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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/28

10:00 a.m., February 18, 1987

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

Executive Directors	Alternate Executive Directors
A. Abdallah	E. T. El Kogali
	J. M. Jones, Temporary
	Song G., Temporary
	M. Lundsager, Temporary
J. de Groote	
A. Donoso	E. Feldman
	T. Alhaimus
	B. Goos
	K.-H. Kleine, Temporary
J. E. Ismael	J. Reddy
A. Kafka	
	M. Foot
H. Lundstrom	
M. Massé	G. D. Hodgson, Temporary
Mawakani Samba	
Y. A. Nimatallah	I. A. Al-Assaf
G. Ortiz	
H. Ploix	S. de Forges
G. A. Posthumus	
C. R. Rye	
G. Salehkhou	O. Kabbaj
A. K. Sengupta	
K. Yamazaki	
S. Zecchini	N. Kyriazidis

L. Van Houtven, Secretary
R. S. Franklin, Assistant

<u>Also Present</u>
IBRD: P. M. Cadario, Western Africa Regional Office; J. B. Sokol, Latin America and the Caribbean Regional Office. African Department: G. E. Gondwe, Deputy Director; E. A. Calamitsis, J. Damon, P. J. Duran, S. L. Rothman. Exchange and Trade Relations Department: M. Guitián, Deputy Director; G. Begashaw, J. Berengaut, C. Brachet, E. Brau. External Relations Department: H. P. Puentes. Fiscal Affairs Department: V. Tanzi, Director; M. I. Blejer, G. A. Mackenzie. Legal Department: F. P. Gianviti, Director; H. Elizalde, A. O. Liuksila, J. V. Surr. Research Department: J. A. Frenkel, Economic Counsellor and Director; L. Alexander, N. M. Kaibni, E. C. Meldau-Womack, R. Pownall. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; H. Arbulu-Neira, C. V. A. Collyns, J. Ferrán, D. N. Lachman, B. C. Stuart. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: E. Ayales, A. Bertuch-Samuels, M. B. Chatah, L. P. Ebrill, S. M. Hassan, J. Hospedales, K. Murakami, J.-C. Obame, G. Pineau, I. Puro, D. C. Templeman, N. Toé, A. Vasudevan. Assistants to Executive Directors: A. R. Al-Abdullatif, H. Alaoui-Abdallaoui, F. E. R. Alfiler, J. R. N. Almeida, H. S. Binay, J. de la Herrán, F. Di Mauro, W. N. Engert, M. Hepp, G. K. Hodges, L. Hubloue, S. King, M. A. Kyhlberg, V. K. Malhotra, T. Morita, A. H. Mustafa, C. Noriega, J. K. Orleans-Lindsay, S. Rebecchini, C. A. Salinas, G. Seyler, H. van der Burg, D. A. Woodward.

1. GUINEA - REVIEW UNDER STAND-BY ARRANGEMENT; AND EXCHANGE SYSTEM

The Executive Directors considered a staff paper on the second review under the stand-by arrangement for Guinea, together with Guinea's request for modifications (EBS/87/14, 1/26/87; and Cor. 1, 2/5/87).

The staff representative from the Exchange and Trade Relations Department remarked that when the mission conducting the review had departed from Conakry in mid-December 1986, the expectation had been that the exchange rate and interest rate measures necessary to secure Fund management's support and allow for a timely completion of the review by the Executive Board would be adopted at the latest in early January 1987. The papers had been prepared with a view to early circulation to Executive Directors and to a Board meeting toward the end of January, a time prior to the date for which it was proposed that the performance criteria for the remainder of the arrangement should be set.

Directors would have noted that some of the measures had not been taken until late January, the staff representative continued. As a result, the policy memorandum had not been signed and forwarded to the Fund until January 22, and the staff paper had not been circulated to Directors until January 23, which explained the late date for the Board's discussion on Guinea and the unintended, although not unprecedented, call for an ex post discussion of performance criteria.

The delays he had mentioned notwithstanding, the staff was encouraged by the latest developments in Guinea, the staff representative commented. The auction market was functioning as freely as could be expected in a country where the Central Bank remained the largest source of supply of, and demand for, foreign exchange. The rate in the most recent auction had been GF 410 per dollar, and the Central Bank had been a net buyer. Also encouraging was the fact that the spread with the parallel market rate in the latest auctions had been less than 10 percent. That narrowing of the spread had been one of the objectives of the authorities.

Another welcome development had been the strong response of output--especially of rice and coffee--to the change in relative prices, the staff representative said. And the international reserves, which had deteriorated significantly between July and November 1986, had strengthened by December 1986 and January 1987. Given those developments, the staff felt that the Guinean program was generally back on course even if, with the slippages in policy implementation in the second half of 1986, the economy at the beginning of 1987 was not in quite as strong a position as might have been hoped. The momentum of policy seemed to have been firmly established, and in a recent visit with the Managing Director at Fund headquarters, the authorities had reiterated their determination to implement the program and improve performance. They had on that occasion requested a mission to discuss the possibility of adopting a program under the structural adjustment facility and financial support in the upper credit tranches. Work on those matters was expected to coincide with the next

Article IV consultation, and a mission would leave for Guinea as soon as work with World Bank staff on the policy framework paper had been completed.

Mr. Mawakani made the following statement:

This second review of Guinea's economic and financial program under the stand-by arrangement approved a year ago gives the Guinean authorities the opportunity to reaffirm their commitment to pursue adjustment efforts to correct the deep-seated imbalances in their economy. Fundamental to the success of this undertaking is the pursuit of efforts to shift the economy from one characterized for more than two decades by central planning and control to one regulated mainly through the market.

At the conclusion of the first review of the program in August 1986, it was noted that the Guinean authorities had successfully implemented the initial policy measures aimed at improving resource allocation and reducing the size and responsibilities of the large public sector while promoting an efficient private sector. Indeed, substantial progress was made during the first six months. Sweeping reforms were made in the banking and monetary systems. The exchange rate was significantly adjusted and a foreign exchange auction system was introduced. The marketing system and most prices were freed from administrative controls. Moreover, cautious fiscal and monetary policies helped in containing the underlying rate of inflation, and steps were taken to restructure the public enterprise sector. Progress was also made to reduce the size of the public service and to loosen the Central Government's direct involvement in activities of the productive sector.

The staff has mentioned in its report that following the satisfactory implementation of the initial phase of the program, the pace of reform has slowed considerably in the second half of the program period, with very few of the policy commitments being carried out. This observation must be viewed in the light of the fact that the Guinean authorities decided to embark on a bold experiment of economic and financial reform under a relatively new and untried environment, with a fresh administrative setup that was charged with the responsibility to implement far-reaching measures involving almost all facets of the Guinean economy. The challenges that the authorities faced were formidable. As the staff itself has observed on pages 21 and 22 of its report, the objectives that the authorities set were perhaps overly ambitious, "given the problems of administration and implementation that the authorities were bound to face." Nonetheless, progress has been made in many respects.

Undaunted by the temporary setback in program implementation, and given their commitment to the adjustment process, the Guinean authorities are determined to carry through the reform measures under way in order to establish a sound foundation for sustained economic and financial recovery over the medium term. To this end, they are continuing with the implementation of policy measures in three broad areas covering resource allocation, demand management and the external sector.

In pressing forward with their policies to improve resource allocation and exchange liberalization, the authorities have taken measures to broaden the foreign exchange market as well as to improve its efficiency. To support the measures taken in the exchange system, the authorities have introduced deposit interest rates that are high enough to encourage domestic savings. Furthermore, they made adjustments in administered prices in January 1987 when postal and telecommunication rates were increased to reflect operating costs. Regarding the price of rice, the authorities have been encouraged by the positive response that the agricultural sector has shown to recent policy measures. They therefore intend to promote domestic rice production by phasing out the subsidy on imported rice. To this end, a study is being undertaken on the viability of local rice production, and its conclusions will be used for introducing further pricing policies. To stimulate private sector involvement in economic activity and to promote investment, a new investment code was adopted in January 1987.

In the public sector, the authorities are continuing with measures to achieve the twin aim of, first, reducing public sector employment and establishing an efficient civil service, and, second, curtailing the Government's extensive involvement in production activities. In pursuit of the first objective, the Guinean authorities are examining the legal provisions governing employees with special reserve status to ensure their final separation from the service. Also, in January 1987, a special office was established to assist those voluntarily leaving the service to integrate into the private sector. Furthermore, government agencies are continuing to assess their staffing needs, and it is expected that through these measures, the desired substantial reduction in public sector employment will be achieved in 1987. Concerning the restructuring of public enterprises, the authorities are building on the progress already made in liquidating a large number of trading and industrial enterprises. They are focusing their attention on reorganizing commercial enterprises, where the pace of reform has been slow. It is worth noting that in the early part of 1987, six enterprises were fully privatized. A substantial number of others is expected to be turned over to the private sector in the immediate future.

In the area of demand-management policies, the fiscal objective is to maintain a cautious stance and to limit recourse to the banking system. This latter objective is predicated upon a substantial increase in external resource availability as well as significant revenue receipts from the mixed mining companies. In support of fiscal policies, monetary and credit policies have also been based on restraint and aimed at encouraging the mobilization of domestic financial resources.

In the external sector, as mentioned earlier, the authorities have taken measures to broaden the foreign exchange market as well as to improve its efficiency. The spread between the parallel market and the official rates has been narrowed by opening up the market to most current account transactions and by permitting the rate to be freely determined by market forces. The authorities intend to pursue their objective of achieving a further narrowing of the spread in order to encourage more foreign exchange resources to be passed through the auction market. This should help to strengthen the country's balance of payments position and allow a build up of international reserves and an adequate level of imports as well as to enable Guinea to continue meeting its foreign financial obligations.

To conclude, it must be recognized that, performance criteria aside, the Guinean authorities have shown a determination to implement sound policies for economic and financial reform. The measures already taken are bold and far-reaching. They hope that their renewed efforts will encourage the international community to continue its support.

