INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 91/37

10:00 a.m., March 15, 1991

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
	A. A. Al-Tuwaijri
G. K. Arora	
C. S. Clark	
Dai Q.	
T. C. Dawson	M. E. Hansen, Temporary
	J. Prader
	G. H. Spencer
R. Filosa	
	A. F. Mohammed
	I. H. Thorláksson
B. Goos	
	T. Sirivedhin
	J. R. N. Almeida, Temporary
J.-P. Landau	J.-F. Cirelli
	O. Kabbaj
	J. Mafararikwa, Temporary
D. Peretz	
G. A. Posthumus	G. P. J. Hogeweg
	A. R. Ismael, Temporary
A. Torres	R. Marino
A. Végh	A. G. Zoccali
K. Yamazaki	N. Tabata

L. Van Houtven, Secretary and Counsellor
M. J. Miller, Assistant

Also Present

M. Todorova, Deputy Minister of Foreign Economic Relations, Government of Bulgaria. IBRD: J. Wilton, Europe, Middle East and North Africa Regional Office. African Department: P. Marciniak. Central Banking Department: H. Ikeno, S. P. Leite, J.-C. Nascimento. European Department: M. Russo, Director; P. B. de Fontenay, Deputy Director; M. C. Deppler, S. Miltner, J. Odling-Smee, D. C. Ross, H. O. Schmitt, E. J. Zervoudakis. Exchange and Trade Relations Department: J. T. Boorman, Director; E. Brau, Deputy Director; D. Burton, C. V. A. Collyns, J. M. Landell-Mills, P. Lenain. External Relations Department: J. Starrels. Fiscal Affairs Department: S. K. Chand, E.-A. Conrad, H. R. Lorie, E. F. Offerdal. IMF Institute: P. R. Rado, N. Tith; P. Gogov, N. Nikolov, A. Zarev, Participants. Legal Department: P. L. Francotte, R. B. Leckow. Research Department: J. H. Green, M. S. Khan, P. R. Menon, B. E. Rourke. Personal Assistant to the Managing Director: B. P. A. Andrews. Office of the Managing Director: J. Grieco, Visiting Scholar. Advisors to Executive Directors: L. E. Breuer, M. Galán, Z. Iqbal, A. Napky, B. Szombati, A. M. Tanase. Assistants to Executive Directors: B. Abdullah, C. Björklund, J. A. Costa, A Fanna, B. R. Fuleihan, M. A. Ghavam, M. Mrakovcić, M. Nakagawa, Shao Z., D. Sparkes, Tin Win, C. M. Towe, S. von Stenglin, J. C. Westerweel.

1. BULGARIA - 1991 ARTICLE IV CONSULTATION; STAND-BY ARRANGEMENT AND EXTERNAL CONTINGENCY FINANCING UNDER COMPENSATORY AND CONTINGENCY FINANCING FACILITY

The Executive Directors considered the staff report for the 1991 Article IV consultation with Bulgaria, and the requests of Bulgaria for a 12-month stand-by arrangement in an amount equivalent to SDR 279 million and for an associated external contingency mechanism under the compensatory and contingency financing facility (CCFF) with maximum access up to the equivalent of SDR 77.5 million (EBS/91/26, 2/22/91; and Cor. 1, 2/28/91). They also had before them a background paper on recent economic developments in Bulgaria, and a letter of intent relating to Bulgaria's requests for a stand-by arrangement and for a purchase under the CCFF for compensation for excess oil import costs, the latter of which was approved by the Board at EBM/91/27, February 25, 1991 (SM/91/52, 3/7/91; and EBS/91/22, 2/14/91; and Cor. 1, 2/28/91; and Sup. 1, 2/14/91).

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

> At the Board meeting on February 25 on Bulgaria's CCFF request, the staff informed Executive Directors that some prior actions had still to be fully implemented. Since then, these actions have been taken as follows:
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> First, Parliament approved on March 5 an increase in interest rates on "old" (pre-July 1988) loans as envisaged under the program. Old enterprise loans will be charged a premium over the basic rate (currently 45 percent). While interest rates on housing loans and the small amount of consumer credits will, as anticipated, have below-market ceilings, these have been allowed for in the design of the interest rate policy.
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> Second, the remaining tax measures that had been agreed under the program have been adopted through laws or government decrees; these included limits on interest deductibility in assessing profit taxes of enterprises and a rise in social security contribution rates.
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> Third, the interbank foreign exchange market started operating fully on February 18. Since then, the lev has appreciated sharply from leva 28.25 per U.S. dollar to about leva 16 per U.S. dollar this week. This appreciation has occurred in the absence of any sales by the National Bank to the interbank market. In the staff's view, a further appreciation of the lev is likely with an improvement in the operation of the market, provided that financial and incomes policies remain appropriately tight. The interbank market remains relatively thin. This may reflect persisting uncertainty and divergent views on the part of

potential buyers and sellers of foreign exchange about the future course of the exchange rate of the lev.

In addition, as anticipated in the staff report, the Parliament approved, in late February, an agrarian land reform bill, which, inter alia, provides for the return of land to former owners. Furthermore, wage policy has been strengthened by eliminating loopholes that allowed enterprises in the past to evade taxes on excessive increases in wage bills.

Directors are aware that Bulgaria has asked the Group of 24 and the European Community for financial assistance within the framework of the European Council decision of last December. Recently, the EC Commission has chaired several meetings aimed at mobilizing additional financial resources to complement Fund resources to be made available under stand-by or extended arrangements negotiated with a number of countries. For Bulgaria, a number of meetings have been held to mobilize the financial assistance requested by Bulgaria and the process is ongoing. EC Finance Ministers have asked the Commission to formulate a formal proposal regarding the EC's contribution to G-24 financing for Bulgaria. This contribution is expected to be up to half the total amount requested by Bulgaria, i.e., a maximum of $400 million out of the requested $800 million. Another meeting of the ECOFIN council is scheduled for next week where it is proposed that a decision be taken regarding the EC's share of the requested financing. Apart from the EC, several countries have indicated a positive attitude but, except for Switzerland, without specific amounts committed at this time. On the basis of the above indications, we are working on the presumption that the needed financing will be raised during the course of the year. However, it is already apparent that the process will be a protracted one. The progress towards securing G-24 and EC financing is proposed to be assessed at the first program review. Satisfactory evidence regarding the closing of the financing gap will be required for completion of the review.

Given the severity of Bulgaria's transition, shortfalls in external financing could presumably have a detrimental impact on the reform process. Although the floating exchange rate regime will help safeguard current account adjustment, this will likely be at a more depreciated exchange rate than anticipated. In addition, many parts of the program could need to be reconsidered, including its output and inflation objectives. Policies under the program might also need to be adjusted, in particular through an even more ambitious fiscal adjustment, higher interest rates, a further compression of real incomes, and acceleration of efforts to regain export market shares. For all these reasons, it appears important to continue helping Bulgaria to secure the appropriate level of external support.

Mr. Posthumus made the following statement:

The staff report on the 1991 Article IV consultation with Bulgaria--the first ever--and on Bulgaria's request for a stand-by arrangement provides a comprehensive view of the financial and economic situation of the country. Also, the staff gives a good description of the policies which the authorities have introduced, and for which they request support from the international community. I will not try to paint the same picture with another brush, but I will try to shed some additional light on it.

Not much more than a year ago, a silent revolution in Bulgaria ended a 45-year long period of central planning, and of external trade almost completely oriented to the other centrally planned economies in Eastern Europe and the U.S.S.R. Following elections in the spring of 1990, protracted discussions between the main political parties took place, not so much on the direction of policies--as I will explain further on--but on the question of whether the opposition should or should not support these policies in Parliament. During this period, the economy deteriorated. The substantial external shocks of 1990--foreign financing almost stopped, the CMEA disintegrated, oil prices increased and oil imports dwindled, trade outside the CMEA with Iraq and Kuwait collapsed--went essentially unanswered. In this period, as the staff puts it, the economy was guided by neither a plan nor a market mechanism.

The worsening financial and economic situation, it seems, did not exacerbate the political disagreements to the extent of leading to a deadlock. Rather, a change of government took place, based on a parliamentary agreement between the political parties represented in Parliament. The Government was to be a coalition Government. The agreement was based on a broadly endorsed decision to introduce a market mechanism, and included a program of stabilization and reform, the outline of which was already visible in the course of 1990. I have tried to follow the developments in Bulgaria last year as closely as I could, and when one of the parties accused the other of stealing its program, it became clear to me that there was broad agreement on the course to be followed. Thus, through discussions, preparations, and finally negotiations in a rather quiet way, a radical program of stabilization and reform developed, and it obtained broad parliamentary support. The policies embodied in the program make it a home-made program, but the staff has lent substantial support in designing it and in arranging and providing technical assistance to the authorities. Bulgaria, by definition, has no long track record with the Fund, but the program which has been set in motion, and the way in which it was developed, seem to me to be as close a substitute as possible for it.

During the period of uncertainty about Bulgaria's intentions, foreign financing dried up completely. This process started last year when the country had to discontinue completely payments, including interest, on its foreign debts. Private creditors, international organizations, and official agencies, while aware of the desperate economic situation, hesitated to provide financing, in view of the lack of a comprehensive stabilization and reform program. In addition, as the Bulgarian authorities are well aware, the country is not known to the world. The agreement with the Fund, which the authorities hope will be approved by the Board today, has therefore become indispensable to assist Bulgaria to turn the deteriorating situation around. On this basis, the uncertainty which has kept private creditors, international organizations, and official agencies away, can be substantially decreased.

Finally, I should recall one of the major observations made by the staff in the recent paper giving an interim assessment of the 1990 programs in a number of Central and Eastern European programs: "...One should not be too sanguine about the performance likely to be achieved under programs." It is not clear which part of the Bulgarian investments of the past, as well as the technical expertise built up, can be made productive in a market-oriented system in the future. On the one hand, the extent to which relative prices are out of line with those in the potential markets abroad is not known in advance. On the other hand, some markets to which Bulgaria exported in the past may continue to exist in the future. This may be true, in particular, when relations between former CMEA partners have been settled once again, but in a market-oriented framework. The radical change which Bulgaria's economy has to accomplish requires, therefore, a continuing commitment to adjust policies to changing circumstances, as well as to realities which may be different than what had been assumed in the program. The broad support for their commitment to reform which the Bulgarian authorities enjoy at the moment is, it seems to me, the best guarantee for a Fund program to serve its purposes without undue risks for the Fund itself.

Mrs. Hansen made the following statement:

We welcome Bulgaria's decision to undertake a rapid and far-reaching economic reform program, and Bulgaria's request for Fund advice and support in this program's design and implementation. Although Bulgaria has only been a Fund member for a short time, there appears to be a very open and constructive dialogue between the authorities and the staff, which we hope will continue to deepen.

Because of its "big bang" approach, the Bulgarian program has been likened to the one adopted by Poland last year. Indeed, a tremendous shock is expected in the first quarter of the year, with a 167 percent rise in the retail price index, a substantial decline in output and real wages, and large exchange and interest rate adjustments. While the costs and risks of such an approach are considerable, we continue to believe that an ambitious program of this kind is likely to meet with greater success than a more gradual, piecemeal approach to reform.

One major difference between the Polish and Bulgarian programs is, of course, Bulgaria's use of a flexible exchange rate system instead of a fixed exchange rate anchor. Whatever the attractions of the latter approach, we agree that in Bulgaria's circumstances of uncertainty about an appropriate rate in the face of massive price distortions and very low reserves, there was no alternative but to choose a flexible system. Indeed, if a fixed rate system had been adopted, there would probably have been a strong temptation to set that rate at an overdepreciated level, as happened in the Polish case. In the event, under the flexible rate system and with strong policies in place, there has been a marked appreciation of the exchange rate, which should have a moderating effect on domestic price increases.

In any case, as we have emphasized in recent Board discussions, it is the strength of the underlying policies, not the type of exchange regime chosen, which will ultimately determine a country's success in establishing stable domestic prices. Consequently, it will be particularly important for the authorities to adhere to strict fiscal, monetary, and wage policies, and to stand ready to take additional measures, as needed, to achieve their objectives. In this connection, we welcome the frequent reviews provided under the program.

One feature which the Bulgarian program shares with the programs in Poland and Yugoslavia is a nominal wage anchor. With the insight gained by the latter two programs, there can be no doubt about the importance of maintaining a strict wage policy, notwithstanding rapid increases in consumer prices. In the case of Bulgaria, it is encouraging that the authorities have a compact with trade unions and employers on preserving social peace in the first half of the year. We hope that this agreement will not be too short-lived, and that expectations have not been unduly raised about a relaxation of wage policy in the second half of the year. While we cannot exclude the possibility of some relaxation, the experience in Poland and Yugoslavia suggests the need to guard against a premature loosening of wage policy.

The fiscal program seems to entail considerable restraint and prudence. We particularly welcome the large reduction in subsidies--from 16 percent of GDP, to less than 3 percent of GDP--and the contingency fund--amounting to 2.7 percent of GDP--provided to cover unforeseen deviations in the fiscal program. The budget also envisions significant reductions in maintenance and operating outlays. We hope that the Bulgarian authorities have been encouraged to consult the World Bank or other competent agencies about any potential adverse environmental consequences which such cutbacks may have.

We also note that the new "pass-through" rate on which administered prices are based--some 10 leva to the dollar--although significantly more depreciated than the previous "pass-through" rate, still does not accurately reflect international prices. The supplementary statement provided by the staff notes that the lev has appreciated sharply in recent weeks, to about 16 leva per dollar, and is likely to appreciate more, provided that financial and incomes policies remain appropriately tight. However, we believe that the appropriateness of the "pass-through" rate should be kept under review given the importance of correcting price distortions and protecting the fiscal program.

