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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 91/97

10:00 a.m., July 22, 1991

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	A. A. Al-Tuwaijri
G. K. Arora	L. E. N. Fernando
C. S. Clark	D. Powell, Temporary
Dai Q.	
	J. M. Abbott, Temporary
J. de Groote	J. Prader
	N. A. Espenilla, Jr., Temporary
R. Filosa	N. Kyriazidis
M. Finaish	A. F. Mohammed
	I. Fridriksson
B. Goos	
J. E. Ismael	
	J. C. Jaramillo
J.-P. Landau	
	O. Kabbaj
	T. Berrihun, Temporary
D. Peretz	
G. A. Posthumus	G. P. J. Hogeweg
	A. R. Ismael, Temporary
A. Torres	R. Marino
A. Végh	
K. Yamazaki	N. Tabata

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

Also Present

IBRD: J. Khalizadeh-Shirazi, Asia Regional Office. African Department: E. L. Bornemann, Director; S. J. Anjaria, R. C. Williams. Asian Department: P. R. Narvekar, Director; H. Neiss, Deputy Director; O. J. Evans, M. R. Figuerola, D. J. Goldsbrough, J. S. Kahkonen, L. M. Koenig, R. S. Teja. Central Banking Department: R. K. Abrams. European Department: S. M. Thakur. Exchange and Trade Relations Department: J. T. Boorman, Director; T. Leddy, Deputy Director; J. C. Di Tata, S. Eken, R. A. Feldman, G. R. Kincaid, C. Puckahtikom, J. P. Pujol, B. E. Rourke, S. M. Schadler, B. C. Stuart, P. J. P. Szymczak, J.-Y. Wang. External Relations Department: V. R. Khanna. Fiscal Affairs Department: V. Tanzi, Director; L. Garamfalvi, A. Premchand, A. Tazi Mokha. Legal Department: W. E. Holder, Deputy General Counsel; P. L. Francotte, A. O. Liuksila. Research Department: E. Hernández-Catá. Secretary's Department: A. Tahari. Treasurer's Department: A. F. Moustapha, B. B. Zavoico. Advisors to Executive Directors: L. E. Breuer, M. B. Chatah, Y.-H. Lee, E. Martínez-Alas, J.-L. Menda, M. Nakagawa, A. Raza, B. A. Sarr, A. M. Tanase, S. von Stenglin. Assistants to Executive Directors: G. Bindley-Taylor, Deng H., S. K. Fayyad, B. R. Fuleihan, K. M. Heinonen, J. Jonas, P. K. Kafle, V. Kural, D. Sparkes, N. Sulaiman, C. M. Towe, J. C. Westerweel.

1. INDIA - PURCHASE TRANSACTION - COMPENSATORY AND CONTINGENCY FINANCING FACILITY - FLUCTUATIONS IN EXPORTS AND COST OF OIL IMPORTS

The Executive Directors considered a staff paper on India's request for a purchase in an amount equivalent to SDR 166.2 million under the compensatory and contingency financing facility (CCFF) with respect to fluctuations in exports and the cost of oil imports (EBS/91/116, 7/11/91; Sup. 1, 7/15/91; Sup. 1, Cor. 1, 7/17/91; and Sup. 2, 7/19/91).

Mr. Arora made the following statement:

My authorities would like to thank the staff and the management for their expeditious response to India's request for a purchase equivalent to SDR 166.2 million under the CCFF. They would also like to thank the Executive Board for allowing an early consideration of their request for use of Fund resources.

My authorities are in broad agreement with the key elements of the staff analysis. Therefore, it remains for me to draw attention to some important aspects. The Executive Board is aware that, owing to political developments, the adjustment program outlined in EBS/91/4 (1/7/91) could not be implemented in full. The pass-through of petroleum prices was largely completed. Additional revenue measures were taken in December 1990 to reduce the fiscal deficit. However, the budget for 1991/92 was postponed until after the general elections to Parliament. Only an interim budget could be presented to Parliament before it was dissolved. Although expenditure restraint was a major feature of the interim budget, additional revenue measures and decisions on administered prices could not be taken. Monetary policy was tightened, and policy measures to restrain imports were brought into effect. Nevertheless, the external position continued to deteriorate.

The new Government that took office in late June 1991 after the elections was confronted with a serious balance of payments problem. It immediately announced a policy package to stabilize the situation. Monetary policy was tightened further through increases in interest rates, and the exchange rate of the rupee was adjusted downward by 19 percent. The authorities also pledged gold held in reserve to obtain bridge financing from the Bank of England and the Bank of Japan. In addition to the action taken in the area of financial policies, the Government also announced important policy measures to rationalize and liberalize the trade regime.

My authorities realize that the stabilization package announced in early July will depend for its effectiveness on a strong fiscal adjustment in 1991/92 set within a medium-term framework, continued tightness of monetary policy, and thoroughgoing structural reform with a view to modernizing the economy and strengthening its competitive position. Indeed, the whole idea is to underpin stabilization measures by major policy reforms, beginning in 1991/92 and extending over the medium term, with the objective of integrating India into the world economy. What is involved here is not merely specific policy measures taken to redress this or that imbalance, but a radical and comprehensive change in what the Finance Minister has called "the mind-set." India now finds itself in line with the trends and forces altering the structure of the world economy.