Mrs. Ploix made the following statement:

The staff report confirms the impression given by the review of late August 1986 regarding the success of the initial phase of the program and the slower pace of reform during the second half of the year. This slowing down can be explained in part by the dramatic changes introduced in January 1986, some of which, in the second phase of the program, are likely to meet with stronger resistance, as they attack many vested interests.

Nevertheless, it is clear that long delays in implementing the program would undermine its consistency and jeopardize its success. Therefore, the authorities' commitment to giving renewed impetus to reform is very much welcome.

As I am in broad agreement with the interesting and comprehensive staff report, I shall limit myself to a few comments on its main issues.

On exchange rate policy, the combination of measures aimed at improving the functioning of the auction system while encouraging domestic savings is very much welcome and essential if a realistic and flexible rate of exchange is to be maintained. The opening up of the auction system to most current account transactions and the channeling of gold export receipts toward the auction market should effectively reduce the parallel market. The recent loss of foreign exchange reserves illustrates the quick and negative impact of quantitative restrictions and of a biased rate of exchange.

On monetary policy, I would like to re-emphasize the importance of strictly following the path designed for credit policy. The introduction of new savings instruments and the upward adjustment of the rate structure remain essential: they will curtail the pressure on the exchange rate and reduce capital flight; but they will also, more directly, encourage financial savings and ensure a better allocation of financial resources. I would thus be grateful if Mr. Mawakani could be more precise on the most recent developments in interest rates and indicate the extent to which real interest rates are positive.

On the restructuring of the public enterprise sector, after several months of slow progress, the recent signing of two privatization contracts is very much welcome; progress on this front is essential to the revitalizing of the Guinean economy. The progressive detachment of the Government from production activities is instrumental in freeing individual initiatives in areas where monopolies and lack of efficiency in management have hampered development. This reform should lighten the burden these enterprises have placed on the government budget.

Finally, on public sector employment, I have noted that 12,000 positions have been eliminated from the public sector during the first six months of the program. This result falls short of the original objectives, maybe because all the conditions for a successful reduction of employees have not been met. Indeed, such widespread layoffs of public servants will work only if former public sector employees are able to find other work in the economy.

We thus encourage the authorities to hasten the reforms upon which they have embarked, namely, the reconstruction of an efficient banking system; the setting up of a legal framework more conducive to private productive investment; and the creation of a special office to assist former public sector employees in putting together bankable business proposals. We also encourage the authorities to continue to assess their need for qualified personnel and to conduct systematic qualification tests.

We welcome the authorities' commitment to the process of reform. The forthcoming Consultative Group Meeting, scheduled for next month, will be an opportunity for the Guinean authorities to show their progress to the multilateral and bilateral institutions and donors. We hope that this meeting will be a success. And we want here to remind the Guinean authorities that they must be punctilious in putting in order their relationships with their bilateral creditors in order to benefit from the opening of their economy. We also look forward to the conclusion of an arrangement under the structural adjustment facility.

Turning to the modifications proposed in the stand-by arrangement, I understand that the staff has taken some account of the special factors of the Guinean case. However, I must say that I am not fully convinced by the rationale behind the reduction in the amount of this arrangement. I even see some contradiction between the statement that "Guinea will be in a weaker position" and "under the circumstances, the reduction of the stand-by appears appropriate."

I realize that, in present circumstances, this reduction will not affect Guinea, since its foreign exchange resources are relatively abundant. I also understand that the Guinean authorities can go along with such a decision. But I would like to mention that I cannot sympathize with a punitive approach in which slippage in the implementation of a program is systematically accompanied by a reduction of the resources available under the stand-by arrangement.

Mr. Al-Assaf made the following statement:

Over the past two years, the Guinean authorities have made considerable and commendable progress in reforming their economy. The extent of the restructuring they have undertaken is quite impressive by any standards. There was an initial thirteenfold exchange rate adjustment, followed by a unification of exchange markets in June 1986. Tariffs and public sector fees were raised five to sixfold, while all other prices were decontrolled. Some 12,000 positions have so far been eliminated from the public sector, and some 50 commercial enterprises and 12 industrial firms are now either closed or are in the final stages of liquidation. These steps were also complemented by a reform of the institutional framework, including an overhaul of the banking system.

The extent of the adjustment points to the magnitude of the imbalances and the deep-rooted nature of the distortions in the Guinean economy. Thus, while much has been achieved, much remains to be done if Guinea is to succeed in reorienting its economy and restoring financial equilibrium. As I am in broad agreement with the staff's assessment and conclusions, I will confine my comments to areas in need of special attention.

First, I welcome the authorities' program to reduce the size of the public sector labor force and to assist departing civil servants in reintegrating into the private sector. However, I am concerned about recent trends in wages and compensation. In particular, wage increases since end-1985 have now virtually compensated in full for the depreciation of the Guinean franc. This is clearly expansionary at a time when the authorities need to adhere to more cautious demand-management policies. It could also lead to a cost-push inflation and depreciation spiral. Moreover, the magnitude of the recent pay increases may jeopardize the drive to reduce civil service employment and could undermine the economy's competitiveness. Therefore, I urge the authorities to review their wage policies.

Second, the recent slippages in policies are a cause for concern, since at this stage of transition from a centrally planned economy to a market-oriented economy, it is essential to send to the private sector and to the international community a strong signal by staying the course. An equally important reason for persisting in the adjustment effort is the fact that Guinea's external position is likely to remain under strain over the next few years. I am therefore very encouraged by the most recent policy actions. They clearly show the authorities' intention to give renewed impetus to the process of reform and to strengthening policy implementation.

Third, Guinea's efforts to revitalize its economy will require continued international financial assistance. In this context, it is essential that Guinea maintain confidence at home and abroad, so as to attract needed capital inflows. Clearly, avoiding the re-emergence of external arrears, while dealing effectively with the arrears overhang, will be crucial in this respect. I am sure that the Guinean authorities are fully aware of this, and I am encouraged by their most recent efforts in this area.

In conclusion, the Guinean authorities deserve to be commended for their efforts at restructuring their economy. Such fundamental restructuring will neither be smooth nor come easily. What is important, however, is that the authorities must be flexible in adapting their policies to changing circumstances and must not lose sight of their basic objectives. I wish them well, and I support the proposed decisions.

Ms. Lundsager made the following statement:

We welcome this conclusion of the second review of Guinea's stand-by program, although it was disappointing to learn that the pace of reform in the second half of the program was considerably slower than during the first half, with slippages in implementation of some of the policy commitments made by the authorities during the first review. In particular, some important structural reforms lagged, leading to the emergence of problems in the functioning of the foreign exchange auction and to delays in interest rate adjustments and parastatal and civil service reforms.

The authorities have, however, recently come to grips with these problems and have implemented a number of measures, thus helping to bring the program back on track. Nonetheless, additional substantial efforts in a number of areas will be necessary beyond the period of this program, and we would hope to see those measures included in any follow-on, Fund-supported adjustment program.

One area of critical importance is the exchange system, and earlier delays in broadening the auction system were most unfortunate, particularly since the auction system had been achieving such positive results at the time of the first review of the progam. The authorities have recently widened access to the auction market to include most current account transactions and, consequently, the spread between the official and parallel market rates has declined to below 10 percent, as reported this morning, which is a welcome development.

The additional adjustments in administered prices currently being implemented to bring them closer to covering costs of production are welcome. Another important consideration is the level of prices in neighboring countries, which should be kept in mind in evaluating the adequacy of domestic incentives. We hope that the study on the rice sector will be available soon so that additional measures can be put into place to encourage rice production.

While fiscal management was tighter than expected last year, that was due in part to slower utilization of external assistance stemming from administrative delays and problems in implementation of structural reforms. We note that Guinea faces administrative difficulties in a number of areas that have caused problems in the mechanical implementation of the program. We are aware that the Fund and Bank provided technical assistance in the fiscal, tax, and central banking areas, and we support continued efforts to assist the Guineans in these areas to facilitate the implementation of the economic program.

On civil service reform, I note that while progress has been made to reduce the number of employees, there remains a great deal to accomplish. We hope that the measures recently introduced in this area will help speed up the process and achieve the desired reduction in 1987.

Regarding reform of the public enterprise sector, we note that progress has been slower than anticipated, particularly in respect of commercial enterprises. Reform in this area is essential to reduce the drain on the budget and encourage manufacturing activity. The privatization efforts that are under way should be continued, and we hope to see the overall reform of this sector continue to be given high priority.

In the monetary sphere, we particularly welcome the introduction of savings instruments offering competitive yields and the upward adjustment in the interest rate structure. These actions could help support the exchange reforms by reducing pressures on the balance of payments. We encourage the authorities to maintain flexibility in their interest rate policy in the future. Also, the authorities' objective for credit policy in 1987, to promote growth in the private sector while dampening the underlying rate of inflation, is appropriately geared toward supporting the reorientation of economic activity now under way.

The medium-term outlook continues to generate concern, in light of the projections indicating that, after allowing for repurchases to the Fund and for building up other net foreign assets of the Central Bank to three months of imports, Guinea's financing gap could be expected to remain at SDR 80 million a year in the 1988-91 period. The staff concludes that a need remains for further utilization of Fund resources in the coming years, as well as additional exceptional financial assistance. In our view, the most appropriate lending to Guinea, in light of its difficult debt service situation, is on very concessional terms. We would prefer to see this lending in the context of an arrangement under the structural adjustment facility (SAF). A comprehensive SAF should include a strengthening of the kinds of reforms the authorities have already begun in the areas of public enterprises, market-oriented pricing policies, the financial sector, and budget, civil service, and exchange rate policies.