With regard to domestic prices more generally, we would like to draw attention to the lessons to be drawn from the programs in Poland and Hungary about the importance of dismantling monopolies in order to avoid excessive increases in the domestic price level. Trade liberalization, and the competition it provides for domestic producers, is also important in establishing market prices and allocating resources efficiently. In this connection, we share the staff's concerns about the deliberate pace of future trade liberalization, and the fine line between avoiding unnecessary bankruptcies of potentially viable companies and protecting uneconomic industry. Rapid structural and institutional change--to establish property rights, privatize state assets, and develop an efficient financial sector, among other objectives--will also be required in order to elicit the desired supply response needed to keep inflation under control.

With respect to Bulgaria's external situation, we hope that the authorities will regularize relations with creditors promptly. The staff report places considerable emphasis on the importance of adequate external support in order for the program to succeed, but as yet, the program is not fully financed. We recognize that Bulgaria has already experienced a large degree of import compression and a sharp decline in output, and we hope that the G-24 process will eventually yield sufficient resources for Bulgaria. In the meantime, we can agree to proceed with the Fund's support in the expectation that a substantial amount of the financing gap will be filled. It should be recognized, however, that a shortfall in external financing may well dictate a smaller reserve buildup and a greater adjustment effort on Bulgaria's part. This is an issue to which we may need to return in greater depth at the next review and the subsequent quarterly financing reviews.

This is a strong program worthy of the Fund's support.

Mr. Prader made the following statement:

We welcome and support the Bulgarian program. It is ambitious, goes in the right direction, and deserves the Fund's support. This is especially true as the domestic political environment that is decisive for the successful implementation of adjustment and reform has significantly improved in the wake of the agreement on the peaceful transition toward democracy that was concluded on January 3, 1991 between all the relevant political and economic agents. Indeed, against the background of the many uncertainties, including financing difficulties and foreseeable possible program revisions, as hinted at by Mr. Posthumus and in the staff's statement, this social and political consensus is perhaps the main capital on which the country can rely in these difficult times.

The introduction of a new exchange system constitutes a major adjustment policy decision taken by the authorities, which did away with the multiple rates and the accompanying distortions of the previous system. Given the magnitude of existing distortions and the complete lack of external reserves, the fixed exchange rate options did not appear practicable for the moment, and we concur with that conclusion. The primary nominal anchor role will be provided by the authorities' incomes and financial policies. These policies should have a stabilizing influence on the pure and clean floating exchange rate system. There should be no debate on the stabilizing effect of those policies. However, they do not serve as a guide to the appropriate level of the exchange rate. The authorities and the staff seem to have somehow arrived at a level of 10 leva per U.S. dollar as their first estimate of the equilibrium rate. I would be interested in the underlying reasoning and the empirical evidence leading to such a conclusion, which implies an 80 percent devaluation in dollar terms.

The authorities have gone a long way in freeing up the foreign trade regime. The remaining restrictions on exports can be justified as a temporary device in an overall scheme of organized transition toward a decentralized market economy. The emphasis here must be put on the process of transition, rather than on its organization. Even if these quantitative export restrictions can be justified by valid considerations regarding the domestic availability of the products concerned, it must not be forgotten that they are also the natural counterpart of an incomplete adjustment of the domestic price structure. Therefore, the authorities' concern about preventing disruptions to the availability of supplies domestically would best be met by eliminating the remaining price distortions. I would be interested in knowing whether a timetable has already been established to that effect.

The authorities have ruled out the neat solution of a monetary reform to the large monetary overhang, which poses substantial risks to program performance. The circumstances for a monetary reform were nearly ideal, however. The monetary overhang is large, implementation of a monetary reform would have been successful given the authorities' commitment to a strong program of macroeconomic and structural adjustment, and it clearly would have marked the break with the previous regime and the beginning of a new era. The early absorption of the existing liquidity overhang is a must for the successful outcome of the stand-by arrangement. Because Bulgaria's housing stock is already largely privately owned--85 percent--liquidity absorption must occur through other means, namely, price reform, privatization of state-owned small businesses, and sales of treasury bills. Given the urgency of this task, I would be interested in learning from the staff what proportion of the liquidity overhang each of the envisaged mechanisms is expected to absorb. I would hope that the bulk of the absorption is to occur through the price reform, because the other two mechanisms are not yet immediately implementable. Confirmation of this would be welcome.

Liberalization of prices is therefore crucial in Bulgaria's program. In the immediate short term, it constitutes the primary vehicle for the required liquidity absorption. In the short and medium terms, it has to correct the existing price distortions and elicit the needed supply response in the economy. The authorities have to be fully aware of these requirements, for the way in which they administer the two groups of directly or indirectly controlled prices, in particular, which still constitute some 26 percent of retail turnover. These prices must be broadly in line with the existing cost structure. The same concerns are in order for the way in which the authorities will handle the monopoly legislation with respect to the commodities the prices of which are liberalized, especially if, after the initial jump in the price level, the rate of inflation does not come down as planned. In that case, the authorities will have to resist the temptation to intervene directly on the price front; rather, it will then be necessary to reconsider the financial variables which underlie the return to a sustainable rate of inflation.

In that regard, incomes policy will have to play a determinant role. A strong prior action has been taken in that field by the tripartite agreement on an incomes policy, which accepts a 35 percent real wage reduction. Although I certainly recognize the importance of that agreement, I wonder why it has not been possible to extend the agreement to the whole period of the stand-by arrangement, rather than only the first half of the year. This, of course, would not imply a 70 percent wage reduction, but would provide greater assurances that the 35 percent reduction is actually met. Also, I view the necessity of increasing wage differentials in the second half of the year as somewhat less urgent than do the authorities. The overriding aim is to keep Bulgaria out of an inflationary process, and wage differentiation could best be met by allowing wages to be freely determined in the privatized parts of the economy.

Such an approach would have provided an additional stimulus for the urgently needed structural reforms. In order to instill financial discipline, elicit a supply response, and, therefore, counteract the drop in output and revenue, the authorities must act rapidly in the fields of demonopolization, privatization, and state enterprise reform. I noticed that the domain of large-scale privatization is still being studied, but that the authorities view with skepticism the distribution of shares to the population. What are the reasons for their skepticism regarding a "voucher" scheme, which has so captured the imagination and enthusiasm elsewhere? Have the authorities in the meantime clarified the vehicle to be used for large-scale privatizations?

There are convincing arguments for the Fund's involvement in Bulgaria's reform strategy. These arguments are particularly relevant given Bulgaria's dismal medium-term balance of payments outlook. We have of course to recognize the methodological limitations which characterize this medium-term outlook; nonetheless, with a current account deficit which ranges between 5 percent and 10 percent over the coming years, it is fairly clear that Bulgaria suffers from a fundamental disequilibrium, and it will certainly not be easy to fill Bulgaria's financing needs. If this balance of payments outlook shows but one thing, it is the evident necessity of debt reductions on a large scale.

Mr. Yamazaki made the following statement:

I commend the authorities and the staff for having concluded the negotiations in the relatively short time since Bulgaria joined the Fund last autumn. The program before us is a strong and ambitious one, and deserves our support.

The program is designed primarily to prevent inflation, and growth is not a priority of the program. Real GDP growth is projected to decline by 11 percent in 1991. In light of the experience in Yugoslavia, it is very likely that price liberalization could lead to hyperinflation, unless the excess liquidity caused by previous lax fiscal and monetary policies is absorbed. If the authorities fail to achieve this anti-inflation target, Bulgaria will have to face a longer and more painful period of adjustment in the future. I fully endorse the program's emphasis on containing inflation, rather than encouraging growth.

As was extensively discussed in the seminar on the evaluation of the recent adjustment programs in Central and Eastern Europe (Seminar 91/4, 3/13/91), the most important element in recovering domestic equilibrium while containing inflation will be the implementation of a stringent incomes policy whereby real income will be reduced, along with a tightening of fiscal policy.

With respect to the incomes policy, the agreement that has been reached by the authorities and the trade unions and employers will permit a substantial reduction in real wages in the program year. A reduction of about 35 percent in real wages for 1991 as a whole is anticipated in the program. The agreement provides for some flexibility, especially after the second quarter of 1991, in order to permit some corrective adjustment if the actual inflation rate exceeds the projection. However, it is clear from the Polish and Yugoslav cases that the departure from the program target was triggered by the weakening of the incomes policy, especially in the latter part of the program period. It is essential for the authorities to maintain a stringent stance on incomes policy throughout the entire program period, and to persevere with the real income reduction targets if the stabilization targets as a whole are to be achieved.

It is also important to be equally vigilant on wages in the state enterprises and cooperatives. In this connection, we welcome the fact that strict ceilings will be placed on the total wage bill, rather than on average wages.

The incomes policy measures and targets set forth in the program are ambitious, and I think that they will provide effective domestic anchors for the stabilization of the economy. I encourage the authorities to implement strictly the proposed measures and adhere to the income targets. In light of the primary importance attached to incomes policy in the stabilization program, the feasibility and usefulness of developing real wage performance criteria should be explored by the staff. I would welcome the staff's comments on this point.

With respect to fiscal policy, the program has set an ambitious target of reducing the overall deficit of the general government to 3.5 percent of GDP this year, compared with 3 percent last year. Capital expenditure is to be reduced substantially to 1.6 percent of GDP this year, from 5.8 percent last year. This is understandable given the interest in achieving the tighter fiscal objectives through drastic expenditure cuts. However, economic recovery in the medium term will be difficult to achieve without a recovery in output and the revitalization of the industrial sector. Only by these means will the external balance be restored. The role of the public sector, especially capital expenditure, in attaining the medium-term objective cannot be overemphasized. In this context, priority should be given to substantially strengthening the revenue side in the medium term in order to increase capital expenditure.

However, social security payments have been maintained at the same level in the program. This is necessary in light of the implementation of the strong incomes policy, which will cause a substantial decline in real wages. Nevertheless, I wonder whether a proper balance has been struck between social safety net expenditures and capital expenditure, which was reduced substantially. Although I understand that such an imbalance might be justified for the time being, the importance of capital expenditure in attaining medium-term objectives should not be disregarded.

On the monetary front, in order to absorb the existing monetary overhang, the program anticipates a further tightening of monetary policy through positive real interest rates and strict credit constraints on state enterprises, which is a step in the right direction. At the same time, I wish to emphasize the importance of swift and decisive implementation of financial system reforms. The institutional framework for controlling monetary aggregates is neither sufficient nor effective. Strengthening of the central banking function of the National Bank and increasing financial intermediation as a tool for monetary control are essential.

On the external side, the program does not appear to provide a firm enough basis for external viability in the medium term. A financing gap of as much as $3.8 billion is projected for this year. It is also a matter of deep concern that the medium-term scenario anticipates a financing gap of the order of $2-3 billion a year until 1996. The scenario assumes 8 percent annual growth in export volume between 1992 and 1996. This is faster than real GDP growth for the same period and, as I indicated in the seminar on March 13, it seems to be on the optimistic side. This intensifies and deepens my concern about the future external viability of the economy. It also raises doubts about the financing assurances of the program. In this context, I welcome the staff's intention to have quarterly reviews to assess the progress in securing external financing to support the program.

From the medium- and long-term perspectives, a fundamental challenge for the authorities will be to maintain a stringent fiscal policy, and thereby contain the growth of external debt outstanding through reduced reliance on foreign savings. However, as a remedy for the immediate future, I would like to endorse the staff's advice stressing the necessity of alleviating the debt burden through debt and/or debt-service reduction.

I support the proposed decisions.

Mr. Landau made the following statement:

We welcome the adoption by Bulgaria of a strong program, which encompasses comprehensive measures of liberalization, as well as a bold adjustment effort. The staff rightly stresses that the task before the Bulgarian authorities is formidable. Indeed, the country faces presently all the difficulties encountered so far in Eastern European economies, including an external shock of great magnitude in 1991. The substantial terms of trade loss following the CMEA reform, disruptions in the U.S.S.R.--on which Bulgaria was very dependent--and the impact of the Middle East crisis, will result in a deterioration of the balance of payments estimated at $3.5 billion in 1991, two thirds of which would be compensated by the adjustment effort. The program before us will aim at limiting the deterioration of the current account to $0.9 billion. This shows the burden which is to be borne by the internal adjustment process.

The staff report clearly highlights the risks involved in this program. I will therefore make a few comments on the program's main features, before turning to the overall financing package.

The initial stage of the program will aim at restoring an adequate structure of relative prices and eliminating the monetary overhang. This stage will be particularly crucial, as the authorities will have to ensure that the initial surge in inflation does not become built into the system. This will be all the more difficult since the program will not benefit from a fixed exchange rate anchor, but will depend to a high degree on incomes policy and strict financial policies.

The measures taken so far are bold and comprehensive. Faced with a liquidity overhang, the authorities decided on a broad-based liberalization of prices. I note, however, that

26 percent of the retail turnover will remain under price controls, although I understand the underlying reasons for that. I would, however, recommend that the authorities pursue price liberalization as soon as antimonopoly laws are adopted. It is also necessary that movements in import prices resulting from exchange rate variations be fully passed through to domestic prices.

Trade reform is an essential element in restoring relative prices. We therefore welcome the measures adopted so far, including the elimination of import restrictions and the reform of the tariff structure. Higher tariff rates on consumer goods are appropriate, at least in the initial phase, in order to avoid a surge in imports. On the export side, I would encourage the authorities to lift import restrictions and reduce export taxes, as soon as shortages have been eliminated on the internal market. Could the staff give us some information on the level of the export taxes, and when the second stage of the trade reform is envisaged?

