrs. Ploix on Yugoslavia delivered at EMB/87/44 (3/13/87).

The staff report we are considering today gives a very clear picture of the disappointing recent developments in and upcoming challenges for the Yugoslav economy. I will not dwell at length on the first of these aspects. Previous speakers have already forcefully described the extent to which the poor results of 1986 were already foreseeable when we examined the Yugoslav program last August. As expressed in the Managing Director's summing up: "Directors expressed doubts about the plausibility of achieving the main objectives of the 1986 quantified economic program. The recent measures introduced would not produce a lasting improvement of growth and inflation."

This having been said, I would like to concentrate on structural reforms and macroeconomic policies, that is to say, on the policies needed for the Yugoslav economy to grow in an orderly and sustainable way, and to be able to maintain the requisite good relations with its creditors.

I shall in the first instance commend the authorities for some of the structural measures already decided on, such as the improvement of the enterprise accounting system, the treatment of unprofitable enterprises, the relationship between wages and the performance of enterprises and, at least in spirit, interest rate policy. These measures address some of the most fundamental and lasting problems that burden Yugoslav economic development. If completely implemented--namely, with more determination than previous reforms, which were weakened because of internal difficulties--they will represent an important step. In the same structural vein, we do agree with the staff that these measures should be complemented by lowering state controls in various respects, such as price determination or foreign exchange allocation. This would lessen recourse to burdensome, inflexible systems of control, and permit the Yugoslav economy to rely more directly on market signals to achieve more efficient resource allocation.

In order to be truly effective, these reforms must be accompanied by other policies of a more macroeconomic nature. In this respect, I share the staff's concerns and will limit myself to commenting on monetary policy, fiscal policy, and the external side.

The success of the tighter monetary policy and its effects on inflation will clearly depend on the rates of interest; the present real interest rate structure gives too much room to disintermediation and grey market processes. In this respect, I confess that the highly regulatory way in which the authorities chose to lead the banks to increase their lending rates appears to be inadequate, given the tighter control by the central bank necessary for the success of such a policy. In any case, such regulatory measures should be complements to more directly market-oriented decisions, like a direct raise in the rate on deposits.

As to fiscal policy, the slippages registered during 1986 necessitated a strong reaction in 1987 in order to achieve the objective of containing the share of public expenditures in GSP. The authorities have to maintain the firm stance they have taken because the apparently tough mechanism for deciding on ceilings will lose a great part of its strength owing to the size of the exemptions and the very permissive initial point of reference, namely, the last quarter of 1986.

On the external side, I wish first to stress that the large differences in the forecasts for 1987 by the Yugoslav authorities and the staff are a real source of concern. I would like to learn from Mr. Posthumus or from the staff whether further thoughts have led to a narrowing of these differences. Indeed, the re-establishment of normal relations between Yugoslavia and its creditors depends not only on an orderly financing of its balance of payments requirements, but equally on increased confidence in the reliability of the projections.

I have noted the uncertainties about the real external value of the dinar. Thus far the Yugoslav authorities have managed the exchange rate with flexibility, and I urge them to continue to do so to avoid any loss of external competitiveness. As recalled by the staff and recognized by the authorities, it will be possible to achieve the medium-term debt ratio target only through sizable current account surpluses. To be translated into results, the very optimistic assumption by the authorities for 1987 requires a most favorable international environment and far more stringent domestic policies than those currently being pursued.

To conclude, we see once again a need for the Yugoslav authorities to translate more firmly into reality the market-oriented policies which they willingly recognize as necessary. The Yugoslav authorities have to control the structural adjustment process if they want to foster less inflationary growth and restore Yugoslav external credibility. It cannot be denied that recent developments "had corrosive effects on the confidence of Yugoslavia's creditors and called into question both the sustainability of the adjustment effort and the feasibility of combining adjustment and growth." It is therefore necessary that significant measures in the areas mentioned above be announced and firmly implemented within a short time. Such measures would indeed have a strong favorable impact on the Yugoslav economy and would provide the international community with a positive signal of the Yugoslav authorities' real willingness to enhance the adjustment effort initiated during past years.