In conclusion, we were disappointed that Guinea experienced difficulties in maintaining the pace of reform in the second half of the program. Yet, while time was lost, the authorities have recently implemented a number of measures that show their resolve to continue with economic adjustment, and we encourage them to take the difficult steps that remain ahead in order to bring about continued improvement in the economy. For these reasons, we can support the proposed decision that provides for a release of a tranche, despite the fact that performance criteria were missed in July and September and we will not know the full outcome for end-January until sometime next month. The slight extension of this program, permitting rephasing of some of the missed purchase, strikes us as a balanced solution.

One final question concerns Guinea's relationship with the World Bank. Our understanding is that despite the fact that Guinea eliminated its arrears to the Bank by the end of last year, new arrears, now more than 30 days overdue, emerged recently. I would appreciate staff confirmation of this information, any indication of the reasons for the arrears, and what implications they have for the Fund arrangement, which includes a particular performance criterion specifying that arrears to multilateral institutions are to be eliminated.

Mr. Kleine made the following statement:

This chair has commented on the current stand-by arrangement at length on two previous occasions. Therefore, today I can confine myself to some brief comments.

After a remarkably good start under the stand-by arrangement, the momentum of the implementation of the program weakened considerably during the second half of 1986. There was a departure from policy understandings in several areas, and two performance criteria for end-July and end-September were breached. This is disappointing news, only partly offset by the recent policy actions the authorities have taken that demonstrate a new willingness to give fresh impetus to the reform process and to strengthen policy implementation. I agree with the staff that under the prevailing circumstances an extension of the stand-by arrangement of one month and a reduction in the amount of the arrangement by SDR 6 million appear appropriate. I can support the proposed decisions.

As for economic policy in 1987 and beyond, I feel that the country would be well advised to cooperate closely with the Fund and the Bank in the design of structural adjustment policies and of investment plans. As has been the case in 1986, such a combined endeavor would be helpful as a catalyst for the needed broad-based support from the international community.

Without sufficient information about the 1987 budget, it is not possible to make any specific comment on the fiscal side at this time. However, I can fully support the idea for a smaller, better qualified and better remunerated civil service. Accordingly, I attach high priority to the task of reducing the excessive level of government employment. Progress in this area has been rather slow. The number of personnel on the Government's payroll has been reduced in net terms by only 1,700 persons as of end-October 1986.

I recognize that much political courage and determination is needed to see this program fully carried out. The process could be greatly facilitated through the formation of a dynamic private sector that, after a transition period, would provide sufficient employment opportunities to absorb the increasing number of those people leaving the public sector. In this connection, the reconversion of unprofitable enterprises and the ongoing effort to establish an effective banking system are highly welcome. This holds also true for the intention of the Central Bank to issue development bonds to the nonbank public and to conduct a flexible interest rate policy. Further improvements can be expected with the operation of new bank branches, including those in outlying regions. An efficient banking system in the rural areas could contribute importantly to the development of Guinea's nonbauxite sectors, especially the agricultural sector.

With respect to the exchange market situation, measures to broaden the auction market and to move toward a more freely determined auction rate are highly welcome. The pursuit of a flexible exchange rate policy is certainly pivotal to the efforts to minimize resource misallocation and to expand the volume of nonbauxite exports.

Finally, I urge the authorities to avoid any new arrears on Guinea's external debt service obligations and I commend them for their firm intention to remain current with the Fund.

Mr. Salehkhou made the following statement:

In contrast to the first half of the year, the financial program with Guinea suffered a number of setbacks from July 1986 which led to a relatively lengthy interruption of drawings under the stand-by arrangement and risked weakening significantly the momentum for structural adjustment and economic rehabilitation. It is encouraging to note that such momentum has now been revived as the authorities have adopted strong measures that have largely offset the impact of earlier policy slippages and permitted the attainment of most program targets for end-1986, thus putting the stand-by arrangement back on track and paving the way for continued adjustment efforts in cooperation with the Fund and the World Bank.

The financial program with Guinea entailed a large number of uncertainties, which reflected the severe imbalances to be corrected and the radical nature of the envisaged reforms, including a major devaluation of the Guinean franc, substantial price adjustments, an ambitious retrenchment of the public sector, the liquidation or privatization of most public enterprises, and the total overhauling of the banking system. In view of such uncertainties, Executive Directors recommended, at the adoption of the stand-by arrangement, a measure of flexibility to ensure the successful implementation of the program. In this regard, the proposed changes in performance criteria and duration of the program are appropriate, even though adequate flexibility could have permitted the resumption of drawings under the program much earlier, particularly since the factors behind the two cases of nonobservance of performance criteria in July and September 1986 were mostly linked to delays in the disbursement of external loans and grants. Such delays caused a lower reduction in government obligations to the banking system and insufficient cash payment of external arrears. It should be noted, however, that the overall budget deficit was kept below the programmed level by a wide margin, while the excesses over the ceiling on net bank credit to the Government were more than compensated for by a larger than programmed contraction in net bank credit to public enterprises.

With regard to the proposed reduction in the amount of the stand-by arrangement, I believe that the Board should avoid mechanistic adjustments of access each time delays are incurred in the conclusion of program reviews, especially when such delays are mostly due to factors beyond the authorities' control. In the case of Guinea, maintenance of the original amount of access is justified not only by the larger need of the member following last year's delays, but also by the scope of the measures already implemented, which have more than compensated for earlier slippages and ensured strengthened adjustment efforts for 1987.

As I support the additional measures implemented and the broad objectives of the stand-by arrangement, I shall confine my remaining remarks to some specific elements of the program.

First, as indicated by the staff and Mr. Mawakani's comprehensive statement, strong external support remains crucial to the successful implementation of Guinea's adjustment policies, especially in view of the initial adverse effect of the far-reaching reforms on production and employment. While commitments appear to be at adequate levels for 1987, it is essential that they be fully mobilized to avoid the kind of bottlenecks encountered last year.

Second, on exchange rate policy, I note that the authorities have now achieved the unification of official exchange rates and largely extended the scope of the auction system. In this regard, considering the implementation of the auction system in an increasing number of African countries under Fund programs, I would appreciate an assessment by the staff of the effectiveness of the system in Guinea and elsewhere in Africa and on the costs involved. Further comments on the prospects of the system in Guinea in view of the considerable reduction of the differential between official and parallel market exchange rates would also be welcome. Moreover, while it is adequate to aim at an "equilibrium" exchange rate, such level should not be confused with that prevailing at the parallel market.

Finally, in the implementation of the authorities' objectives with respect to the size of the civil service, there should be a measure of caution so as not to cripple the administrative system, which is indeed crucial to the success of current adjustment efforts. Administrative weaknesses appear already to be partly responsible for the delays in mobilizing external loans and grants. The staff's position that wage adjustment in the public sector should be tied to the reduction in the size of the civil service is consistent with the need to contain the growth of public expenditure and achieve the required reduction in the large fiscal deficit. It is also necessary, however, to maintain adequate compensation for qualified civil servants who are the most likely candidates for employment in the private sector.

Mr. Jones made the following statement:

> I note the Guinean Government's commitment to economic reforms and the many positive actions that the authorities have taken recently along those lines. There have been some slippages, as the staff has pointed out, but it would not be pragmatic to assume that a major restructuring of an economy of the order of what is being attempted in Guinea could proceed without running into some bottlenecks. Guinea, in our opinion, is one case where flexibility in the design of programs and in the application of conditionality remains essential. It is against this background that I question the staff's proposal to reduce the resources available under the current stand-by arrangement by SDR 6 million. By the staff's own assessment, the program remains on track and "the authorities have shown their intent to give renewed impetus to the process of reform and to strengthen policy implementation... ."
>
> One general point to keep in mind when it comes to economic management is that ambitious programs carry a greater risk of slippages in the implementation of policy. For instance, it is not easy in a short time to transform an economy from one that is state-centered, as in the case of Guinea, to one driven by private initiative and the market. Institutions need to be changed, and the private sector needs to build confidence. This takes time. It is also a major task to make significant reductions in public sector employment, especially where the Government is the major employer in the money economy, or where there is no social security safety net. These observations are not meant to question the direction of policy in the specific case of Guinea, but only to draw attention to the limits to which adjustment can go in a given period.
>
> On the role of foreign assistance in the adjustment effort in Guinea, it is clear from the staff report that the adjustment process cannot make much headway without an extraordinary amount of concessional external financing. Many countries have built programs on the assumption that such inflows would be forthcoming, only to be faced with major shortfalls. I hope that donors would follow up on their pledges to Guinea and that ways can be found to remove any bottlenecks that might impede speedy disbursements. I would also urge those countries that have not responded favorably to Guinea's request for debt relief to be more accommodating.

Mr. Foot said that he must record his disagreement with the implication that could be drawn from Mrs. Ploix's earlier statement that the flow of Fund resources should not necessarily be closely linked with the implementation of agreed adjustment measures under a Fund program. As he saw it, the staff had achieved appropriate balance in recommending a reduction in the resources available under the stand-by arrangement. The reduction was not mechanical, as Mr. Salehkhou had suggested; rather, it was based on a balance between the objectives of responding to the belated Guinean attempts to put the program back on track and the recognition that, even with such efforts, the program was no longer what it had originally been intended to be. Like others, he would be interested in knowing the implications for Guinea's relations with the Fund and the Bank of its arrears to the World Bank. He would also be interested in knowing the effect of such arrears on Guinea's relations with, say, the Paris Club.

Mr. Hodgson noted that the policy slippage in 1986 had not been surprising, in view of the degree of disequilibrium in the Guinean economy and the strong resistance within the economy to economic reform. In fact, the real surprise had been the success encountered in the first half of the year, particularly with respect to the reform of the foreign exchange market. He had taken note of the intensification of the policy effort in the areas of exchange rate and monetary policy, and he urged the authorities to stay the course.

He agreed with Mr. Foot's remarks on the level of access under the program, Mr. Hodgson continued. It was fully appropriate to reduce the amount envisaged under the program in view of the slippages that had taken place. He was happy to note that the program was back on track, but it must be recognized that a link was required between the level of financing and continuity under Fund programs.