What seems to be the core of the stabilization program is the linkages between the exchange rate and incomes policies. Let me first welcome the bold reforms in the exchange markets, especially the unification of the exchange rate and the creation of an interbank market. Nevertheless, regarding the exchange rate policy, the lack of a nominal exchange rate anchor will have a substantial impact on the program, since inflation obviously represents a serious threat. I fully understand the constraints imposed on exchange rate policies by the lack of international reserves and, although the views of this chair are well known in principle, I would not think it appropriate to insist on the establishment of a fixed exchange rate in the immediate future; but it then has to be fully recognized that the entire stabilization effort will rest on the incomes policy.

The agreement reached in February with trade unions and employers is therefore encouraging. I have, however, some questions for the staff. First, the agreement has a built-in mechanism which seems to limit the decline in real wages to 35 percent. This means that when the level has been reached, nominal wages will be fully indexed, especially as there is no fiscal sanction to enforce the agreement reached with the trade union. It is, moreover, my understanding that this 35 percent decline in real wages is consistent with an informal target of the nominal exchange rate at the level of 10 leva per U.S. dollar. This target has already been exceeded, since the exchange rate stands today well above that level.

So, by itself, the program may incorporate all the elements of a wage-price inflation spiral, without any anchor or stabilization mechanism. This impression is reinforced by the fact that nothing has been agreed upon for wage increases for the second half of the year, and the staff report even mentions that there would be room for an increase in real wages.

I am not sure, in these circumstances, whether monetary and fiscal policies can do the job by themselves. In the face of cost-push inflation and indexed nominal wages, monetary policy in particular is powerless in slowing down the rhythm of inflation, unless it is strong and visible enough to trigger a dramatic change in expectations. There is a strong case, anyway, for a more stringent incomes policy. If that does not appear politically feasible, perhaps an alternative would have been to proceed more cautiously toward external convertibility of the currency, thus allowing the authorities the possibility of preserving some control over the exchange rate without the need for overly large amounts of international reserves. This would have appeared all the more convincing in the case of Bulgaria, since Bulgaria's economy is a rather new one, with imports accounting for about 15 percent of GDP. I would appreciate any comments by the staff in this regard.

The fiscal situation is surrounded by many uncertainties. The authorities have decided upon a large reduction of the public deficit, from 13 percent to 3.5 percent of GDP. The measures taken are bold, and include a reduction of subsidies equivalent to 9.5 percent of GDP, and a reduction of the wage bill. I have some concern, however, about the drastic reduction in capital expenditure. Could the staff tell us if this is feasible, given the need to implement broad structural reforms? But the main uncertainty will come from the revenue side and the maintenance of profit taxes. A fiscal reform will certainly be high on the authorities' agenda, but will take some time to be implemented. We therefore welcome the contingency measures incorporated in the program and the prioritization of public expenditures. Lastly, the maintenance of a broad-based safety net will be an important asset for the success of the program.

The restructuring and privatization of the state enterprise sector, and the building up of private market institutions, will have to proceed as rapidly as feasible. Some progress has already been achieved in the housing sector and with the privatization of small units, but more remains to be done. I support the authorities' intention to enforce financial discipline in the enterprise sector during the phase-in of stabilization, but perhaps a clear timetable could have been established for returning to private ownership. This is also particularly true for the privatization of banks, the links of which to enterprises are particularly tight.

At this stage, uncertainties still surround the full financing of the program, and prolonged financing gaps involve a large degree of risk, first, regarding the Fund's involvement itself, and, second, because the implementation of the program itself is threatened. I would be interested in knowing how the performance criteria would be modified according to the availability of external financing. However, it is my strong view that Bulgaria deserves the support of the Fund and of the international financial community at this critical juncture. As noted by the staff, negotiations in the framework of the G-24 are being protracted, partly due to procedural problems, but also to burden sharing issues, and I hope that they will have a positive outcome. It is my understanding that the European Community and its member States, as on previous occasions, should be able to meet their obligations. We strongly hope that others can do the same in the near future. In any case, we agree that a close monitoring of the program will be necessary, and that quarterly reviews should be completed.

Concerning Bulgaria's relations with the commercial banks, we share the staff's analysis that Bulgaria, given the high debt burden, will need to benefit from debt and debt-service reduction operations. We hope that the discussions on such operations will take place rapidly, and we believe that Bulgaria should be able to benefit from a large discount on the price of its debt and from the support of multilateral institutions in the framework of the Fund's debt strategy.

The risks in this program are large, but they mirror the considerable efforts that are being required of the Bulgarian people. We believe that the program deserves the support of the international financial community. We accept the proposed decisions.

Mr. Peretz made the following statement:

Let me join others in commending the authorities for adopting a macroeconomic program which is at least as ambitious as those underway elsewhere in Eastern Europe. Measures have already been taken to lift price controls, liberalize trade, free the exchange rate, and introduce current account convertibility. Rather less progress has been made in some other areas, however, and I wonder whether certain crucial elements of the program will turn out to be sufficiently robust to achieve the authorities' quite correctly ambitious targets.

With respect to the macroeconomic framework, like other speakers, I understand the reasons why the authorities have decided not to adopt a fixed exchange rate anchor for the time being, particularly in view of the difficulty of determining the equilibrium exchange rate. However, no other country in Eastern Europe has yet attempted a rapid liberalization of trade and prices without a fixed exchange rate, and none has done so in such inauspicious circumstances, with the background of a monetary overhang, a sharp decline in domestic output and the supply of goods from imports, serious external indebtedness, and chronic excess demand.

Indeed, it is difficult to think of any country in the world in which inflation has been brought down from monthly rates which I believe have been running at well over 100 percent a month, to the 1 percent or 2 percent a month which is programmed in Bulgaria for the second half of this year, without the introduction of a fixed exchange rate regime.

The question is whether the policy weapons which are at the authorities' disposal will be sufficient to stabilize the price level. If the Polish experience is anything to go by, the efficiency and effectiveness of monetary policy are likely to be blunted by the nature of, and inefficiencies in, the banking system, the absence of hard budget constraints on enterprises, and the ease with which enterprises will be able to pass on higher borrowing costs in the form of higher prices. Meanwhile, despite the degree of social consensus that exists, I have doubts about whether a wages policy will be able to bear all the weight that is being placed upon it.

I hope, therefore, that the authorities will at the very least take signals from the exchange markets very carefully into account in framing policy. At a time of structural change, when underlying inflation will be difficult to determine, this may well be the best guide there is to policy action. Even then, however, I am anxious about what is being attempted. The need for large reserves to accompany a move to a fixed exchange rate regime should not be exaggerated. The key, I believe, is to take prompt policy action; so long as that is taken, large reserves to support a fixed exchange rate arrangement are not necessarily needed.

Another area of concern is the rather limited progress made so far with the reform of the commercial banking sector, and in imposing financial discipline on state enterprises. Unless structural reforms in these two areas are accelerated, it is all too likely that the impact of liberalization on the price level will be more severe than it needs to be. In this respect, I am rather distressed, as a joint Director, that the World Bank's proposed structural adjustment loan will not be finalized until later this year.

Progress in these areas seems to be too important to wait until then. I see no mention in the staff report, for example, of measures to address banks' nonperforming assets, or suggestions for controls to be placed on spreads between bank deposit and lending rates. While there are a great number of commercial banks in Bulgaria, they are all state owned. I wonder how much has been done to encourage competition between them, because without competition, monetary policy will not be transmitted efficiently. I wonder whether there is technical help that the Fund, as well as the World Bank, might be giving in this area.

As for the other state enterprises, although antimonopoly legislation is now before Parliament, it does not appear that state enterprises are yet subject to hard budget constraints, or, indeed, that the means exist to put enterprises into liquidation where that is necessary. However, it is clear from the staff report that the authorities recognize that these structural reforms are needed and are quite fundamental to the success of the program. I hope that progress can be made on these items.

If I have dwelled at some length on the risks attached to this program, it is because Bulgaria raises in a particularly acute form the questions which many Directors asked at the seminar on the assessment of programs in Central and Eastern Europe (Seminar 91/4, 3/13/91), namely, what should be the extent and duration of the Fund's financial involvement in Eastern Europe, and is the Fund's financial exposure justified? My conclusion is that these risks are well worth taking in this case, given that Bulgaria itself has demonstrated such a strong will to make sure the program succeeds. Indeed, multilateral and bilateral assistance, inflows of private capital, rescheduling, and the prospects of debt relief will, of course, all depend on continued strong policy action.

Close monitoring of the program will be essential, and I welcome the provision of three program reviews, which is entirely appropriate. I hope that the authorities' request for a Fund resident representative in Sofia can be met. I also hope that the World Bank can accelerate its efforts, and that that message will be transmitted across the street. I note that the staff will be reviewing regularly Bulgaria's success in securing external finance, and like Mr. Landau, I would stress the importance of finalizing the G-24 financing facility soon, and of Bulgaria coming to an agreement with its commercial bank creditors. I can support the proposed decisions.

Mr. Goos made the following statement:

Like the previous speakers, I should like to welcome the decision of the Bulgarian authorities to embark on a radical transformation of their economy. The program attests to their commitment to bold and comprehensive macroeconomic adjustment and structural reforms, which deserve the support of the international community.

However, the staff papers leave little doubt that the process of reform will be very difficult and prolonged, and subject to considerable risks. By the same token, the implementation of the program will be exceptionally demanding, as evidenced in particular by the sheer size of the envisaged reduction in existing financial imbalances and real wages, as well as by the related absorption of some two thirds of the external shock in the domestic economy.

Under normal circumstances, these program objectives, including the drastic reduction envisaged for government subsidies, would raise legitimate questions about the acceptability of the program to the general public and, hence, its feasibility and sustainability. However, it is rather clear that there is no realistic alternative to such a radical approach. At the same time, I found it reassuring to note that the program appears to have the support of virtually all social and political forces, including the trade unions. I am equally encouraged by the fiscal contingency element built into the program, and the substantial prior actions that have already been taken. Still another indication that would appear to bode well for the future is the recent sharp appreciation of the lev, which, notwithstanding the thinness of the exchange market, can be interpreted as a sign of confidence in the authorities' adjustment strategy.

Yet, the overall task of adjustment will be daunting and require an exceptional commitment on the part of the authorities to stay the course--a task that will be complicated even further by the weak administrative capacities of Bulgaria. Here, I would hope that the authorities will make the most effective use of the technical assistance provided by the Fund.

Strict adherence to the program objectives and perseverance will, of course, also be crucial to the mobilization of external financial assistance needed to close the very large external financing gaps. In that regard, it would be interesting to learn from the staff the status of the negotiations between the Bulgarian authorities and the commercial banks. I was surprised that the staff's statement did not address that issue.

When we discussed Bulgaria's request for financing under the oil element of the compensatory and contingency financing facility (CCFF) (EBM/91/27, 2/25/91), I, like others, expressed concerns about the insufficient financing assurances and the lack of medium-term viability under the program. However, notwithstanding the implied nonadherence to fundamental principles of Fund policy, I indicated a willingness to support Fund financing on an exceptional basis in recognition of the exceptional strength of the adjustment effort undertaken by the authorities. I certainly maintain this view, but I wonder whether the fiscal contingency provision should not be activated now so as to improve the medium-term prospects, or at least to compensate for any significant shortfall that might emerge in external financing. I know that Mrs. Hansen also saw a possible need to strengthen the program if there were a shortfall in external financing. A possible activation of the contingency clause could be discussed on the occasion of the quarterly financing reviews envisaged under the program. Perhaps the staff would care to comment on this point.

On more specific policy issues, I will not comment on the importance of a strict incomes policy, which is clearly critical to prevent inflation from running out of control. Here, I can associate myself with the views of previous speakers. I also endorse specifically the view expressed by Mr. Prader on the potential advantages monetary reform might have offered in absorbing the monetary overhang, over the course which has been chosen of using the inflation tax in that regard. Apart from this, I noted with some concern that incomes policy as planned for the first half of this year will lead to the further compression of real wage differentials. That runs counter to the objective of establishing appropriate incentives for increased efficiency. I therefore would hope that, after an initial period of transition, a more appropriate differentiation of wages will be established without delay.

I should like to encourage the authorities to move ahead with determination with their legislative agenda on structural reforms, notably in the area of state enterprises, the financial and banking system, and ownership rights. Here I would associate myself also with the observations made by Mr. Peretz on the importance of moving ahead in the area of banking sector reform. As to ownership rights, I am concerned about the remaining restrictions on foreign ownership of real estate, which are likely to work as an impediment to the inflow of foreign direct investment.

I can support the staff appraisal and the proposed decisions.

The staff representative from the European Department stated that a number of speakers had raised questions about the exchange rate assumption under the program, and the importance of passing through the exchange rate into domestic prices. In that connection, it needed to be borne in mind that until recently, there had been at least three exchange rates for the Bulgarian lev--the basic rate, at about 3 leva to the U.S. dollar; the officially determined cash rate, fixed at auctions that had begun in the previous year, at about 7 leva to the U.S. dollar; and the official market rate, at about 10 leva to the U.S. dollar. There had also been a parallel market rate that was even more depreciated than the official market rate. The domestic price structure had been based on a pass-through rate of about 1.5-2 leva to the U.S. dollar until the recent price reform. That illustrated the extent to which domestic prices would have to move to take the exchange rate into account, and the difficulties the authorities and the staff had confronted in trying to distinguish the equilibrium exchange rate, especially in the light of the additional uncertainties caused by the disintegration of the trading system under the Council of Mutual Economic Assistance (CMEA) rules, and the lack of reserves.

The authorities had attempted to set the exchange rate at a level that would not quickly prove unrealistic, and thus erode public confidence in the reform program, the staff representative pointed out. Because of the uncertainties regarding exchange rate developments, the program was based on a liberalization of most prices, other than on energy, and surveillance over the prices of certain food commodities that constituted about 18 percent of total turnover. In the latter regard, it was noteworthy that the Government had not found it necessary to recontrol prices of those commodities, even though the initial effect of the liberalization of prices had been greater than anticipated.

The staff had initially taken the assumption of an exchange rate of about 7 leva to the U.S. dollar, noting that such a rate entailed a depreciation of over 100 percent in local currency terms from the previous pass-through rate, the staff representative continued. The staff had also assumed an oil price of about $26 a barrel, but as the negotiations had progressed, it had become clear that a more realistic assumption would be about $17-18 a barrel, meaning that the pass-through rate for energy prices could be about 10 leva to the U.S. dollar. Since other prices had--by and large--been liberalized, that was the principal operative assumption in the program regarding the exchange rate. Additionally, the authorities had decided to provide some subsidy to heating and electricity costs. The program emphasized nominal wage and financial policy restraint to ensure that the price liberalization would not spill over into permanent inflation.

There was great uncertainty as to where the exchange rate would ultimately settle, but the staff had been greatly encouraged by the appreciation of the leva vis-à-vis the U.S. dollar over the previous ten days--from 28:1 to about 16:1--the staff representative commented. He would not wish to pretend that that would be a sustained rate, or that it constituted a trend that could be regarded with confidence. The exchange market over that period had been extremely thin, and in the immediate past few days had become thinner, as divergent expectations had led to a slowdown of market transactions. It was to be hoped that the interbank market would begin to operate efficiently, enabling the rate to serve as a true representative indicator of exchange rate trends.

Some speakers had raised the question of whether a floating exchange rate was consistent with the inflation objective, the staff representative recalled. Over the previous few weeks, prices in Bulgaria had actually begun to decline from the levels at the beginning of the liberalization. In that connection, in Viet Nam a few years previously, an inflation target no less ambitious than the one in the Bulgarian case had been achieved in the context of a floating rate system during the first year of the program.

The wage agreement was only for three months because, given the great uncertainties, especially the magnitude of the nominal increases in financial aggregates, there would be a need to review developments carefully thereafter, the staff representative pointed out. The wage agreement recognized explicitly that real wages would have to fall by 35 percent, and no indexation of wages was envisaged. The decline in real wages as a result of the price liberalization seemed, in fact, to have been already much greater, and it was noteworthy that the Government had not attempted to change the wage agreement or increase wages in reaction to it. However, a drop in real wages that was so large that public support for the program would be jeopardized remained a serious concern of the authorities.

Wage differentials were a problem under the program, the staff representative acknowledged. The staff hoped that differentials would be restored in the second half of the year, not just by raising nominal wages, but also through a reduction in employment and an improvement in efficiency. The staff had considered using wages as a performance criterion, but decided that for the time being the monitoring of the nominal wage targets presented in the program would be sufficient. Moreover, there were serious measurement problems in monitoring wages in the very large number of enterprises that existed in Bulgaria.

The new Government had decided firmly against monetary reform as a means of addressing the liquidity overhang, for reasons that had been discussed in the Board seminar assessing programs in Central and Eastern Europe (Seminar 91/4, 3/13/91), the staff representative noted. The authorities believed that the reform process should not start with a confiscation similar to that employed by earlier governments in Bulgaria.

The price liberalization would be the main instrument for eliminating the monetary overhang, the staff representative continued. Nevertheless, an attempt had been made before the price liberalization to create the conditions to absorb as much liquidity as possible, including by raising interest rates, issuing government treasury bills, and encouraging loan repayments, by a number of means. Those vehicles had had some success in absorbing liquidity, but the principal mechanism would be the liberalization of prices; there had already been a very large reduction in real magnitudes of money and credit.

The staff was concerned about the pace of financial system reform, and Fund technical assistance was underway in that connection, the staff representative related. In the context of a structural adjustment loan, the World Bank would be providing for an audit of the nonperforming assets of the financial system. Progress could not be expected immediately, and there would be a period of uncertainty and insufficient competition in the financial system, which, indeed, would constitute a risk to the program.

With regard to the question of external viability, and the related question of the export projections, it needed to be recognized that the situation in Bulgaria was so uncertain that the projections might be seen more reasonably as alternative growth paths, with the related implications for domestic and external policy, the staff representative said. The staff had tried to be conservative in its export and import projections. Even at the end of the medium-term period, exports and imports would barely have been restored to their levels at the end of the 1980s.

If the projections were reconsidered in the light of the cessation of hostilities in the Middle East, they might not appear so overoptimistic, the staff representative from the European Department commented. Bulgaria had traditionally had a close trading relationship with the Middle East, and Bulgarian exports of machinery and construction goods might benefit from reconstruction efforts in the Middle East. If the still conservative assumption were made that exports to non-CMEA countries would not fall any further in 1991 and would rise 12 percent in 1992--reflecting increased demand from the Middle East and other sources--and with growth in exports of 8 percent per year thereafter, as programmed, the financing gaps in the latter part of the medium-term period could be seen to fall dramatically. The gap for new money would be narrowed from about $1.5 billion to about $0.5 billion in 1994, and would be eliminated by 1996. Perhaps some comfort could be taken from the case of Poland, which had managed a surprising recovery of its exports.

Mr. Landau commented that the issue of real wages was a critical one, because real wage restraint seemed to be the only stabilization mechanism that had been incorporated into the agreement between the Government and the labor union. Yet, the staff report noted that the wage agreement provided for flexibility with regard to a subsequent increase in compensation consistent with the anticipated reduction of about 35 percent in real wages for 1991 as a whole; and that for the second half of the year, there would be room for an increase in real wages. Therefore, he wondered what kind of developments with respect to real wages would be consistent with the balance of payments projection, and what would happen if real wages did not fall to the level that was anticipated, or if a wage-price inflation spiral were to be triggered.

The staff representative from the European Department replied that a decline in real wages of 35 percent would be consistent with the design of the overall program. The staff expected the fall in real wages in the first half of 1991 to be greater than 35 percent, thus leaving room for some improvement in the last quarter of the year, provided that the program was on track. For that reason, the staff had provided for some upturn in real growth in wages in subsequent quarters over the preceding quarters of 1991.

The program as negotiated did not extend the agreed understandings beyond the first half of 1991, the staff representative from the European Department said. The program would be reviewed comprehensively in light of developments in the first quarter of the year, and the Government would then proceed to set its wage policy with the trade unions in the second quarter of the year based on the Fund's review. The Government would be discussing with the trade unions the corrective adjustment in the second quarter about the time of the staff's visit to Bulgaria in late April 1991, but the staff did not expect to be in a position to discuss the second half of the year until well after that. Therefore, the program contained the safeguard that the wage policy in the second half of the year was not finalized and would be adjusted in light of the experience in the first quarter and the authorities' discussions with the Fund.

Mr. Landau observed that if inflation turned out to be greater than anticipated, a decrease in real wages might need to be accepted that was greater than what might be strictly necessary to be consistent with the balance of payments projections, in order to avoid an inflationary spiral. He wondered whether the program provided for such a decrease at some stage, if inflation was faster than expected.

The staff representative from the European Department replied that the focus in the program on nominal income targets was intended to serve as the stabilizer. The authorities had accepted absolutely that, for the program as a whole, one of the two important nominal anchors would be nominal wages.

With respect to Bulgaria's relations with its commercial bank creditors, the staff representative continued, the authorities hoped to be able to conclude an interim deferral agreement, but perhaps for a shorter period than envisaged earlier; the current rollover period extended through March 1991. The authorities hoped to begin medium-term discussions as soon as possible--even by September 1991. The deferral agreement was not already in place because discussions had been complicated by the issue of guarantees. The Government had made it clear that, unlike in the past, it would recognize the sovereign nature of the debt of the Bulgarian Foreign Trade Bank, and that it would extend that guarantee once a medium-term restructuring exercise was undertaken. With respect to the banks, the position was mixed. Some in the advisory group were pushing for a precise, legally binding guarantee by the Government of Bulgaria at the present time for purposes of the interim deferral agreement. The staff had been told by other bankers that that insistence was not their position and, further, that the legal language proposed was not acceptable to the legal authorities and framework in other countries. The staff believed that a compromise would emerge, under which there would be another rollover of at least six months or through the end of 1991, and that in the spirit of compromise the Government would move to discuss a medium-term package involving debt reduction.

There was a fiscal contingency of 2.7 percent, but the staff would not feel comfortable invoking its use at present because there were shortfalls in foreign financing, the staff representative stated. That contingency was there precisely because of the uncertainties in Bulgaria's case over the course of revenues, profits, taxes, growth, and other aspects that would affect the fiscal framework, including perhaps the need for temporary subsidies. However, the contingency could well be invoked for various purposes in the course of the program reviews.

The present legislation forbade foreign ownership of land, whether agricultural or urban, although long-term leases to companies were allowed, and foreign residents and individuals were legally entitled to buy and sell apartments and houses, the staff representative related. The Government was aware of the concern of investors about provisions that prohibited land ownership, but believed that the possibility of contracting long-term leases--up to 70 years--should be sufficient to alleviate that concern. The World Bank believed that the current legal framework for foreign investment was adequate and, indeed, favorable. The obstacles to inflows of foreign investment were not so much in the regulatory framework, but rather with respect to the other uncertainties of the transition process.

The authorities had taken great care to supplement the stabilization measures with a wide range of structural policies, and the decision to aim for an early and comprehensive price liberalization had been taken precisely in order to create the incentives for the revival of private sector activity and economic growth, the staff representative pointed out. The authorities were not in any way discounting the importance of growth. They were hoping that the program contained sufficient stimuli for agriculture and light industry to respond in the course of 1991, and it was for that reason that the staff had held out the prospect of some limited upturn in the last quarter of the year.

The authorities, and the Finance Minister in particular, believed that distribution of vouchers would not be the proper way to jumpstart the entrepreneurial process, as a true sense of entrepreneurship did not come--in his view--through the easy acquisition of assets, the staff representative commented. He also had the view that, although it might be easy to distribute assets, it might not be so easy to distribute the liabilities.

Capital expenditures were so low partly because the state investment credit fund had pursued for many years extensive capital-intensive investments in heavy industries, energy, and metallurgy, and the Government believed that it was time to reassess and restructure that investment, which they proposed to do in consultation with the World Bank, the staff representative from the European Department concluded. However, despite the overall decline in capital expenditures, the authorities had tried as much as possible to maintain capital spending on education and health.

The Director of the Exchange and Trade Relations Department stated that, although the staff believed that the Fund's policies with respect to financing assurances and the attainment of medium-term viability would not be breached in the case of the Bulgarian program, there were certain clear risks, as the staff representative from the European Department had already stressed.

On the issue of financing assurances and the coordination of assistance with the World Bank, the staff had made representations to the Bank's management and senior staff on the same points, and with the same concerns, that had been noted by Mr. Peretz, the Director continued. He hoped that those arguments would spur the World Bank to move forward at a faster pace on the structural adjustment loan. With respect to assistance from the European Community and the G-24 leading industrial countries, the staff expected the process of securing the necessary financing to unfold successfully, on the basis of the comments that had been made by the European Community and the reflections of individual bilateral donors at a recent donors' meeting.

Great uncertainties confronted the staff's medium-term scenarios, which needed to be viewed with those uncertainties in mind, the Director observed. The attainment of medium-term viability would hinge on a number of factors the outcome of which could not be seen clearly, with respect to prospects for Middle East trade, in particular. The degree of debt reduction that could be obtained from the commercial banks would also have a bearing on medium-term viability, as in other similar cases. The negotiations for debt reduction were being conducted in a friendly atmosphere, and it was to be hoped that they would bring positive results. For those reasons, the staff was confident enough in the program to present it for Executive Board approval.

There was no trade-off between inflation and growth, the Director of the Exchange and Trade Relations Department concluded. The inflation that was built into the Bulgarian program, particularly in the early part, was a result of administered price changes and the exchange rate adjustments. Growth would be affected primarily by the disruption which was occurring in the economy, in the external sector because of the breakdown of the CMEA arrangement, in particular. While there might--at the margin--be some choice in the design of the program between inflation and growth, most of the parameters on inflation and growth were driven by different factors.

The staff representative from the European Department, responding to a question from Mr. Landau, said that the staff had assumed that $600 million of the financing that was to be made available by the G-24 leading industrial countries and the World Bank would have been disbursed by the end of June 1991. There was an automatic adjustment of the performance criteria under the program of half the shortfall. The balance would have to come in the form of further tightening of the program.

Mr. Yamazaki observed that the medium-term projections appeared to be on the optimistic side. Export volume was expected to increase by 8 percent a year between 1992 and 1996, even though in the same period world import volume was assumed to increase by 5-6 percent, implying a coefficient of 1.6--on the high side. Perhaps the staff could explain the increase in export volume by breakdown of industries.