The staff representative from the Exchange and Trade Relations Department observed that the proposal to reduce access under the stand-by arrangement had been based on the staff's attempt to strike a balance between various possible strategies, which had been discussed at length with the authorities. The arrangement was one that had been due to expire in early March 1987, and the staff was aware that slippages in policy implementation had occurred that, while not viewed as particularly serious in terms of the performance criteria for September, had been looked at with concern in terms of future developments in the Guinean economy. Guinea had experienced a large loss in foreign reserves between July and November, a steady widening of the spread between the official and parallel exchange markets, and almost no export earnings from products other than bauxite, all of which had sent negative signals to the public about future progress under the program.

Three possible courses of action had been discussed, the staff representative continued. One had been to lengthen the period of the arrangement until May, keeping the amount available under the arrangement unchanged. Another strategy would have been to allow the program to expire and to begin discussions immediately on a new program. A third possibility was to propose to the Board an extension of the arrangement by one month and to begin immediately discussions on a structural adjustment facility loan. The approach being proposed to Directors at the present meeting was one that struck an appropriate balance between the three aforementioned alternatives, and that also took into account the interest of the authorities in maintaining an operational relationship with the Fund.

In response to Mr. Salehkhou's question on the functioning of the exchange market, the staff representative observed that experience had been generally positive in the first half of the year and, more recently, in the past two months. It was not his impression that there was widespread concern about the gaps between the official and parallel market rates, which in fact were spreads against broken cross rates depending on whether transactions took place in CFA francs, French francs, or the U.S. dollar, on which there was a premium. That was why the staff had recently been using the concept of a weighted parallel rate in order to measure the spread more precisely. On that basis, it had been determined that the spread had indeed declined over the past three or four auctions at which, for the first time, there had been a supply of foreign exchange by exporters that in previous years had either not exported at all or had exported through unofficial channels. The flexibility of the exchange rate had apparently had a positive impact on the relative price structure and on the general rebound of production of tradeable goods.

Another staff representative from the Exchange and Trade Relations Department remarked that if Guinea had indeed incurred arrears to the World Bank as of end-January, that would constitute a violation of the performance criterion for end-January that required that all arrears to multilateral institutions be eliminated. Before a purchase linked to observance of the end-January performance criteria could be made, the authorities would provide data on all the criteria, including data concerning possible arrears to other multilateral institutions. Guinea's arrears to the World Bank totaled only $150,000, which suggested that the arrears were probably due to a technical delay or administrative difficulties. If all other performance criteria for the end of January were observed--and it would be possible to make that assessment in six weeks' time--the staff would propose that, provided the arrears were cleared in the meantime, a waiver be granted on a lapse of time basis to permit the purchase to be made.

Adding to his colleague's explanation of the staff's proposal to reduce access under the stand-by arrangement with Guinea, the staff representative commented that, without such a reduction, a severe bunching of purchases would have occurred under the arrangement within a five-six week period. In fact, more than half the total resources to be provided under the arrangement would have become available in a matter of weeks, a possibility that the staff had felt was not entirely consistent with the spirit of the guidelines on the phasing of purchases and performance criteria agreed by the Board some two years previously. There had been a number of other cases in recent history in which a similar approach had been adopted.

The staff representative from the Legal Department, in reply to a question concerning the implications of the staff's remarks for the proposed decision on Guinea, commented that in order to block the purchase that would become available immediately upon the completion of the review, the decision would have to be amended. The final sentence in the proposed text stated that "the Fund decides that the review contemplated in paragraph 4(b) of the stand-by arrangement is completed and that Guinea may proceed to make purchases under the arrangement equivalent to SDR 6 million until February 28, 1987, notwithstanding that the data as of January 31, 1987 for the performance criteria specified in paragraph 4(a) of the arrangement are not available." The decision had been drafted on the understanding that the data would not be available at the present meeting for the end-January performance criteria. Besides, the only information available was that received from the World Bank indicating that payments arrears existed. The practice of the Fund was not to prevent purchases on the basis of creditor information alone, and it might take some time to verify the information that the World Bank had provided. In the circumstances, the Legal Department had gone along with the proposed decision, which would permit the purchase to be made as of the conclusion of the review and would make the second purchase subject to the observance of performance criteria as of January 31, 1987.

Mr. Mawakani commented that under normal circumstances, and as a matter of principle, Guinea's access under the current stand-by arrangement should have been maintained. However, his authorities had agreed to the reduction on the understanding, and in the expectation, that greater access to Fund resources would be allowed in support of a further adjustment program.

On the matter of interest rates in Guinea, Mr. Mawakani observed that the minimum deposit rate was 15 percent; the maximum lending rate was 15-20 percent, and development bonds were 17 percent. He had no information on inflation rates in January and February, although the annual rate was 15.5 percent.

The Executive Board then took the following decisions:

Review Under Stand-By Arrangement

1. Guinea has consulted with the Fund in accordance with paragraph 4(b) of the stand-by arrangement for Guinea (EBS/86/4, Supplement 2, 2/6/86) and paragraph 7(iii) of the memorandum annexed to the letter of the Head of State of Guinea and Chairman of the Military Committee for National Recovery dated December 12, 1985 attached to the stand-by arrangement, in order to review progress in implementation of the program and establish suitable performance criteria for the remaining period of the arrangement.

2. The letter and annexed memorandum from the Head of State of Guinea and Chairman of the Military Committee for National Recovery, dated January 22, 1987, shall be attached to the stand-by arrangement for Guinea, and the letter and annexed memorandum of December 12, 1985, as modified, shall be read as supplemented and modified by the letter and annexed memorandum of January 22, 1987.

3. Accordingly,

(a) The references in paragraph 4(a) of the stand-by arrangement to paragraph 7(i) and Table 1 of the memorandum annexed to the letter of December 12, 1985 (relating to the performance criteria on total domestic credit, net bank credit to the Government, bank credit to public enterprises, minimum net foreign exchange sales by the Central Bank at the auctions, minimum reductions of external payments arrears through cash payments, minimum increase in net external reserves of the Central Bank, and nonconcessional external loans contracted or guaranteed by the Government) shall be read as references to paragraph IV and to the table included in the memorandum annexed to the letter dated January 22, 1987.

(b) Paragraph 1 of the stand-by arrangement is amended by substituting "14 months" for "13 months" and by substituting "SDR 27 million" for "SDR 33 million."

(c) Paragraph 2(a) of the stand-by arrangement is amended as follows:

Purchases under this stand-by arrangement shall not, without the consent of the Fund, exceed the equivalent of:

SDR 9 million through June 1, 1986;
SDR 15 million through January 15, 1987;
SDR 21 million through February 28, 1987.

(d) The Fund decides that the review contemplated in paragraph 4(b) of the stand-by arrangement is completed and that Guinea may proceed to make purchases under the arrangement equivalent to SDR 6 million until February 28, 1987, notwithstanding that the data as of January 31, 1987 for the performance criteria specified in paragraph 4(a) of the arrangement are not available.

Decision No. 8528-(87/28), adopted
February 18, 1987

Exchange System

In the circumstances of Guinea, the Fund approves the restriction on payments and transfers for current international transactions arising from the foreign exchange auction system until the conclusion of the 1987 Article IV consultation with Guinea or June 30, 1987, whichever is earlier.

Decision No. 8529-(87/28), adopted
February 18, 1987

2. ARGENTINA - REQUEST FOR STAND-BY ARRANGEMENT; AND USE OF FUND RESOURCES - COMPENSATORY FINANCING FACILITY

The Executive Directors considered a staff paper on Argentina's request for a stand-by arrangement in an amount equivalent to SDR 1,113 million (EBS/87/5, 1/13/87; Sup. 1, 1/26/87; Sup. 1, Cor. 1, 2/18/87; and Sup. 2, 2/17/87), together with a paper on a request expected to be received from Argentina for a purchase equivalent to SDR 388.7 million under the compensatory financing facility (EBS/87/17, 1/29/87; and Sup. 1, 2/17/87).

The Acting Chairman, reporting briefly on the status of Argentina's negotiations with the commercial banks, noted that over the past several weeks, the Economic Subcommittee of the Working Committee of Commercial Banks had conducted a detailed examination of Argentina's economic program. On February 12, 1987, representatives from Argentina had met with the Working Committee and had presented Argentina's economic program and financing requirements. Presentations had also been made by Fund and World Bank representatives. On February 13, the Argentine representatives and the Working Committee had agreed to resume discussion on February 25. In the period before that date, the Working Committee would be holding technical discussions with the Economic Subcommittee and with representatives from the Fund and the World Bank. The Chairman of the Committee had informed him that the atmosphere at the initial meetings had been positive and that work toward the meeting on February 25 was well under way.

Mr. Feldman made the following statement:

On behalf of my authorities, I would like to thank the members of the Executive Board for including in today's agenda the discussion on Argentina's request for a stand-by arrangement in an amount equivalent to SDR 1,113 million and for a purchase equivalent to SDR 388.7 million under the compensatory financing facility.

My authorities also wish to express their appreciation to the staff for the comprehensive analysis of economic policies and events included in the papers.

I will focus my comments on some aspects of Argentine economic policies since the implementation of the Austral Plan and the 1987 program as well as on providing information on the latest economic developments.

By mid-1985 it became apparent to the Argentine authorities that the strategy of gradual stabilization adopted in 1984 was not working as had been envisaged. The country was at the threshold of hyperinflation combined with strong recession, and there was increasing concern about social and political stability. The program of Economic Reform, known as the Austral Plan, introduced in June 1985, opted for a drastic stabilization approach and recognized the need for attaining internal and external balances simultaneously. The program was based on three key elements. First, to reduce inflation it was necessary to get a major reduction in the fiscal deficit to a level that would be externally financed and to design a monetary policy consistent with the fiscal situation and with the expected low rate of price increases. For a country with such a long record of high inflation and social pressures resulting from so many years of economic decadence (the GDP per capita being 15 percent lower than in the early seventies), this first premise of fiscal and monetary discipline was deemed as a necessary, though not sufficient, condition to attain stabilization. Consequently, to break inflationary expectations built up in the behavior of economic agents, income policy--in the form of a temporary freeze on wages and prices and the fixing of the value of domestic currency in terms of the U.S. dollar--was introduced as the second key component of the program. Finally, to avoid strong redistribution of wealth from debtors to creditors, which would have resulted from the sudden deceleration in inflation, a mechanism was designed to facilitate the deindexation of financial contracts.

The first stage of the Plan, characterized by the above-mentioned price-wage freeze lasted from June 1985 to March 1986; during that period, the consumer and wholesale price indices rose by 2.5 percent and 0.5 percent a month, respectively, as compared with 31 percent and 42 percent in June 1985. Initially, the decline in inflation was mainly the result of the successful implementation of income policy coupled with the favorable impact on the public confidence stemming from the Government's commitment not to expand domestic credit to finance the fiscal deficit. These factors contributed to a dramatic increase in the demand for domestic financial assets. The M1 to GDP ratio more than doubled, and the broad money to GDP ratio increased from 11 percent to almost 20 percent from the second quarter of 1985 to the first quarter of 1986. There was a large inflow of foreign funds and the Central Bank discouraged the entry of short-term financing, which in the past had proven to be destabilizing.

The abrupt decline in inflation made the recession short-lived; following a drop in output in the third quarter of 1985, there were clear signs of economic recovery in the last quarter of 1985 and the first quarter of 1986.

In March 1986, the Economic Plan entered into a second stage characterized by price deregulation. The freeze was replaced by a mechanism of administered prices designed to adjust prices, wages, public utility prices, and the exchange rate in a way that would maintain a very low rate of inflation while providing room for smooth accommodations in relative prices. Fiscal and monetary policies were designed to be consistent with the objectives of low inflation and continued economic growth. However, wage increase exceeded in many cases the guidelines set by the Government; as these slippages occurred during a period of monetary permissiveness, aggregate demand was stimulated, thus leading to an acceleration in inflation. Supply inelasticities for foodstuffs and other wage goods also helped to fuel inflation. As a result, even with the fiscal deficit under control, the monthly average rate of inflation (consumer prices) increased to 4.4 percent in the second quarter and to 7.6 percent in the third quarter.

In late August 1986 new steps were taken to regain control over inflation; the Government announced that key prices would be adjusted monthly in line with the projected decline in inflation rather than being indexed to past inflation, with the exception of the exchange rate, which would be kept in line with actual price increases. More important, this phase of managed prices was combined with a very active monetary policy. The Central Bank regained its control over the domestic factors of the money base expansion, notably rediscounts and on-lending. At the same time, important steps towards financial market deregulation were taken: compulsory reserves on the increases in nonregulated, interest-bearing deposits were reduced from above 50 percent to 3 percent, resulting in an impressive transfer of funds from the interfirm to the institutionalized financial markets. The rate of inflation decelerated all along the last quarter of 1986: consumer prices increased 6.1 percent in October, 5.1 percent in November, and 4.7 percent in December.

Even as some slippages occurred, the Austral Plan succeeded in atraining its goals as the inflation rate in Argentina decelerated dramatically and the country resumed economic growth. The rate of inflation during 1986, though still high (82 percent for consumer prices), was the lowest in the last 12 years. Real GDP rose 5.5 percent during 1986, with industrial production expanding more than 13 percent. More important, investment grew faster than domestic consumption, reversing the pattern of past experiences.

The main objectives of economic policy for 1987 are to persist in the stabilization efforts initiated in mid 1985 as well as to consolidate the path of economic growth. It is the aim of the Argentine authorities to reduce inflation to around 40 percent during 1987, to strengthen the balance of payments position (the overall deficit is targeted to decline from $2.1 billion in 1986 to $1.7 billion in 1987) and to attain an increase in real GDP of 4 percent.

To achieve these objectives the economic authorities' strategy for 1987 includes a combination of demand management and income policies with the adoption of structural reforms aimed at consolidating stabilization and laying the basis for a sustained economic growth.

Regarding fiscal policy for 1987, the Argentine authorities are committed to lower the combined public sector deficit to 2.5 percent of GDP from 3.9 percent of GDP achieved during 1986. It is worth to recall that prior to the implementation of the Austral Plan the combined public sector deficit had reached 12.5 percent of GDP (first half of 1985). The 2.5 percent targeted for 1987 will result from a cash deficit of the nonfinancial public sector of 1 percent of GDP (2.3 percent in 1986) and from operating Central Bank losses of 1.5 percent (1.6 percent in 1986). As the level of total cash expenditures of the nonfinancial public sector will remain practically unchanged during 1987 (though with a slight shift from current to capital expenditures), the reduction in the deficit will come from an increase in public sector revenues. The additional revenues will derive from a variety of measures, including a Tax Amnesty Law recently approved by the Congress, an increase in social security taxes and the improvement in tax administration which would allow for increase in revenues from value-added and net worth taxes. The operating losses of the public enterprises as a percentage of the GDP are also projected to decline during 1987.

It is important to stress the Government's commitment to introduce structural changes in the public sector aimed at finding a permanent and stable solution to Argentina's fiscal sector. In this line, the authorities have recently introduced a voluntary retirement program for public employees which would reduce employment in the National Administration, laying the basis for a permanent reduction in current expenditures in the years to come. The Government has also created a holding company for public enterprises aiming at increasing their operational efficiency and has sent a law to Congress to speed up the transfer of some of these enterprises to the private sector.

Finally, the projected decline in the operating losses of the Central Bank during 1987 assumes a decline in the spread between interest rates paid on Central Bank liabilities (a sizable proportion of total bank's reserves) and the rates charged on rediscounts. A major effort will continue to be made to limit rediscounts and to lower reserve requirements.

The implementation of monetary and financial policies for 1987 will be consistent with the attainment of the economic objectives. Consequently, the rate of monetary and credit growth will be in line with the declining rate of inflation projected in the program. Interest rate management will continue in a way so as to encourage financial savings and induce an efficient allocation of resources. Deregulation of financial markets has progressed significantly since the Austral Plan was launched: the proportion of nonregulated rate deposits in total interest-bearing deposits increased from 24 percent in June 1985 to 61 percent last December; the authorities are committed to further induce this trend as well as to maintain regulated deposit rates at least approximately equal to the average rate of inflation and regulated lending rates to be kept moderately positive in real terms.

The high level of real interest rates in nonregulated markets is a matter of great concern for the Argentine authorities. It is expected that these rates will gradually decline as the fiscal situation is consolidated and as structural reforms--tending to lower rediscounts and compulsory bank reserves as well as to induce a drop in banking operating costs--are being introduced in the Argentine financial sector.

Wage and price policies in conjunction with demand-management policies have played an important role since the implementation of the Austral Plan. Price management has been conducted with an increasing degree of flexibility and it is clear that no shortages of goods have occurred. My authorities have recognized the long-run costs of maintaining a system of wage and price controls, though it is apparent that a policy of scheduled prices and wages is still needed to bring down inflationary expectations and until Argentina becomes increasingly integrated to the world markets. Wage and price guidelines have been set for the first quarter of 1987. Price and wage management will be relaxed cautiously and gradually over time; it is the Government's intention to return to full collective bargaining (though the authorities would retain the right to set bands on wage settlements) and to carry out a selective policy of price deregulation for sectors with high degree of competition.

Regarding external policies, my authorities' Economic Program aims at lowering the overall balance of payments deficit from $2.1 billion for 1986 to $1.7 billion for 1987. The surplus on capital account is expected to remain about the same as in 1986, but manufactured exports are expected to rise by approximately 40 percent during 1987 as a result of the export promotion programs adopted in recent months.

The balance of payments situation of Argentina deteriorated sharply in 1986 as the current account deficit went from less than $1 billion in 1985 to $2.6 billion, owing to the collapse of international commodity prices--coupled with extensive floods which affected crops in Argentina--and to the increase in Argentine imports associated with economic recovery. Argentine export prices fell by 30 percent between 1980 and 1985, and the forecast is that by the end of 1987 there will be a further fall of 16 percent. The drastic reduction in the international prices of Argentina's main exports has more than offset the increase in the volume of the country's exports (around 65 percent between 1980 and 1987). The dramatic decline in Argentine imports since the early 1980s is a well-known feature of the country's external economic adjustment. The 1980 trade deficit of $2.5 billion turned into a surplus of 4.6 billion in 1985, that is a shift which represents about 12 percentage points of 1985 GDP. Had the 1984 export prices for Argentina prevailed during the 1985-1987 triennium, trade surpluses would have been $7 billion higher. The losses incurred have negatively affected the performance of the fiscal sector and made the management of the foreign debt more difficult.

To attain the balance of payments objectives of the 1987 Program, the Argentine authorities are committed to the firm application of the above described policies as well as to keep an adequate exchange rate in real terms so as to ensure the appropriate degree of external competitiveness. To this end, other steps have been recently taken, including a significant reduction of tax rates on agricultural exports and special incentives for industrial exports.

The economic program for 1987 will strengthen Argentina's external position and will allow the removal of some remaining exchange and payment restrictions. To this end, the authorities are committed to the elimination of all arrears and to liberalizing the transfer of profits and dividends by June 15, 1987.

A program of trade liberalization for Argentina is now well advanced and is being carried out with the support of a trade policy loan from the World Bank. Priority is attached to both export promotion and import liberalization. The number of tariff positions on an automatic list has been increased and is intended to be enlarged; moreover a comprehensive regime for the temporary admission of duty-free imported inputs for export production is being implemented.

Finally, as for the debt management, the Argentine authorities expect to cover the external financial needs from private and official creditors. The financing program for 1987 recently submitted to the international financial community envisages a net financial gap for the year of $3,530 million.