The staff representative from the European Department responded that the staff expected the growth of import demand for Bulgarian exports on the part of Bulgaria's trading partners at about 6 percent. Therefore, although the elasticity would certainly be greater than 1, it would perhaps not be as large as had been said. That export growth assumption was crucial to the medium-term outlook, as if it were not realized, a serious compression of imports would result. The staff had made the export growth projection on the assumptions, first, that there was a good reason to believe that Bulgaria could recover some of the loss of its market share of recent years; over the previous two years, Bulgaria's exports had declined by close to 40 percent. Of course, that included the loss of CMEA markets in the area, but the staff hoped that that could be recovered, at least to some extent. Second, the staff believed that the Government's strategy of shifting the pattern of industrial growth to that of light manufacturing and agroprocessing industries would contribute to bolstering the country's export potential. In the past, Bulgaria had had a comparative advantage in those types of industries. In addition to light industry, there were the electronics industry, and rather well developed but inefficient construction, engineering, and heavy equipment industries, the last three of which had been geared to the CMEA area and, therefore, required a massive amount of restructuring. However, there was a skilled labor force and an industrial base that had dealt with those exports in the past; the staff believed that, with restructuring, they could be revitalized. Therefore, the assessment of an 8 percent export volume growth a year, which might on the surface seem optimistic because it ran ahead of the growth of import demand, was actually on the conservative side, given the potential in the areas he had noted, and given the other changes in the program to reduce real wages and to improve competitiveness.

Mr. Posthumus commented that, with regard to the issue of financing assurances, he understood that the Monetary Committee of the European Community had taken a positive view of the Bulgarian program, and that there was good reason to expect that the Community would commit itself to the full share of the $400 million that had been assumed.

The Chairman commented that he welcomed the indications that the Monetary Committee had responded favorably to the program. He had recently had a conversation in Basle with Vice President Christophersen of the Commission of the European Communities, who had confirmed very strongly the points made by Mr. Posthumus, as well as Mr. Posthumus's optimism about the probability of soon having the global financing in place in support of the program.

Mr. Goos observed that his concerns about the full financing of the program centered on the uncertainty about the financing that was expected from the commercial banks, about which there were still some unsettled issues. He assumed that the financing of the program would also depend on a formal agreement between the Bulgarian authorities and the banks on the standstill on interest payments.

On the issue of medium-term viability, the staff's comments might be interpreted as suggesting that the greater the degree of uncertainty in the medium term in a program, the better, as it allowed for more flexibility in projecting the attainment of medium-term viability, Mr. Goos remarked. The staff had referred to the possibility that the outturn might be better than expected; equally, however, it might be worse. It was clear from the report that there were many uncertainties whether the medium term would turn out one way or the other.

The criterion of medium-term viability had been introduced as a safeguard for the Fund's resources, Mr. Goos stated. The uncertainties in both directions--negative, as well as positive--needed to be taken into account in the judgment of medium-term viability. In the case of Bulgaria, for example, that meant that the possibility that trade with the Middle East would not improve as expected should also be considered. Under that assumption, there would be no medium-term viability and, hence, correspondingly high risks for the safety of the Fund's resources. He had some doubts that there could be a reasonable assurance that medium-term viability would be achieved in the case at hand.

It had been noted by the staff representative from the European Department that the staff would feel uncomfortable activating the contingency provision at present, but that begged the question as to what the staff had in mind if there were to be a shortfall in external financing, Mr. Goos pointed out. Would the staff intend to tighten the program, or to incur deliberately external payments arrears?

The Director of the Exchange and Trade Relations Department stated that the staff had not wished to leave the impression that it believed that the greater the degree of uncertainty under a program, the better. He wished to assure Mr. Goos that the staff shared his concerns, and that over the preceding three or four months the staff had discussed intensively what should be done under a number of different scenarios. However, when all the prospects for the external sector were taken into account, the outlook seemed on the positive side, in the staff's judgment. It was certainly possible, with a suitable agreement with the commercial banks, that a solution could be found that would bring the situation much closer to, if not to, medium-term viability.

The staff representative from the European Department said that both the commercial banks and the authorities recognized that any medium-term restructuring must involve debt reduction, which was therefore at the forefront of the agenda.

With respect to the staff's recommendation that the fiscal contingency not be invoked at present, the staff had merely wished to indicate that it was not yet time to give up hope on the financing assurances at the present stage and change the program, the staff representative from the European Department explained. During the course of the reviews, the staff would examine comprehensively all policies; for example, perhaps the exchange rate would have to be more depreciated, or perhaps real wages would have to be further compressed.

Mr. Peretz observed that the faster the introduction of structural changes in the economy--and the faster the better--the more likely would be the achievement of medium-term viability. That emphasized the importance of the World Bank's role. Medium-term viability was more likely to be achieved if inflation could be brought down, and held down. He saw no tradeoff between inflation and growth in the long term, as in the long term, the lower the rate of inflation, the better the prospects for growth.

Mr. Clark stated that, with respect to medium-term viability, the staff's projections were cause for serious concern, since they suggested that Bulgaria would likely be a prolonged user of Fund resources. While he hoped that the balance of risk turned in favor of Bulgaria, as Mr. Goos had observed, it was equally probable that the balance of risk might turn in the other direction. In terms of the alternative scenarios presented in the staff report, the baseline scenario appeared to be in the center, and on that basis there should be concern about the medium-term viability of the program, even if the rather massive debt reduction that was assumed took place.

Moreover, during the Board's discussion on Bulgaria's request for a purchase under the oil import element of the CCFF, there had been some comments as to what might happen if oil prices turned out lower than previously envisaged, Mr. Clark recalled. He wondered whether the staff had made any revisions to the projections of the compensable amount under the oil element, as the issue of a possible early repurchase might arise.

With respect to the structure of the financing program, it was assumed that a certain amount of financing would be forthcoming, Mr. Clark observed. If the financing was not forthcoming, there would be a revision of the performance criteria in July. He recognized that the process of agreeing financing in the G-24 major industrial countries had been a protracted one, partly because it was a political process. In order to speed up the process, perhaps an alternative approach might be considered, of constructing the program not around assumed financing, but, rather, assured financing--financing that had been agreed. If more financing turned out to be forthcoming, then the program could be adjusted to take it into account.

In the case of Bulgaria, that would imply that the program would contain greater domestic adjustment.

He fully supported the staff's rather eclectic approach to exchange rate policy in the case of Bulgaria, Mr. Clark stated. In particular, he agreed with the assessment that it would have been difficult to fix the exchange rate without having established the credibility of the authorities' financial policy, and without having access to substantial foreign exchange reserves or a substantial stabilization fund.

With respect to the exchange rate, domestic prices, and slippages with regard to subsidies, he understood that, on the fiscal side of the program, subsidies were based on the official exchange rate of 10 leva to the U.S. dollar, Mr. Clark continued. As the parallel market exchange rate was considerably more depreciated, he was concerned that the program's fiscal targets would be in jeopardy.

He had also been concerned about the rather strong upward trend in the deficit in the social security system, Mr. Clark went on. The average deficit of the social security system had been 0.8 percent of GDP in 1986-89. It had risen to 2.7 percent of GDP in 1990, and was expected to rise again, to 5.7 percent of GDP, in 1991. The system appeared to be seriously underfunded, constituting a very real fiscal risk. Perhaps the staff could comment on the factors underlying that trend, as well as what reforms might be contemplated to deal with the problem. He supported the proposed decisions.

Mr. Al-Tuwaijri made the following statement:

> Bulgaria is embarking on a bold and wide-ranging economic reform. The authorities are faced with a daunting task, which poses major risks, but large payoffs. External debt is high, the redirection of trading relations is yet to take hold, and structural reforms will bear fruit only gradually. In the process, the long-term financing gaps remain uncomfortably large. However, actions already taken to initiate the comprehensive adjustment show seriousness on the part of the authorities, and augur well for the future.
>
> I broadly agree with the thrust of the staff appraisal and the underlying policy mix. However, the present program should be viewed as basically the first step toward a protracted period of transformation. It has been obviously difficult to fully integrate structural adjustment into the short-term stabilization program. Clearly, in the longer-term context, a better inter-relationship will be called for. Moreover, it would have been easier to analyze the medium-term adjustment needs if projections of savings and investment had been provided to supplement the balance of payments forecasts for the next few years. It is to be hoped that the provision of technical assistance and the

establishment of a resident representative in Bulgaria would help in this process.

A number of issues need to be addressed concerning the program under discussion. The 1991 program appears quite ambitious. It calls for a sharp economic contraction, a 35 percent reduction in real wages, and almost a 300 percent increase in retail prices. These adjustments are obviously necessary to implement financial retrenchment so that the desired cut in excess demand could take place. It is to be hoped that the institutional capacity and the social contract are sufficiently strong to implement the needed measures.

What is more important, even if the desired fiscal and monetary policy measures are fully implemented and all the expected results are realized, the external financing gap will continue to be very large, at 7.5 percent of GDP in 1991. Equally, large gaps are also projected for the medium term. Therefore, the availability of the desired level of financing and debt relief will be crucial. If adequate funding fails to materialize, would it be possible for the authorities to intensify adjustment--which we prefer--or would it be necessary to shift to a more gradual adjustment path? In turn, can the weaker adjustment path be viewed as fully consistent with Fund support at the proposed level? I assume that these issues will be addressed during the review of the program.

While I can understand the reasons calling for the floating of the exchange rate through the establishment of the interbank market, I would encourage the authorities to maintain a tight leash on incomes and financial policies. This will help the exchange rate to converge to the rate implicit in the newly adjusted, administered prices. A failure to achieve the inflation target would force a greater exchange rate depreciation than envisaged. Such a development might call for greater budgetary subsidies and expenditures, which could further fuel inflation and exchange rate instability. Given the experience of other Eastern European countries, I am confident that the authorities are conscious of the need to maintain strict macroeconomic policies.

It seems that Bulgaria is encountering a large, but hitherto indeterminate, liquidity overhang. The burden of eliminating this overhang is being placed principally on price increases, which might have implications for other objectives. In particular, any overshooting of inflation could pose difficulties not only for the exchange rate policy, but also for the interest rate policy. Similarly, it is not clear whether the reduction in wealth and real savings following price increases would affect the marginal propensity to save, with consequent implications for the future economic transformation.

Bulgaria is expected to undertake an impressive array of structural changes in 1991. Ideally, all such reforms should be undertaken simultaneously and in conjunction with stabilization. Nonetheless, in practice, such a scenario would be unrealistic. Naturally, an appropriate sequencing would be needed to minimize the costs of adjustment. However, it is difficult to discern a clearly defined sequencing in the Bulgarian program. Could the staff describe the nature of sequencing and the principles guiding it? For example, as has become apparent from the experience of other Eastern European countries, external liberalization--which is undoubtedly called for--without a corresponding internal structural transformation can lead to difficulties in simultaneously addressing internal and external objectives. Moreover, priority should be accorded to reforming and privatizing commercial banks.

I support the proposed decisions.

Mrs. Sirivedhin made the following statement:

I welcome the discussion on Bulgaria's first Article IV consultation. Unfortunately, this is a very difficult time for Bulgaria, and Fund support is being sought, in various forms of financing, as well as technical expertise. On balance, Bulgaria deserves the Fund's support, and I can go along with the proposed decisions.

My support for Bulgaria is based to a large extent on the firm commitment shown by the authorities to reorient the economy toward market mechanisms and steer itself out of the present difficult situation. This is evidenced by the strong prior actions that have been taken, and the strong adjustment program that accompanies the proposed stand-by arrangement. With the huge financing gaps predicted over the medium term and the arrears that have recently accumulated, the primary concern for the authorities should be the restoration of Bulgaria's creditworthiness, in order to achieve the financing necessary to improve the medium-term prospects. The Fund's blessing of Bulgaria's program can be considered as a first step, but the rest is up to the authorities themselves. They must spare no effort in pursuing the necessary adjustment measures and strengthening them as unforeseen circumstances may necessitate. In this connection, I am pleased to see that Bulgaria's program actually provides some leeway in certain elements, such as the contingency that has been incorporated under the heading of fiscal expenditures, in order to provide for deviations and shocks to be accommodated without jeopardizing fiscal objectives. This is much preferable to a program that is designed to look attractive, but is in fact too tight to be achievable in practice.

I am in general agreement with the authorities' basic strategy and objectives, and with the staff's assessment. The thrust of the stabilization program seems particularly appropriate, considering the circumstances. Measures to absorb the liquidity overhang are to be supported by those designed to contain further imbalances. With regard to the first group of measures, I wonder whether thought is being given to sales of longer-term government securities, in addition to treasury bills, once market interest rates have converged to a level consistent with a more stable inflation rate. Like other Directors, I would also like to stress the need to keep a firm hand on incomes policy. Regular consultations between all parties concerned, especially the trade unions and parliament, as well as the strengthened social safety net measures, will help maintain the social consensus necessary to carry out these measures to their successful conclusion.

I welcome the structural reform measures that have already been introduced, and those that are being contemplated, including in the area of financial reform. They will contribute both toward underpinning the stability objective and paving the way for sustained growth in the future.

Mr. Filosa made the following statement:

Let me congratulate the Bulgarian authorities for having agreed so quickly and courageously upon the ambitious program which is before us today. Their successful efforts in preparing a radical and comprehensive macroeconomic and structural reforms program for 1991 is particularly commendable in the light of the critical economic situation prevailing today in Bulgaria, as a result of both decades of tight central control of the economy, and the emergence of major exogenous shocks. I am pleased to learn from Mr. Posthumus that the program has obtained broad parliamentary support.

Notwithstanding the exceptionally difficult external environment in which the reforms are being implemented, I share the authorities' view that a more gradualist approach could risk the exacerbation of financial imbalances and the postponement of the important benefits of the reform process. The program that we have in front of us today is thus very much in the spirit of those adopted by other Eastern European countries in transition, although I recognize that the expected economic trends were far more favorable when programs for Poland, Hungary, and Yugoslavia were adopted in 1990. I will therefore comment on those points that I consider specific to the Bulgarian case.

Two major elements of uncertainty in the program are a source of great concern, as they could undermine the program's successful implementation: the exchange rate and its related policy issues, and the financing.