The rebound in the rate of inflation during January (consumer prices rose by 7.6 percent and wholesale prices by 5.3 percent) has become a matter of concern for the economic authorities. The result is largely explained by increases in the prices of some foodstuffs (fruits and vegetables) and in the price of a variety of private services (medical insurance schemes, tourism, restaurants, etc.) which account for 25 percent of household expenditures.

The Government has reacted by emphasizing its commitment to the objectives and targets set for 1987. Wage guidelines defined for the first quarter of the year are not going to be modified (public sector wages limited to 9 percent and private sector wage settlements limited to a range between 7 and 11 percent with a productivity clause allowing for an additional 2 percent). The authorities will strictly stick to the monetary and fiscal policies already designed and will keep to their commitment of adjusting the exchange rate in line with the observed rate of inflation (the Austral has been devalued by 11 percent since January 1).

Developments in the fiscal area show a situation under control and the January data would suggest that there are no deviations with respect to the quarterly targets: the price of public sector services and public sector wages have been adjusted as projected and Treasury outlays for January are slightly below one third of the outlays projected for the first quarter. Excise taxes on tobacco were raised as planned towards the end of January, and the Congress has just passed the Amnesty tax law and reinstated the banking transactions tax law.

On the monetary side, preliminary estimates indicate that the rate of increase in M1 was slightly below target. Moreover, the regulated interest rate for deposits was raised at the beginning of February by 1/2 percentage point, to 6 percent per month. Finally, it is worth emphasizing improvements in banking supervision that will certainly result in a better functioning of financial markets: by mid-January the Central Bank intervened three important domestic banks which were facing serious liquidity and solvency problems, contributing in this way to the soundness of the banking sector.

As important as the Argentine authorities' reiterated commitment to the short-run macroeconomic policies for 1987 is the increasing emphasis that is being put in fostering structural reforms.

It is the Government's strong belief that inflation will be finally abated and the country will follow a sustained path of economic growth only if the appropriate fiscal, monetary, income, and external policies are combined with long run measures that will be decisive to remove Argentine structural imbalances. Struggles over the distribution of income, the failure to open the domestic economy to the world markets, and the overregulation of key sectors of the economy have systematically affected the long trend performance of Argentina. The implementation of structural reforms has already started in several areas and in others is about to be initiated, in some cases within the framework of programs with the World Bank. The programs include the structural reform of the State (basically affecting the operation of public enterprises, tax reforms, and the voluntary retirement scheme), the integration of Argentine's economy into the world markets (export promotion schemes, import liberalization and integration agreements as those recently reached with Brazil), the restructuring of capital and financial markets (entailing banking deregulation, a stronger Superintendence, and the dismantlement of rediscounts and reserves) and a variety of sectoral reforms, affecting agriculture, the industrial and the energy sector.

Mr. Kafka made the following statement:

This chair warmly supports both the stand-by and the compensatory financing facility requests. It took considerable political courage to devise and to implement the June 1985 monetary and anti-inflationary program, and further courage will be required to keep the adjustment process moving forward with this proposed stand-by arrangement. It is an ambitious program aimed at halving the inflation rate and achieving a 15 percent decline in the current account deficit of the balance of payments for 1987. At the same time, economic growth is to reach 4 percent, not dramatically less than in 1986, which was an exceptionally good year for Argentina. The accent on growth is essential if the program is to be successful.

One of the main instruments of the program is the reduction, by 1.4 percentage points of GDP, of the cash deficit of the so-called combined public sector. It is apparent that the reduction in the combined deficit is to occur entirely in the second half of the year. A second instrument is a very tight monetary policy; limits on net domestic assets are based on the assumption that M1 will grow in line with projected inflation. The third instrument is wage policy, under which the Government will continue to set "bands" on wage increases in the private sector until a new labor law is passed to establish free collective bargaining. A fourth key factor is how the authorities are going to deal with price controls. As Mrs. Ploix mentioned during the Board discussion on Argentina in March 1986, in referring to the French experience on the matter of price control, "the removal of a general wage-price freeze must be managed cautiously." It seems to me that the authorities are doing exactly that by liberalizing prices only in those sectors where competition is strong and by keeping wage growth under control. In this way, they are retaining the momentum created by the 1985 initiative to achieve the goal of balanced restoration of growth. However, it cannot be stressed too much that the best administered price control cannot prevail in the absence of demand control and, in any case, cannot be helpful for long.

It is clear that the Argentine program is extraordinarily tight and strict. First, there are none of the innovations included in the Mexican stand-by program, even though there are some dangers regarding Argentine primary product exports, and there is a clear need of assurance that growth will not be unnecessarily hampered. It does not seem to us that paragraph 25 of the Memorandum of Understanding is an adequate substitute for genuine contingency clauses. Second, the same not inconsiderable numbers of quantitative performance criteria of the 1985 stand-by are found in the proposed one. Third, the same time framework for determining the ceilings of the performance criteria adopted in the previous stand-by arrangement has also been adopted here, with ceilings in foreign currency fixed for four quarters and in domestic currency for two quarters. One should consider that arrangements for countries with very high debt levels and very high inflation rates only work when administered very flexibly--including the generous use of waivers--as was done in Argentina's previous stand-by arrangement.

In the medium-term balance of payments scenario, we found export projections within the limits of feasibility. As for nondebt-creating flows, it is difficult to compare Tables 6 and 11 in Appendix VII.

The compensatory financing facility request speaks for itself, and all conditions have been met. I shall therefore limit myself to saying that we strongly disagree with the proposed decision to delay disbursement under the request.

Mr. Ortiz made the following statement:

Argentina's experience with the Austral Plan confirms one of the lessons that has been relearned since the outset of the debt crisis: inflation is stubborn. So far, it has proved to be extremely resistant to both orthodox and so-called heterodox approaches.

A second lesson is that the fight against inflation--especially when the rates are very high--is an objective that rallies much more political support than a reduction of fiscal deficits. Yet, from a deeper analysis of the Argentine case, one can see that both targets are intimately intertwined. Indeed, one of the more successful aspects of the first phase of the Austral Plan was that the political support gathered in the fight against

Since I can endorse the thrust of the staff appraisal, my comments on policy issues will be brief.

First, the containment of the public sector deficit represents a key element of the program. In view of the importance of fiscal restraint, it is alarming to note in the staff report that not all the necessary measures to achieve the intended deficit reduction are yet in place. Perhaps the staff could elucidate the magnitude of additional measures that are required to achieve the program's targets.

On the modality of the deficit reduction, the staff has highlighted the fact that Argentina's fiscal adjustment in the past has been concentrated on revenue-raising measures. In this respect, the measures introduced last November to streamline government employment and the public enterprises were steps in the right direction. However, more efforts will be required in expenditure cuts.

Second, adequate monetary restraint is equally important for the attainment of the program targets. Since the performance criterion regarding the limits on the change in net domestic assets for the period beyond June 1987 is not set at this initial stage, I attach particular importance to the program review that will take place as early as June of this year.

It is encouraging to know that, in the implementation of monetary policy, some progress has been made over the last year or so in increasing the flexibility of interest rates. However, like the staff, I would caution against too large a role for the Central Bank in financial intermediation through rediscounts.

Third, the above-mentioned demand restraint management will continue to be complemented by the use of a system of wage and price controls, which, in the past, has been managed in a relatively flexible manner. The importance of continued wage moderation cannot be overemphasized.

Fourth, on exchange rate policy, since last August the authorities have resumed adjusting the exchange rate. A flexible exchange rate policy would be instrumental to export promotion and repatriation of capital and thus to the attainment of the program's objectives.

Before concluding, I shall make two observations of a procedural nature. First, today's decisions are being proposed for approval in principle. As in the Mexican case, I have some reservations about whether today's case strictly meets the general guidelines adopted by the Board for approvals in principle. Moreover, our experience with the reactions of the commercial banks to the in-principle decision in the case of Mexico has reinforced these concerns. Nevertheless, I can go along with the proposed stand-by decision in the spirit of international cooperation, if that is the wish of the Executive Board, but only on the understanding that this is an exceptional case. In this regard, I would ask the Fund management to give the appropriate advice to both the commercial banks and the Argentine authorities, so that they could agree without any undue delay on a mutually acceptable financial package.

Second, while I agree with the staff that the request by Argentina for a compensatory financing facility purchase equivalent to SDR 388.7 million is expected to meet all the requirements under the relevant Board decision, the proposed decision involves a procedural issue in the sense that a more flexible treatment can be, and will be, taken concerning the timing of the compensatory financing facility drawing than that under the stand-by arrangement. However, I can also go along with the proposed compensatory financing facility decision in the recognition that such a procedure is unavoidable in order to secure the necessary bridging finance and on the condition that this should not be seen as a precedent in the future.

Mr. Massé made the following statement:

The proposed arrangements present us with an interesting problem. On the one hand, it is clear that Argentina in many respects has made considerable progress in the past few years, in particular, after the introduction of the Austral Plan. This progress has included not only a large reduction of the budget deficit and a considerable slowdown in the rate of inflation; it has also included a resumption of growth and an attack on a number of difficult longer-term problems. In our view, the program now being presented by the authorities sets out the right kinds of objectives, including better inflation and balance of payments performance, and indicates the appropriate direction for policies, including a reduction in the budget deficit, tighter monetary policy, a selective liberalization of wage and price controls, some very necessary structural reforms in the public sector, continuation of financial reform, and the liberalization of trade and exchange restrictions.

On the other hand, we are concerned by a history of policy slippage in Argentina, which has often resulted in waivers being required. And in this program, there are a number of potential problem areas, particularly with respect to fiscal and monetary policies. The reacceleration of inflation in January, as indicated by Mr. Feldman in his very interesting statement, is worrisome, as is the deterioration in the current account and the balance of payments in 1986.

Yet, the broad thrust of the policies described by the Government does seem appropriate, and I think that it is important at this time to sustain the momentum of adjustment in Argentina. However, we attach considerable importance to the upcoming midterm review of this program, and I would expect that by that time, the Government will have moved a good distance toward achieving its objectives. I would also emphasize the need for the Argentine authorities to be prepared to act very quickly should there be external or domestic developments that would adversely affect the program's chances of success.