With regard to the former, the authorities have eliminated the various official multiple exchange rates that have been a prime source of distortions in the economy. They have preferred to adopt a flexible regime in the light of both the limited availability of official reserves and the difficulties in assessing an equilibrium exchange rate in the present circumstances. While I certainly view the first reason as a valid basis for such a choice, I doubt that in the short run it will be an easier task to identify an equilibrium exchange rate. The different option chosen in other cases was essentially based on the different prospect concerning the sustainability of a fixed exchange rate regime, and not because the authorities or the staff had strong views about the "right" level of the exchange rate. In the case of Bulgaria, I agree that the choice made is the right one, but the flexibility of the exchange rate does not diminish the need to closely monitor the behavior of the exchange rate, and to use effectively the instruments of macroeconomic management--monetary policy, in particular--to ensure an orderly functioning of the foreign exchange market.

In fact, in Bulgaria, the risks of volatility or overshooting phenomena, inherent in any floating system, are greatly reinforced by the critical economic situation, and by the high degree of uncertainty concerning the effects of the programmed adjustments.

The program relies heavily on the assumption that the exchange rate will appreciate vis-à-vis the level reached one month ago, so as to converge at a level consistent with the programmed price path and with the reduction of the monetary overhang. The restrictive stance of financial and incomes policies is accordingly set so as to contain excess demand pressures on real and financial flows that will emerge once this programmed adjustment has occurred. It might well be, however, that the effective appreciation of the exchange rate could fall short of the desired level, and that the programmed stance of macroeconomic policies will be insufficient to contain inflationary pressures. In that event, the Bulgarian authorities should stand ready to tighten the restrictive stance of financial and incomes policies so as to avoid the well-known vicious circle of exchange rate depreciations, inflationary pressures, and wage increases, which will certainly undermine the success of the program.

Also, it might well be that high volatility of the exchange rate, or "jumping on the bandwagon" behavior regarding the exchange rate, might occur, preventing an orderly convergence of the exchange rate toward the desired level. In these circumstances, the role of monetary policy--and particularly of interest rate policy--will be essential in counteracting the volatility of the exchange rate. The Bulgarian authorities should therefore stand ready to use flexibly the existing key monetary policy instruments, while implementing as quickly as possible financial market reforms that could enhance the effectiveness of monetary control. It would be difficult otherwise to ensure the degree of exchange rate stability necessary to produce positive effects on inflation, and ultimately to guarantee a successful implementation of the program. Therefore, I would like to know from the staff whether the instruments of monetary policy are flexible and effective enough to prevent excessive volatility, and to ensure that an appropriate path and level for the exchange rate are ultimately achieved.

In the light of the importance of an effective control of macroeconomic management--but without entering into the details of the cumbersome form of incomes policy chosen--I am encouraged by the agreement reached to preserve social peace in the first half of 1991. However, I would also like to warn the Bulgarian authorities of the dangers involved in the temporary nature of the agreement with trade unions, as it may likely lead to strong wage pressures once the period comes to an end, as shown by experiences in many other countries. The need to achieve social peace is a long-term objective which requires, therefore, a lasting agreement. A short period of wage moderation is not a sufficient anchor to achieve price stability. Given the exchange rate regime chosen, I believe, like Mr. Landau, that monetary and fiscal policy will be insufficient to contain price pressures.

I note that as of today a residual financing gap still remains. This is a serious cause for concern. From the statement of the staff representative, I also understand that the process of securing financial support will be a prolonged one. The European Community will soon decide on the share of its contribution, which could be equivalent to half of the amount requested from the G-24 leading industrial countries, if appropriate conditions are met. Today I am prepared to approve the program, despite the lack of financing assurances. This issue, however, should be re-examined in depth on the occasion of the next review. In the meantime, I urge the Bulgarian authorities to quickly and resolutely normalize their relations with all creditors, as the prompt settlement of arrears on short-term officially supported credits and reschedulings, or deferral arrangements, are vital for the program. Finally, I support Mr. Peretz's suggestion to take a formal initiative to urge the World Bank to take the leadership more quickly and effectively in the structural reform process. This is precisely in the spirit of my intervention in the seminar on developments in Central and Eastern Europe (Seminar 91/4, 3/13/91).

I fully support the courageous efforts of Bulgaria, despite the high degree of uncertainty related to the implementation of the program and to the size of the exogenous shocks. Quarterly reviews will allow the Executive Board to regularly assess progress and to suggest, if necessary, corrective policy measures. In this respect, I am reassured by the flexibility allowed in the program, and by the authorities' recognition of the need for such flexibility. I can therefore support the proposed decisions.

Mr. Dai made the following statement:

Let me commend the staff for its comprehensive and excellent analysis of the Bulgarian economy. I also found Mr. Posthumus's statement very helpful and interesting. As I broadly agree with the thrust of the staff's appraisal and policy recommendations, I can support the authorities' requests for a stand-by arrangement and for an external contingency mechanism.

In recent years, the Bulgarian economy has experienced severe domestic hardship and sharp external deterioration. With lax macroeconomic policies and large imbalances in the economic structure--combined with serious external shocks--economic growth has been negative for the last two years, and 1991 is also expected to be another year of a large decline, while inflationary pressures rise. In order to change this economic picture, the authorities are determined to pursue a comprehensive economic restructuring under the Fund-supported program. As the reform program is rather ambitious and the Government is starting from a very difficult position, it is expected that efforts will have to be doubled and external financial resources be provided in order to support the economic restructuring process. It is our hope that firm efforts by the authorities, supported by financial assistance from the international community, will allow the Bulgarian economic reform to proceed on course.

In terms of the program itself, I share the authorities' view that controlling excess demand and achieving a sharp reduction in inflation should be the first priorities.

With respect to monetary policy and the monetary overhang, with a severe shortage of supplies in the domestic markets, the large liquidity overhang poses a big problem of macroeconomic instability. Although the lax income policy of 1990 was one of the factors adding pressure to the large monetary overhang, the long-time distorted price structure contributed more to the disequilibrium in demand and supply, which could fuel even more inflationary pressures at any time. It is encouraging to note that certain measures are being taken to restrain inflation. In this regard, we agree that while a restrictive monetary policy has primary responsibility for curbing the growth of the broad money supply, a flexible interest rate policy is needed to reinforce monetary policy and to redirect resources to productive sectors. Seemingly, if inflationary pressure can be eased, then potential capacity utilization will also be invigorated. Like other countries in the region, a restrictive monetary policy is particularly important in the process of price liberalization or when the demand-supply imbalance is serious.

Concerning the fiscal policy and stabilization strategy, implementation of a sound budget is the key to the stabilization strategy for Bulgaria's economic restructuring, as was noted in the staff report. As fiscal deficits have persisted over a fairly long period, deficit reduction will be difficult for two reasons. First, recent negative output growth will further restrain revenue receipts and, second, the establishment of a social safety net will require enormous fiscal expenditure, which is expected to be maintained at about 13 percent of GDP in 1991. We welcome the important measures that have already been taken to reduce expenditures--for example, in the areas of subsidies and personal outlays--and it is equally important to explore the possibility of revenue mobilization. This is crucial not only to the imminent task of stabilization, but also to the medium-term economic recovery. It is noted that the authorities have adopted some measures on the revenue side through a restructuring of the tax system.

I raised the matter of negative economic growth during the Board's discussion on the recent experience with reform programs of Central and Eastern European countries (Seminar 91/4, 3/13/91), as I am worried about the credibility of the reform strategy and the programs in those countries if negative growth lasts too long. The situation in Bulgaria seems again to provide further evidence of the staff's conclusion that a decline in output is unavoidable during transition. We also noted that the extent and the duration of the decline are even harder to anticipate in Bulgaria. Although it is encouraging to note that there are some favorable political conditions in Bulgaria, as there has been wider social consensus and political support for the rapid transition, I am of the view that greater efforts should be made to minimize the cost of comprehensive reform while it is being implementing. Even though it is difficult, it is not impossible. In this regard, it seems that the authorities have taken a vigorous and pragmatic approach by establishing as a first important step and in a short period of time a new regulatory and incentive framework in those areas which can be expected to have a quick supply response, such as agriculture, and small-scale agroprocessing and light industries. I believe that these policies are based on Bulgaria's current circumstances, and the success of these policies would not only alleviate the difficulties and costs in the transition period, but also lay a solid foundation for medium-term recovery and development. We believe that a successful reform program is always a pragmatic program. The central problem is whether a program is well-suited to the specific circumstances in a specific country. It is our hope that the Bulgarian authorities will succeed in their efforts to pursue a stabilization and reform program.

I would like to quote from Mr. Posthumus's statement: "The radical change which Bulgaria's economy has to accomplish requires therefore a continuing commitment to adjust policies to changing circumstances, as well as to realities which may be different than what had been assumed in the program." I fully share this view, which applies not only to Bulgaria, but also to other Central and Eastern European countries.

Mr. Végh made the following statement:

I support the proposed decisions, and join my colleagues in commending the Bulgarian authorities and their efforts in this difficult stage of transition from a socialist to a capitalist economy.

On the matter of financing assurances and capacity to repay the Fund, I share the observations made by Messrs. Goos and Fogelholm. In any case, these questions will be fully addressed on March 15 at the Board discussion of the Bulgarian request for a stand-by arrangement.

On the matter of the request for a purchase under the oil import element of the CCFF, I share the concern expressed by Mr. Yamazaki and Mr. Wright about the relevance of volume changes instead of price changes in recent Board approvals of disbursements under the new mechanism. I will suggest that this concern, together with the high volatility of recent oil prices adopted for baseline calculations by the staff and, above all, the recent events in the Middle East, demonstrates that the time has come for a Board reappraisal of the mechanism approved in November 1990.

With respect to energy pricing and electricity subsidies, the authorities are going in the right direction in order to harmonize external prices with world prices, and especially with energy prices in the European Community. I urge them to move more quickly in that direction and to remove, in the very near future, the subsidy for household consumption of electricity. This subsidy is counterproductive from the point of view both of efficiency and equality. The largest share of the subsidy goes to the large consumers and, therefore, it helps those who are in a better income position more. It is a form of reverse discrimination, a social safety net of negative value.

Mr. Spencer made the following statement:

After Seminar 91/4, (3/13/91), I too was considering the Bulgarian program in the context of some of the general conclusions that we discussed at that meeting. The brief comments I have fall under three of the main subheadings used at the seminar, namely, supply responses, sequencing, and nominal anchors.

On supply responses, the staff told us on Wednesday that we should not expect too much in the way of results too soon. If this is true anywhere in Eastern Europe, it must be so in the Bulgarian case, in which the adversity of the starting position and the size of the adjustment task are both clearly very great. Notwithstanding the staff representative from the European Department's comments about export performance, it would seem that the projections for an upturn in activity in the second half of this year, followed by ongoing growth of 4-5 percent, seems a bit optimistic. As highlighted in the seminar, it is the time that is needed to change basic economic incentive structures--via new laws and institutions that have apparently yet to be put in place in Bulgaria--that suggests that a somewhat longer lag may be expected for the delivery of positive overall growth. I would share Mr. Yamazaki's concerns in this respect.

Regarding the sequencing of reforms, it was recognized in the seminar discussion that the persistence of noncompetitive, or monopolistic, forces was a basis for not pursuing in a general sense the rule of liberalizing all markets as quickly as possible. However, I agree with Mr. Prader and Mr. Landau that this argument is perhaps being taken a bit far in the Bulgarian case, in which about 26 percent of retail turnover is still subject to direct or indirect price control after the February 1 price liberalization. In particular, the continued controls on essential food and service items would not seem to have a rational economic basis in this regard. I would be interested to hear from the staff whether they feel these ongoing controls will continue to distort the supply of many basic food and service items.

With respect to nominal anchors and stabilization policy, as emphasized by earlier speakers, it is clearly crucial that both monetary policy and incomes policy work to prevent any feed-through of the large initial price shock into an ongoing inflationary spiral.

On the monetary policy side, while the exchange rate has been floated, it has apparently been set up as the main guiding light for monetary policy, with interest rate adjustments intended to maintain the exchange rate somewhere around the level used to determine the controlled price increases--at about 10 leva per U.S. dollar. I have no problem with this general approach, and I note that the staff's statement reports a trend in the recently floated exchange rate toward the target level, suggesting that initial interest rates and prices may have been set consistently. I would encourage the authorities to maintain a firm monetary stance until inflation is reduced on a sustained basis.

With inflation expectations likely to be volatile, and given the uncertainty over the extent of the liquidity overhang, like Mr. Peretz, I believe that the exchange rate will probably remain the best guide for monetary policy through the transition period. However, I do not agree with the earlier speakers who feel that it would be preferable to go one step further and peg the exchange rate. Pegging would be particularly dangerous with very low levels of reserves, as this would be an invitation to speculators to try and break the bank, thus causing unnecessary volatility and fiscal cost.

My only problem with the proposed approach to monetary policy is the potential inconsistency, or overidentification, arising out of the simultaneous pursuit of guidelines for the exchange rate and domestic credit. The credit guidelines may well be useful if a lack of financial discipline in enterprises prevents the normal transmission of interest rate effects; but, ultimately, an overconcern with the credit targets may cause unnecessary conflicts. Since I see the exchange rate as the preferred main anchor--over domestic credit--for Bulgaria during this transition period, I do not see the logic in setting up the domestic credit targets as firm performance criteria. Perhaps the staff would like to comment on this.

One further concern is with the new interbank foreign exchange market, and the prospects for deepening and stabilizing this market--and, indeed, in bringing the informal market to it--when exchange controls remain on capital account transactions. From New Zealand's experience, when the New Zealand dollar was floated in March 1985, the removal of capital controls was seen as an important precondition for a smoothly running foreign exchange market, and I suspect that this may also be the case in Bulgaria. I would be interested to know whether there are any intentions at present to free up the capital account to facilitate the exchange rate float.

Like Mr. Landau and others, I am not confident that the authorities have got incomes policy right. First, given the large drop in national income over 1990-91 and the need to develop a competitive traded sector in the face of a firm nominal exchange rate, real wages must clearly fall by a substantial amount. It has been noted that in the initial phase, measured real wages will actually fall by more than the 35 percent mentioned in the staff report, but the report also notes that actual real wage reductions will be significantly less than the measured reduction in real wages, as a result of effective prices in the preliberalization period having been higher than measured prices. I wonder how significant that gap is. More fundamentally, I wonder whether the incomes policy is a nominal anchor, or whether it is aiming at a fixed real wage. There is a clear role for nominal restraint in the short term to help prevent a breakout from the initial price liberalization, but I do not think it is appropriate for incomes policy to be a nominal anchor in the medium term, as it generates an overidentification. When monetary policy is setting an anchor for the price level, a fixed wage anchor will imply a loss of flexibility in real wages. Real wages in the medium term have to be flexible so as to clear the labor market to support the real exchange rate adjustments that are needed to achieve external balance.

For the second half of the year, it is suggested--prematurely, I would think--that there will be room for increases in real wages. This is the key area in which restraint must be maintained if Bulgaria is to achieve price stability and a return to external viability within the medium term. Wages cannot be used as a nominal anchor in the medium term, as real wages must be allowed to adjust to clear the labor market and support real exchange rate adjustments. The large absolute size of the flat initial wage adjustment points to an undesirable degree of wage compression. Like Mr. Goos, I do not see this as a useful first step toward a freer and more efficient allocation of labor resources.

I share some of the concerns of earlier speakers regarding the size and persistence of the financing gap, as estimated in the medium-term scenarios. There is clearly a high risk attached to the Fund's involvement in this program, and we must therefore ensure that every precaution is taken against policy slippage, as well as emphasizing the Fund's role as a catalyst for the participation of other creditors.

However, the program is a very comprehensive and commendable one. The broad-based support for the program within Bulgaria, as emphasized by Mr. Posthumus, is very encouraging. We would therefore support the stand-by arrangement and the associated decisions.

Mr. Torres made the following statement:

Like previous speakers, I would like to commend the Bulgarian authorities for the strong efforts they have made in the transformation of their economy. We are confident that the objectives of the overall restructuring program being implemented by Bulgaria--in the context of an exceptionally difficult external environment--will be achieved. The set of measures already implemented, as well as the remaining ones envisaged in the program, demonstrate the commitment of the authorities to the path of reform and the real likelihood of reaching this commendable aim.

So far, the main anchor for the success of an economic program has been achieved: a strong consensus among the Government, political parties, and unions on the need to move toward a market-oriented economy and to face all the difficult tasks involved in this process.

Moreover, the general framework of stabilization and structural reform embodies a strong fiscal reform--including the elimination of most of the subsidies--a tight monetary policy, price and trade liberalization, a comprehensive privatization scheme, as well as an exchange system reform. Also, the social safety net provisions will be maintained and some systems of social assistance will be enlarged, thus lowering the transition costs to the most vulnerable groups of society. All these efforts are highly commended by this chair.

In spite of these efforts, we realize that Bulgaria still has a difficult and long way to go in the stabilization and structural reform process. Excess demand needs to be controlled and the inflation rate sharply reduced so as to achieve the objectives of the program. Moreover, achievement of the fiscal objectives--both revenues and expenditures as envisaged in the 1991 budget--will be necessary in order to avoid using foreign resources to finance budgetary operations, instead of domestic credit to the nongovernment sector.

Interest rates should be kept under close control so as to avoid early reductions in the event of higher levels of inflation. Also, incomes and financial policies should be especially supportive, so as to avoid unnecessary pressures on the newly established exchange rate system.

We welcome the steps already taken toward the establishment of private ownership rights. Nevertheless, we urge the authorities to accelerate their efforts in restructuring the state enterprise sector, and to establish the foundations for achieving this goal.

Restoring Bulgaria's external viability is a very challenging task. Not only is the current account deficit high, but the overall financing needs are considerable. In this effort, the strong commitment of the authorities to the timely implementation of economic policies, as well as the strong support of the international financial community--in the form of pipeline financing, private and official assistance to cope with the debt obligations falling due, and balance of payments support to restore official reserves--are needed. Indeed, they will be crucial to support an early recovery of output levels in the economy.

As the staff points out frequently in its report, Bulgaria's reform program is surrounded by many uncertainties: the restoration of normal relations with the Middle Eastern countries, its heavy debt burden, the achievement of a sharp reduction of the inflation rate, the implementation of the 1991 budget, the inherent risks of the new exchange rate system, the scale and timing of foreign assistance, the sequencing and speed of enterprise reforms and privatization, among others. Nevertheless, we share Mr. Posthumus's view that the program which has been set in motion, and the way in which it was developed, seems to be the closest substitute for a track record with the Fund. Since I share this view, and understand as well the uncertainties surrounding the economic program of a country recently embarked upon the transition from a centrally planned to a market-oriented economy, I would like to support the proposed decisions regarding the Article IV consultation and the stand-by arrangement and external contingency financing. Also, I would like to commend the Bulgarian authorities for their strong efforts to restore their economy.

Mr. Thorláksson made the following statement:

Like previous speakers, this chair very much welcomes the new direction of economic policy in Bulgaria. It is regrettable, however, that this turnaround took place only after the economic and financial situation of the country was no longer sustainable. The previous almost total centralization of all economic activity in Bulgaria, together with Bulgaria's complete isolation from market influences, distorted prices and made it impossible to use resources efficiently. However, there is one exception to this picture: some degree of freedom had been granted to a cultivated area comprising only 15 percent of all arable land, and the fact that this small segment produced one half of total agricultural output should indeed be an encouragement to the authorities to tackle decisively the daunting task ahead.

The need for radical structural change in Bulgaria is overwhelming, as is the need for simultaneously creating a stable macroeconomic environment as a basis for economic reforms. It is therefore reassuring to see that the Bulgarian authorities' economic program, in support of which a Fund stand-by arrangement has been requested, includes both comprehensive stabilization policy measures and an array of structural reforms. In this context, we welcome the fact that far-reaching prior actions have already been implemented, with the objective of curbing excess demand in the economy. However, to restore growth over the medium term, it is imperative that the demonopolization and privatization of public enterprises be rapid.

Bulgaria's external position, which has been deteriorating for some years, worsened further in 1990 with a drastic decline in exports, depletion of foreign exchange reserves, and a buildup of arrears both to official and private creditors; the result is that Bulgaria no longer has access to convertible currency financing. External shocks stemming from the disintegration of the CMEA countries and the U.S.S.R. and, in particular, the Middle East crisis, have exacerbated this situation.

As the low level of international reserves does not permit the use of a fixed exchange rate as a nominal anchor for the economy and the floating exchange rate system is unstable, developments in the external situation will depend heavily on adherence to stringent financial policies. In this connection, I am pleased to note that the recent changes in the external value of the leva indicate an increasing confidence in the policies being pursued.

In the monetary area, there is great uncertainty attached to the assumptions of the velocity of money, and developments there should be followed carefully. In this context, we support the strengthened role of the National Bank in controlling the expansion of credit and monetary aggregates, and would generally like to emphasize the need quickly to strengthen the financial system.

We are, however, concerned about the financing of the program and its medium-term viability. There are considerable risks inherent in the program itself, due to uncertainty relating not only to the implementation of the reforms, but also to the response of economic agents to the new economic environment, for example. In addition, there is a great deal of uncertainty concerning external financing--relating to the possibility of receiving private capital, in particular.

It should also be noted with some concern that while the financial involvement of the Fund is substantial and the disbursements of its resources are front-loaded, other external financing remains uncertain. For this reason, it is important that the contribution from the G-24 leading industrial countries be in place shortly. It is also to be hoped that the Fund program will have some catalytic effects among the providers of private capital, although their reactions to date have not been encouraging.

Because of the lack of financing assurances, I think it is fair to say that in this case the safeguards for the Fund's resources rely heavily on the political commitment of the authorities to persevere in the reform effort, and on the hope that the Fund will be treated as a preferred creditor, rather than on the assessment of Bulgaria's ability to repay the Fund.

In view of the Bulgarian authorities' strong economic program, their commitment to implement additional adjustment measures if necessary, and the obvious balance of payments need, we can support the proposed decisions on the stand-by arrangement and the contingency mechanism under the CCFF.

Mr. Arora stated that he supported the bold and courageous program that had been implemented by the Bulgarian authorities, and which Mr. Posthumus had characterized as "home-made."

It had been his understanding that when there was some uncertainty about a country's prospects and the possibility of the medium-term viability of its economy, the Fund should be one of the first players to become involved, and not shirk its systemic responsibility, Mr. Arora observed. That was especially applicable in the case of a comprehensive and radical structural reform, like that being attempted in Bulgaria. The Fund's leadership in that regard should provide the necessary message to the international community. If the Fund's fundamental principles were correct, the question of medium-term viability would be bound to be resolved eventually. The present was not the time for the Fund to be timid in its approach to supporting economic and structural reforms.

When countries decided to move from the paradigm of central planning to what might be called the Fund paradigm, the whole question of growth was taken out of the hands of governments, and growth could not be consciously planned for, Mr. Arora commented. Rather, growth became part of the actions taken by the private sector. The authorities' program was intended to establish the institutional and structural conditions under which growth would take place. Therefore, in the interim period, growth would not come as a result of the actions of government. But it should not be doubted that growth would eventually come, in his view, and perhaps sooner rather than later.

Mr. Ghavam made the following statement:

Like many Eastern European countries, Bulgaria is at a preliminary stage of transforming a command economy into a market-oriented one. Indeed, the magnitude of the economic difficulties and the country's strong ties with the CMEA, resulting in the high vulnerability of the economy to external developments, will definitely make the restructuring process a formidable and time-consuming task for the authorities, and impose substantial short-term hardship.

However, it is heartening that the formation of a coalition Government in Bulgaria has provided a strong supportive domestic environment for embarking on an ambitious economic program, the objectives and instruments of which deserve our full endorsement. We also agree with the thrust of the staff's appraisal, which supports providing the authorities with large external financing, in the form of a stand-by arrangement with an external contingency mechanism and CCFF resources. While we have no objection in this respect, it is hoped that other developing countries with severe economic difficulties that are willing to embark on strong and credible economic programs will continue to have Fund support for adequate access to external finance.

Economic stabilization in different sectors of the economy is highly dependent on the removal of the large excess liquidity and the control of flows. In coping with this problem, the authorities have rightly envisaged a mixture of measures in the areas of fiscal, monetary, and pricing in their program for 1991 and beyond.

On the fiscal front, the Government's intention to reduce sharply current expenditure from 50 percent of GDP in 1989-90 to nearly 35 percent of GDP in 1991, through lowering subsidies on trade with the CMEA area, in particular, is encouraging. Given the uncertainty surrounding the attainment of budgetary objectives, particularly the revenue targets, the incorporation of a contingency element representing 2.7 percent of GDP to take care of possible deviations, and the classification of expenditures into two categories, so as to make lower priority outlays contingent upon the materialization of expected revenues, are both steps in the right direction, and are likely to facilitate the attainment of the fiscal objectives.

The adoption of an adequate social safety net program, as well as equitable sharing of the burden of the stabilization and structural adjustment process among various parts of the population, are the important aspects of the authorities' economic program that will certainly facilitate the adhesion of the population to the economic program. In this respect, the authorities' success in concluding a landmark wage agreement with trade unions and employers, based on sharing the burden of the restructuring process by all parties involved, is commendable.

Concerning the structural reforms, as mentioned in the report, despite the Parliament's approval of the general framework for transforming the economy--including the authorities' program and a number of other regulatory and institutional reforms--the successful and timely implementation of the structural policies and reform measures is crucially dependent on the adoption of a number of new laws providing the necessary legislative and institutional basis.

In the external sector, timely conclusion of arrangements between the authorities and creditors on substantial restructuring of debt, including rescheduling of the debt and arrears, and debt reduction, are essential to support the adjustment process, and crucial for restoration of economic recovery.

However, given the fact that the new external financing in 1991 is programmed to be divided between the Fund and the Bank, on the one hand, and other official creditors, on the other hand, and in light of the uncertainties surrounding the external financing arrangements, the authorities' vigilance in this regard and the monitoring of developments by the Fund will remain essential in order to accommodate the potential risks which may jeopardize the program targets, as well as the collective interests of the membership.

We support the proposed decisions.

The staff representative from the European Department stated that the second anchor of the Bulgarian program was domestic credit, as some speakers had implied.

Regarding incomes policy, the fact that targets had not been established for the second half of the year did not mean an erosion of the nominal wage anchor, the staff representative explained. Given the large changes that were taking place in prices, and the uncertainty about the impact of those changes, the staff had believed that it would be more appropriate to wait until some experience had been acquired before setting the nominal wage target for the second half of the year.

At the time of the staff's discussions with the authorities, very little was concretely known about foreign financing, the staff representative pointed out. The staff did not believe that the program should be based on the assumption of no foreign financing.

If the exchange rate did not converge to the level assumed under the program, the authorities would need to raise energy prices once more, in order to preserve the budget, the staff representative noted.

The authorities were aware of the increase in the social security imbalance, the staff representative related. The imbalance had grown worse as a result of certain special factors that had taken place in 1990, and the recent increase in the contribution rate would address the problem.