I would now like to amplify my general remarks with some brief comments on specific policy areas, beginning with fiscal policy.

The objective of a reduction in the overall public sector deficit to 2.5 percent of GDP this year seems appropriate. I do, however, have a number of concerns. As Mrs. Ploix and the staff note--correctly, we believe--the adjustment effort seems to overemphasize revenue measures relative to spending decreases: in 1987, revenue is projected to be about 7 percent above 1984 levels in relation to GDP, while expenditures are to decline by only 0.2 percent as a proportion of GDP over the same period. I recognize, however, that if successfully implemented, some of the measures the Government is taking in the area of structural reform of the public sector could give the authorities an opportunity to reduce expenditures in the future.

With respect even to the proposed revenue measures, there is an uncomfortable reliance on temporary measures to bring down the budget deficit. In this connection, I join the staff in noting that more permanent measures will need to be in place by 1988 if the adjustment effort is to be sustained. On the tax amnesty scheme itself, recently there have been reports that indicate that revenues from the scheme may well be less than the forecast 1 percent of GDP. For this scheme to work well, it will be important for the Government to have in place a strong tax administration system so that potential evaders see that there is a cost to noncompliance with the scheme. I would be interested in the staff's assessment both of likely revenues from the scheme and of the current strength of tax administration.

Control of government expenditures will continue to be important to fiscal improvement, and in this connection, there are several factors which make me uneasy about the prospects for success. For instance, I wonder whether there is any likelihood that the "state of emergency" declared in the social security system could be contested in the courts. Should the authorities lose such a challenge, there would be a potential for a large increase in required social security payments. Perhaps the staff or Mr. Feldman could comment on this problem. Also, I would be interested in the staff's view on the likelihood of satisfactory expenditure control by the provinces.

Given the uncertainties associated with the points raised above, as well as the impact on the budget of what could be higher than forecast inflation, I strongly urge the authorities to monitor very carefully budget execution, and to be prepared to act very quickly should there be signs of problems, as there is little room for slippage in this area.

I welcome the initiatives in the areas of structural reform of the public sector, in particular the preparation of the multi-year investment program in conjunction with the World Bank, the Bank's annual review of the investment program, and the attempts to rationalize public sector employment and wages. Similarly, I welcome the authorities' indication that if free interest rates remain high in 1987, the rates on rediscounts would be raised to achieve the targeted decline in the operating losses of the Central Bank. I would have preferred, however, stronger measures, which could have led to an early elimination, or at least an early substantial reduction, in this deficit.

Given past slippages in monetary policy and indications that inflation and inflationary expectations are not yet under control, the authorities will have to be very careful in the conduct of monetary policy. In particular, they would be well advised to take a conservative view of the extent to which the demand for real money balances would increase this year. In this connection, I welcome the indication in the letter of intent that monetary policy will be kept under review to ensure the achievement of the program's objectives. And I commend that feature of the program which attempts to limit the extent to which any balance of payments overperformance could contribute to an excessively rapid rate of monetary growth.

Over the last few years, the authorities have taken measures to introduce and increase the scope of nonregulated interest rates and financial instruments, and, more generally, to improve the functioning of the financial system. Much remains to be done in this area, however. We attach considerable importance to the authorities' commitment to make efforts to limit rediscounts and to lower reserve requirements under this program, together with the reduction of intermediation costs in the banking system.

On price and wage policies, I share the staff's concern about the distortions that the present controls could cause and the uncertainty they create for investment. I agree that controls should be removed soon, with primary reliance for controlling inflation placed on policies to control demand and promote competition. To the extent that the easing of controls is seen to create problems because of domestic oligopolies in many sectors, a helpful partial solution could be the implementation of the long-awaited liberalization of trade policy, to which we attach considerable importance, as we do also to the elimination of exchange restrictions and arrears.

Appropriate exchange rate policy is of vital importance. In this connection, the terms of trade deterioration, the projection of weak performance of agricultural exports, the planned liberalization of exchange and trade restrictions, the perceived need for assistance to exports, and the significant spread between parallel and official exchange rates are all strong indications that the authorities should be evaluating the adequacy of the present rate.

In concluding, let me underline again the importance of continued support by the Government for the objectives the authorities have set out in their program, the importance of a thorough implementation of the present proposals, and the importance of follow-up measures. In these conditions, we support in principle the proposed decisions, and look forward to the upcoming review.

Mr. Zecchini made the following statement:

The outcome of the Austral Plan has been fairly encouraging so far. Inflation has been drastically reduced from the previous three digit figures; the public sector budget deficit has continued to decline; and real GDP growth has increased in 1986 at a remarkable 5.5 percent after the sharp drop in 1985.

Despite these positive results, however, external developments and, particularly, a substantial weakening in policy discipline have reduced to some extent the expected far-reaching benefits of the adjustment efforts initially implemented. As a consequence, the economy still shows signs of disequilibrium and tension, especially with respect to inflation and the external accounts. Therefore, a very cautious economic management along the lines suggested by the staff is necessary in order to redress these imbalances.

We believe that the program presented to us today can indeed constitute a useful basis for the needed adjustment. Therefore, we support its approval in principle. However, we broadly share the concern expressed by the staff, especially on monetary policy, fiscal adjustment, wage policy, and external developments; and we will comment briefly on each of these areas.

Monetary policy is the area that in our opinion deserves most of the attention. The experience of the Austral Plan has shown, in fact, not only how powerful monetary policy can be in controlling inflation, but also how easily this policy can run out of control.

A comparison between the two major monetary restrictions which took place during the Plan--one in mid-1985 and the other in mid-1986--is in this respect quite illuminating. While in the first instance, the drastic decrease in monetary aggregates reduced inflation substantially and without significant lags--forcing its dynamics to undershoot its equilibrium level--in the second major restriction, the outcome was much less positive. As the table on page 12 of the staff paper shows, inflation reacted with a lag of about three months to the monetary restriction which took place in July 1986. Moreover, it appeared that the correlation between money creation and inflation tended to become much looser, particularly in the last part of 1986.

The reasons for these different outcomes are certainly to be found in the stance of monetary policy since the first monetary restriction. The authorities, by attempting to take advantage of the presumable increase in the willingness of the private sector to hold higher real cash balances, injected money in the system at a pace inconsistent with a lower inflation rate objective. The result of this remonetization of the economy was a rate of money expansion fairly unstable, if not random, last year.

The consequences are quite significant. On the one hand, as the staff mentions, inflationary expectations have continued to persist and even to grow, as is shown, for instance, by the large discount of the austral in the parallel market. On the other hand, monetary policy has clearly lost some effectiveness in controlling inflation. These are disquieting developments. They show that the consolidation of the anti-inflationary program is a much more difficult task than the initial reduction of inflation. Whenever the announcement effect of the monetary reform is exhausted and the price freeze is partially released, what makes monetary policy effective is the consistency of its conduct. In this respect, however, the 1987 program does not give us completely reassuring signals.

First, the rediscount operations still represent a very important and volatile component of monetary base creation; and in the program presented today, there are not very constraining measures that can contain the scope of these operations. In the present conditions, the large volume of rediscount operations considerably hinders the effectiveness of monetary management. Furthermore, such a volume does not contribute to the efficiency of the banking sector (because of the high proportion of credit intermediated by the Central Bank) and it involves sizable losses for the Central Bank (because of the negative spread between rediscount rates and market interest rates paid on domestic liabilities). It should be recalled that at present the utilization of the rediscount is not really constrained by cost considerations for the commercial banks. Therefore, its dimension and the consequent impact on monetary aggregates appears to be quite unpredictable.

The intention of the authorities to develop a more detailed data base on the repayment schedule of existing rediscounts is welcome. However, there have been delays in the implementation of this measure, and we would like to know from the staff the envisaged timing of its implementation. In any case, we would urge the authorities to proceed faster in reducing the latitude of rediscounts, and we regret that the concern of the Board expressed during the most recent Article IV consultation was not sufficiently taken into account in 1986.

The instruments of monetary control are still very limited and basically consist of the reserve requirement ratio and the management of central bank credit. In this regard, we would like to know what progress has been made in developing open-market operations, an aspect which was considered in the previous report on Argentina but not in the present one. The question has somewhat more relevance now because of the intention of the authorities to partially sterilize increases in the external component of the monetary base. While we certainly welcome this intention, we wonder whether the range of maturities and the size of the bond market are such as to guarantee the effectiveness of such sterilization.

Turning to fiscal policies, I wish to commend the successful efforts of the authorities to redress the fiscal imbalances. The adjustment, however, should be further enhanced to relieve monetary policy from the constraints of public sector financing. We agree with the staff that the current adjustment is based too much upon revenue measures. Therefore, we urge the authorities to find ways to reduce expenditures by striving for cost effectiveness and by enhancing wage discipline. In this respect, a massive improvement in the management of public enterprises, and especially of the State Oil Company, should be sought.

Wage developments represent a major source of concern in relation not only to the public sector but to the entire economy. The possibility of vicious circles of inflation-wage increases-inflation, is not remote in the current Argentine economic environment with very sensitive price expectations and rather powerful labor unions. It is therefore with particular favor that we see the establishment of general rules for wage increases which are based on the pre-established rate of inflation. Although these rules could have a substantial negative impact on wage differentiation if maintained for a long time, they are useful to the extent that they show a social consensus in the fight against inflation. Incomes policy represents in our opinion an important tool when it is complemented by appropriate monetary and fiscal policies.

On external developments, we note with concern that the economy is reducing continuously its degree of openness. The ratio of exports and imports to GDP decreased from 39 percent in 1980 to 23 percent in 1986. In this respect, we regret that trade liberalization is proceeding rather slowly. In particular, the transfer of most imports to the "automatic" list was not carried out as scheduled under the previous stand-by arrangement.