The staff expected that the central bank currently had full latitude to change interest rate policies, and that that would be done flexibly in light of the exchange rate and other targets of the program, the staff representative observed. One important rigidity in the interbank market had been abolished--the tax on foreign inflows the sources of which could not be documented--which should serve to broaden the interbank market.

The estimate of 60 percent as the proportion of nonperforming assets of banks was only an initial estimate, which would have to be confirmed by external and internal audits of the branches of the banks, the staff representative noted.

In response to a question from Mr. Al-Tuwaijri, the staff representative from the European Department said that if the exchange rate policies failed, the entire budgetary situation would be assessed at the time of the first review of the program. Corrective measures would not center on, or necessarily be limited to, raising energy prices. Indeed, there were uncertainties in the Bulgarian program about many factors, not only uncertainties with respect to the evolution of oil prices.

The Director of the Exchange and Trade Relations Department stated that he was not certain of the advisability of designing a program around only the financing that had been definitely secured, and then perhaps adjusting downward the performance criteria of the program when additional financing became available. The Bulgarian program anticipated already a 35 percent decline in real wages and an 11 percent decline in GDP, and it was unlikely that those could be compressed any further. Like Mr. Filosa, he believed that the Bulgarian program was at the upper level of what could be tolerated. Beyond that, it was not just a matter of adjusting performance criteria ex post as the financing materialized, but of planning for that financing so that it could be put to the best use. Moreover, the staff had had indications--although admittedly not final ones--that the financing would in fact be forthcoming. The receipt of that financing was complicated by the fact that the Fund, as well as the G-24 leading industrial countries and the European Communities, had never had a program with Bulgaria before, and mechanisms for coordination, including at the staff level, had had to be worked out. As the process unfolded, it was to be hoped that a routine flow of information would evolve, eliminating the start-up problems with regard to financing that had been seen in the case at hand.

The staff representative from the World Bank stated that the Bank's strategy with respect to Bulgaria had been very clear from the beginning. It consisted of a technical assistance loan and a structural adjustment loan, with sectoral lending to follow. The technical assistance loan was intended from the first to stand alone, because the Bank also believed that structural adjustment measures should move ahead as quickly as possible. The technical assistance loan had been separated from the structural adjustment loan because some of the measures the Bulgarian Government would need to implement in order to secure the approval of the World Bank Board for a structural adjustment loan would be slow to appear. The structural adjustment loan had now been fully appraised, and would be submitted for the Board's consideration in April 1991.

The Bulgarian Government had not moved as quickly on structural adjustment issues as on stabilization issues, which was understandable, given their technical capacity, the massive reorganization of the Government, and the fact that many structural adjustment measures would require political backing and legislative changes that would take time to secure passage by the parliament, the staff representative pointed out. The World Bank Board required some prior actions--in addition to those that had been taken to stabilize the economy--in order to put forward a structural adjustment loan, and those had been slower to come.

The Bank's management was concerned about medium-term viability as well, and collaboration with the Fund to resolve that issue would continue, the staff representative stated.

Privatization would be the central component of the structural adjustment loan, and also the largest component of the technical assistance loan, the staff representative from the World Bank concluded. The Government lacked a definitive privatization strategy because it did not have the administrative capacity to design one, and the technical assistance loan was intended to provide expertise in that regard. Banking reform would be the first or second sector operation that the World Bank would have in its lending program with Bulgaria, which would include a banking modernization project, which should be appraised in calendar year 1991. The World Bank would also extend an agricultural loan and a banking loan. The Bank would try to move in parallel with the Government's own capacity to implement the needed reforms. Those loans were to sectors that were most important in terms of the overall structural adjustment strategy.

Mr. Posthumus stated that he was very heartened by the support in the Board for the Bulgarian program. It was indeed an ambitious program; in many respects, there was less risk attached to an ambitious program than to a gradual one, in his view. Nevertheless, Directors had delivered a sobering message, which he would convey to the Bulgarian authorities, as to the magnitude of the problems that lay ahead. The experience of other cases would be very useful for Bulgaria, and he was certain that the authorities would take those lessons to heart.

The Chairman made the following summing up:

Directors strongly commended the Bulgarian authorities for launching a decisive economic program within a short period of time after joining the Fund. The program represented a sharp break with the past, and Directors agreed that Bulgaria's exceptionally difficult starting conditions argued for the strongest possible program, and that there were no viable alternatives to an ambitious and frontal approach.

All speakers agreed that Bulgaria's large inherited disequilibria, combined with the breakup of the CMEA system on which Bulgaria had been among the most dependent, left little latitude for phasing in stabilization and structural reforms. Thus, Directors endorsed the priorities and pace of the program, in particular the upfront measures to liberalize prices and the external trade and payments system, eliminate the monetary overhang, and seek an early start to privatization and other structural reforms. Those measures would help to ensure that the reform process took root in an environment of vastly improved relative prices and allocative efficiency.

Directors generally endorsed the program's reliance on a floating exchange rate arrangement and the newly created interbank market for foreign exchange. Several speakers emphasized the risks associated with such a choice, in terms of its potential for volatility that could make the re-establishment of financial stability more difficult. However, all Directors agreed that the tight financing constraints and the lack of reserves, together with the uncertainties regarding the likely equilibrium exchange rate, were persuasive arguments in favor of the authorities' policies. By the same token, all Directors stressed the cardinal importance of keeping to the monetary, fiscal, and incomes policy targets set out in the arrangement if the risks associated with the exchange rate arrangement were to be kept to a minimum.

Directors placed the highest importance on ensuring adherence to the wage bill ceilings in the program, particularly with respect to the state enterprises, over which previous control mechanisms had broken down. While Directors were encouraged by the tripartite wage agreement that had created room for the necessary reduction in real wages, they cautioned against any premature relaxation of wage restraint, and they emphasized that the incomes policy to be pursued later in the year would have to be weighted carefully in the light of changing circumstances. Indeed, Directors observed that the projected downward path of inflation was unusually fast and ambitious. If inflation were to prove more stubborn than anticipated, real wages might have to decline by more than the 35 percent built into the program, and the macroeconomic policies might need to be tightened further, in order to achieve the balance of payments objectives.

Directors recognized that the budgetary targets were ambitious--in that they targeted a decline of 10 percentage points of GDP in a single year--but they saw no alternative if the large macroeconomic disequilibria were to be eliminated in an orderly manner. Directors commended the far-reaching revenue and expenditure measures that had already been taken in support of the budgetary objective. Given the difficult reform process ahead, Directors attached importance to the existence of a social safety net. However, several Directors, having in mind in particular the need for the reconstitution of productive capital, were concerned about the large size of the safety net that had been introduced, equivalent to 13 percent of GDP. Concern was also voiced that the cuts in public investment outlays could adversely affect the desired revitalization of the economy. Within expenditures, Directors welcomed the safeguards that had been instituted--through a contingency provision and the prioritization of expenditures--to protect the program from the uncertainties inherent in a period of such a radical transition. Nevertheless, the uncertainties surrounding fiscal developments could well exceed the margins provided by these safeguards, and some Directors cautioned the authorities to be ready to take remedial measures should they be required to preserve the programmed fiscal adjustment.

Directors supported the authorities' monetary and credit expansion limits in the program. Given the exchange rate objective of the program, Directors emphasized the need for flexibility in administering the new interest rate structure, and they urged the authorities to resist pressures to reduce interest rates prematurely, before there was sustained evidence that inflationary expectations had been subdued. Equally, they emphasized the need to protect the monetary program from the many risks to it that were inevitable during the transition. Those risks stemmed, in particular, from the potential for interenterprise credits to grow, and from the weak portfolios of banks still emerging from a monobanking system. Financial reforms to promote competition, recapitalize banks, and reduce intermediation spreads were needed urgently.

Indeed, Directors considered that structural reforms across a very wide spectrum were required to support stabilization and attract foreign investment. While commending the progress that had already been made in dismantling some monopolies, establishing the institutional framework for small privatization, and promoting agrarian reform, Directors noted a long agenda of legislative, institutional, and attitudinal changes that demanded attention. Directors observed that the most urgent priorities among those related, in addition to the reform of the financial institutions, to the state enterprise sector. While expecting that small-scale privatization could proceed relatively quickly, Directors cautioned that it was the larger state enterprises that posed the biggest threat to the program. Restructuring those enterprises, including through closures, when needed, would be a critical test of Bulgaria's reform process. Directors encouraged the authorities to work quickly with the World Bank and other agencies to develop a detailed plan for the rapid transformation of state enterprises.

In that context, Directors underscored the crucial role of external assistance in 1991, especially as the program already provided for over two thirds of the external shocks to be absorbed by the domestic economy. Directors recognized that overall access to Fund resources would be high, but believed that that was justified by the strength of the adjustment program and the financing need. Directors were aware that a request had already been made to the Paris Club for a restructuring of obligations falling due during the program period. Noting that Bulgaria's principal creditors were the private banking community, however, Directors considered Bulgaria to be a prime candidate for debt and debt-service reduction through a comprehensive restructuring of its relatively large indebtedness to private creditors. Directors consequently urged Bulgaria to initiate such restructuring negotiations and that, meanwhile, arrears be avoided through interim deferral arrangements.

Directors noted that the 1991 financing gap relied heavily on G-24 and World Bank financing, without which the reform process would be seriously threatened. A number of speakers voiced the hope that World Bank financing would become available faster and in larger amounts than presently envisaged. Although a request for $800 million had been made to the Group of 24, progress toward securing commitments had thus far been slow. Directors were of the view that exceptional efforts would be required from public creditors to secure financing to that extent. In any event, satisfactory evidence regarding the closing of the financing gap would be required for completion of the scheduled program reviews.

Thus, given the financing uncertainties and the doubts voiced by a number of speakers regarding the restoration of balance of payments viability in the medium term, Directors considered that the risks to Bulgaria's program had increased even further, which argued for great perseverance on the part of the authorities. In particular, fiscal adjustment would have to be reinforced to accommodate possible shortfalls in programmed financing, and other policies--notably, incomes and interest rate policies--adjusted to protect erosion of the program objectives. The flexible exchange rate system adopted by the authorities would facilitate such additional adjustment. The three program reviews that had been planned would provide the necessary opportunities for re-examining the program in light of developments. Directors welcomed the strong program of technical assistance that had already been launched by the Fund, and considered that it would also help safeguard program implementation.

It was expected that the next Article IV consultation with Bulgaria would be held on the standard 12-month cycle.

The Chairman noted that he would convey to the management of the World Bank the Executive Board's concerns about the progress of the World Bank's loan program with Bulgaria.

The Executive Board then approved the following decisions:

Decision Concluding Article XIV Consultation

1. The Fund takes this decision in concluding the 1991 Article XIV consultation with Bulgaria, in the light of the 1991 Article IV consultation with Bulgaria conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. Bulgaria's restrictions on payments and transfers for current international transactions are maintained under the transitional arrangements of Article XIV, Section 2, as described in EBS/91/26 and SM/91/52. The Fund encourages Bulgaria to eliminate these restrictions, including the restrictive features of bilateral payments agreements with Fund members, as soon as circumstances permit.

Decision No. 9672-(91/37), adopted
March 15, 1991

Stand-by Arrangement and External Contingency Financing
Under Compensatory and Contingency Financing Facility

a. The Government of Bulgaria has requested

(1) a stand-by arrangement for a period of 12 months from March 15, 1991, in an amount equivalent to SDR 279.0 million; and

(2) a decision that, should adverse external contingencies occur during the period of the program supported by the stand-by arrangement, the Fund will provide, in association with the stand-by arrangement, external contingency financing

under the compensatory and contingency financing facility (Decision No. 8955-(88/126), as amended) up to a maximum amount equivalent to SDR 77.5 million.

b. (1) The Fund approves the stand-by arrangement set forth in EBS/91/26, Supplement 2.

(2) The Fund decides that

(a) should adverse contingencies occur during the period of the program supported by the stand-by arrangement, the Fund will provide, in association with the stand-by arrangement, external contingency financing under Decision No. 8955-(88/126), as amended, up to a maximum amount equivalent to SDR 77.5 million, in accordance with the factors set out in Appendix VI to the letter attached to EBS/91/26.

(b) should favorable external contingencies occur during the period of the program supported by the stand-by arrangement, adjustments of up to SDR 77.5 million will be made by the Fund at that time under paragraph 27 of Decision No. 8955-(88/126), as amended, in accordance with the factors set out in the same Appendix.

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

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

Decision No. 9673-(91/37), adopted
March 15, 1991

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/91/36 (3/13/91) and EBM/91/37 (3/15/91).

2. BELGIUM - REPRESENTATIVE RATE FOR BELGIAN FRANC

The Fund finds, after consultation with the authorities of Belgium, that the representative exchange rate for the Belgian franc under Rule O-2(b)(i) against the U.S. dollar is the midpoint between spot buying and selling rates for the U.S. dollar in the

Brussels foreign exchange market, as ascertained by the National Bank of Belgium. The National Bank of Belgium will determine this rate daily by observing the buying and selling rates for the U.S. dollar quoted at 11:30 a.m. (Brussels time) by banks that are active in the U.S. dollar/Belgian franc exchange market (EBD/91/68, 3/8/91).

Decision No. 9674-(91/37) G/S, adopted
March 13, 1991

3. MOROCCO - 1990 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, as amended, the Executive Board agrees to extend the period for completing the 1990 Article IV consultation with Morocco to March 20, 1991. (EBD/91/69, 3/12/91)

Decision No. 9675-(91/37), adopted
March 14, 1991

4. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/91/55 (3/12/91) and by Assistants to Executive Directors as set forth in EBAP/91/56 (3/12/91) and EBAP/91/57 (3/12/91) is approved.

APPROVED: November 6, 1991

LEO VAN HOUTVEN
Secretary