Furthermore, greater attention should be paid to the development of external competitiveness and to the export structure, if sustainability of economic growth has to be ensured. The recent shortfall in export earnings shows that there is a need to enhance the diversification of exports. In this respect, the intention of the authorities to conduct a policy of export promotion associated with a flexible management of the exchange rate might not be sufficient.

To conclude, we wish to state again that we support the efforts that the Argentine authorities are making to redress economic imbalances. And we look forward to seeing timely participation by the banking community to help the country to cover the financing gap. We also support the use of the compensatory financing facility as spelled out in EBS/87/17, Supplement 1.

Nevertheless, I have a final question to ask. Is there any rule or regulation which prevents a country from drawing on the compensatory financing facility immediately after its approval, given that the country's request is for 35 percent of the quota, i.e., in the lower tranche, and that a stand-by program has been accepted by the country and approved in principle by the Fund, which means that the test of cooperation with the Fund has been met?

Mr. Nimatallah indicated that it was important to differentiate between two major issues facing the Board in the present discussion. One was related to policies of the Fund; the other had to do with policies of Argentina. On the Fund side was the question of the approval in principle of the stand-by arrangement and the effective date of the decision on a purchase under the compensatory financing facility. At issue in that latter respect was whether the compensatory financing facility purchase should be made dependent in some way on the coming into effect of the proposed stand-by arrangement. It should be understood that putting a program in place would not necessarily guarantee the Fund the return of its resources; in the circumstances, the Board might not wish to approve disbursement of resources under the compensatory financing facility even with a program in place. The question before the Board at the present meeting was whether to deny the compensatory financing facility request entirely until matters were clearer, to approve a disbursement under the compensatory financing facility in tandem with disbursements under the stand-by arrangement, or to disburse resources under the compensatory financing facility even before the coming into effect of the stand-by arrangement. The middle course had been followed in other cases, as had the third option.

It seemed that the Argentine case was one of political importance, the significance of which derived from Argentina's place in the international monetary system, Mr. Nimatallah continued. If it was decided to disburse resources under the compensatory financing facility before the coming into effect of the stand-by arrangement, that decision would be based on the political significance of the Argentine case. The issue was whether it was the responsibility of the Fund to provide monies sufficiently early to enable Argentina to deal with its bridging finance or whether it was the responsibility of the commercial banks and other creditors to take that initiative. It was his understanding that efforts to negotiate bridging finance had not been successful and that the Fund might have to take some action at the present meeting to save the program. He, for one, would have no difficulty in approving such a step before the stand-by arrangement was fully in place, although he would want it made clear to commercial banks and other creditors that the Fund was helping Argentina without being certain that the program would fully enable the authorities to achieve their objectives. The Argentine case was a good example of the principle that compensatory financing facility requests should be handled on their individual merits. Argentina carried great weight in the international monetary system, and that weight had a bearing on the Fund's decision.

He had no difficulty with the approval in principle procedure proposed for the stand-by arrangement, Mr. Nimatallah commented. He could support the objectives for economic policy in 1987 as outlined by Mr. Feldman in his opening statement, and he agreed with the authorities that it was important to sustain growth while keeping inflation under control. Moreover, the approval in principle procedure had been applied in other cases and seemed to work reasonably well.

Remarking on the policies to be used to achieve the authorities' objectives, Mr. Nimatallah noted that growth had not been emphasized as much as he would have liked in the staff papers. Moreover, he sensed some lack of clarity in the structural adjustment measures necessary to achieve the objectives. For example, on page 26 of the staff paper, it was stated that "the authorities' economic program envisages a further reduction in the overall public sector deficit, which should help reduce inflation and strengthen the external current account without crowding out the private sector." He was not certain of the meaning of that statement; nor was he clear about the indication on the same page that all the measures needed to achieve the intended reduction in the deficit were not yet in place and that the tax amnesty program was of a nonrecurring nature. The staff had gone on to suggest that even if the program yielded the resources contemplated by the authorities, it would need to be replaced by a program involving more permanent measures. If the intention was to achieve sustainable growth, it would be important to sustain aggregate demand, which had mainly two components: expenditure on investment and expenditure on consumption. Of course, the savings ratio was an important element in that regard. The table on page 42 of Supplement 1 of the staff paper showed that gross national savings had been in the range of 11-13 percent since 1982 while gross aggregate investment had dropped from a high of 18.1 percent of GDP in 1982 to a low of 13.5 percent of GDP in 1985. It was apparent that the difference between savings and investment had been financed by borrowing. If one wanted to sustain growth, it was necessary to live within one's means and aim for a rate of growth that could be financed by a reasonable rate of savings and by the ability to borrow. The latter would depend on the ability of Argentina to service its debt and to keep good relations with its creditors, which itself depended on the rate of growth. The implication was that the Argentine authorities could not be asked to reduce expenditures too quickly, since such action might jeopardize the rate of investment. At the same time, they could not be asked to increase taxes to the extent that the private sector could not save. Those two delicate functions had to be handled carefully over time to enable the private sector to take over responsibility from the Government as it reduced its size. It was not appropriate to tell the Government to reduce expenditures as rapidly as possible on a permanent basis unless the private sector was at the same time encouraged to take over and maintain a reasonable level of expenditure on investment; and that encouragement required a great many incentives and much time. Argentina was at present absorbing some revenue from the private sector, but the amnesty tax program was not sufficient. It was reasonable to say that what little liquidity was influencing the inflationary pressures in Argentina should be absorbed; the question whether the measures aimed at achieving such absorption should be more permanent was a matter to be decided later. The important thing was to work toward achieving some structural adjustment that would take responsibility gradually from the public sector and give it to the private sector so as to sustain a certain level of aggregate demand and a credible rate of economic growth.

There was economic growth in Argentina, but it was at a rate that was too high to be sustainable in his view, Mr. Nimatallah commented. It could be sustained only if measures were taken to increase savings and encourage the private sector to invest more as the public sector reduced its expenditure on investment. What was important in the circumstances was to look closely at the quality of expenditure with a view to improving capital formation. Without rapid reductions in expenditure, inflation could become a problem, but it could be beaten by increasing output and capital formation and by encouraging Argentina to achieve sustainable growth at rates more compatible with the rate of savings. To make it sustainable required a delicate balance between the control of the quantity of expenditure and improvements in the quality of expenditure over a somewhat longer period. He had no difficulty with a short-term approach, so long as the authorities began to give effect to their intentions to reduce the size of government and liberalize trade and prices. His authorities in Saudi Arabia had tried price determination, which had worked quite well. Competition was the key, and he agreed with his colleagues that the removal of price controls must be done carefully. He had been surprised, in that connection, by the speed at which Brazil had lifted price controls. He had cautioned against such a rapid lifting of controls at the time, and he would repeat his caution to Argentina, while reminding the authorities to complement the approach with exchange rate and trade liberalization efforts. The more liberalization, the easier it would be in the medium term for Argentina to beat inflation. Finally, controlling inflation required persistence in the deindexation of wages and in the reduction of the deficits with a gradual takeover of investment expenditure by the private sector.

Mr. Nimatallah then made the following statement:

Since the Austral Plan was introduced in June 1985, the Argentine authorities have been pursuing a comprehensive adjustment program with a view to restoring economic balance and reducing inflation. This program has achieved a number of notable successes, for which I commend the authorities. I also commend them for their determination to tighten monetary policy further and to resist demands for a restoration of wage indexation in 1986, when new pressures emerged. Since I am in broad agreement with the thrust of the staff reports, I will confine myself to a few brief observations.

First, Argentina's experience with high rates of inflation is quite recent. To ensure credibility, therefore, it is important that the authorities adhere closely to their anti-inflation policies. Specifically, I would encourage the authorities to persist with their efforts to ensure wage deindexation. In addition, they should continue with their policies aimed at controlling prices. At this stage, these policies will rely more on direct controls and price guidelines. Over time, however, these controls can be gradually phased out, with ever-increasing reliance being placed on competitive market forces.

Fiscal policy also has a role to play in meeting these objectives. The authorities have succeeded in reducing the fiscal deficit sharply over the past few years. I believe from this point on, further deficit reductions should be gradual and should be in tandem with an improved performance of the private sector, setting the basis for a permanent reduction in inflation. Incidentally, I am not concerned about the temporary revenue implications of the tax amnesty measure. In fact, I like it as a means of short-term control of aggregate demand, and it is preferable to a permanent tax increase.

At this stage, the authorities also need to consolidate the path of economic growth. That, in turn, depends on a sustainable aggregate demand. Growth in aggregate demand depends, in turn, on the growth of components, including investment and consumption expenditures. The key element in between is the saving ratio.

If growth is to be sustained, it needs to be at a credible rate, which can be maintained by Argentina's ability to save and borrow. Ability to borrow depends on Argentina's capacity to service its debt. Encouraging savings is important, and I believe that this can be achieved by pursuing credible adjustment policies, as well as by emphasizing supply-side structural changes. I would like to have seen more discussion of the structural policies the authorities intend to implement.

In conclusion, the Argentine authorities are proposing a program which is a step in the right direction. However, given the limited room for maneuver, the authorities will have to stand ready to make whatever further adjustments are needed as the situation develops. I can support the proposed decision. I can also support the request for a compensatory financing facility drawing since all the conditions for such a drawing are satisfied.

The Executive Directors agreed to continue their discussion at 3:00 p.m.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/87/27 (2/13/87) and EBM/87/28 (2/18/87).

3. PENSION COMMITTEE - INVESTMENT OFFICER - ESTABLISHMENT OF POSITION

The Executive Board approves the recommendation for a new position of Investment Officer in the Office of the Managing Director, as set forth in EBAP/87/29 (2/12/87).

Adopted February 17, 1987

4. EXECUTIVE BOARD TRAVEL

Travel by an Assistant to Executive Director as set forth in EBAP/87/28 (2/12/87) is approved.

APPROVED: September 17, 1987

LEO VAN HOUTVEN
Secretary