For 1991/92, the main features of the adjustment process are as follows: adherence of the Union budget for 1991/92 to the target of reducing the fiscal deficit to 6.5 percent of GDP; continuation of a tight monetary policy--growth in money and total domestic credit is programmed to be held within a range of 11-14 percent for the entire year; a significant reduction in the current account deficit; and initiation of major policy reforms in the trade regime--which have already been announced--industrial regulation, the financial sector, and public enterprises. The basic approach of my authorities is to increase domestic savings--thereby reducing reliance on foreign savings--to lower significantly the inflation rate through a sustained effort to remove macroeconomic imbalances afflicting the economy, and to boost growth by moving decisively toward a more open and competitive economy.

During 1991/92 and beyond, India will need significant external financial assistance to pursue a growth-oriented adjustment strategy. Without such assistance, adjustment might, indeed, impose intolerable burdens on the weaker sections of the national community. Progress toward structural reform would also be slowed down. Fortunately, the Fund, the World Bank, other multilateral institutions, and the donor community have consistently taken a positive and helpful attitude which provides ground for hope that the adjustment process would be sustained, leading to strong growth performance with external viability in the medium term.

I would request a favorable decision from the Board on the proposal placed before it. We expect to request additional assistance from the Fund soon to support what we think would be the most ambitious effort at adjustment and structural change in our postindependence history.

Mr. Yamazaki said that he strongly supported the proposed decision. He had long urged the staff to explore the possibility of a purchase under the CCFF for India. He commended the Indian authorities for their firm commitment and courageous policies to overcome the current difficulties. The timely and sizable depreciation of the rupee, the raising of interest rates, and the abolition of import subsidies were all steps in the right direction.

The Japanese Government had supported India from the beginning and would continue to do so, Mr. Yamazaki remarked. As early as May 1991, his authorities had pledged to lend India $300 million on concessional terms, and $150 million had been disbursed by June 5, 1991. In addition, the Bank of Japan and the Bank of England had each committed $200 million as a bridge loan; of that amount, $310 million had been disbursed. The remaining $90 million would be disbursed on July 24, 1991.

He hoped that the negotiations on the further purchase under the CCFF and the stand-by arrangement would soon be successfully concluded in view of the extreme importance of India's economy in the international financial community, Mr. Yamazaki stated. Given India's difficulties, it was imperative for international organizations and donor countries to take concerted action as soon as possible.

Mr. Peretz made the following statement:

> Like Mr. Yamazaki, I fully support this request for Fund assistance. It is justified by India's circumstances, the authorities' bold policy response in recent weeks, and their stated intention to negotiate a stand-by arrangement in the near future.
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> The proposed access for the second drawing under the CCFF is only a small proportion of the net compensable amount, and this proposal has in turn been scaled down by the application of the 20 percent limit to the export projections for the two post-shortfall years. So I have no doubt that India qualifies for this drawing, both on technical grounds and in terms of its cooperation with the Fund.
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> India essentially faces two problems. First, there are long-standing financial and structural weaknesses in the economy that have led to a medium-term balance of payments problem that has been exacerbated by the Middle East crisis. Second, there is a serious liquidity problem, stemming from the delays--some of them the inevitable result of the electoral process--in adopting the appropriate policies to deal with longer-term weaknesses.
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> Negotiations on a comprehensive adjustment program to tackle the first of these problems will take place over the coming weeks. Meanwhile, I see this drawing under the CCFF as part of a package to deal with the second of these problems--the immediate liquidity problem. What is needed, above all, is a package that will restore the confidence of world financial markets in India's economy. The Indian authorities have already implemented a sizable devaluation and tightened monetary policy. They have gone

to great lengths to ensure that there is no interruption in their debt service. And on Wednesday, July 24, 1991, they will be unveiling a budget that will have to be tough to achieve the targeted reduction in the deficit in the remaining months of this fiscal year.

Meanwhile, the international community can help by expressing its confidence in the new Indian administration. There are three elements to this: the approval of this drawing under the CCFF today, a fast-disbursing loan to be considered by the World Bank Board tomorrow, and a short-term loan from the Bank of England and the Bank of Japan that has already been arranged. Altogether, then, this package ought to send a powerful and reassuring message to the financial markets. I hope that it will help reverse the outflow of capital and reopen India's access to external credits.

The success of this package in rebuilding confidence will depend to a large extent on the determination with which the authorities are seen to act. I have to say that I was a little uneasy with the decision to devalue the rupee earlier this month in two stages, and the increase in interest rates may not have been substantial enough. I cannot help feeling that a single-step devaluation and a steeper initial increase in interest rates would have made a more decisive impression and would have been a more reliable way to ensure that confidence recovered quickly; after that recovery, interest rates could have been reduced. But this is a matter of judgment. I would not go on further about interest rate levels. I think what has been done is sufficient.

Following the recent devaluations, some kind of commitment to exchange rate stability would add greatly to the credibility of policy. There must be a danger of an upsurge in inflation from the impact of successive devaluations this year, the earlier increases in energy prices, and any changes in administered prices that may be announced on Wednesday. This risk strengthens the case for the adoption of a nominal anchor. I was somewhat concerned to read in the staff paper that the authorities only intend to hold the exchange rate stable "for a while." Certainly, this message could be dangerous if given to the markets. Although I do, of course, see that some further depreciation may in due course be necessary in the context of a wide-ranging program of trade liberalization, I was pleased to see that the authorities' own letter to the Managing Director contains a much less equivocal commitment to exchange rate stability.

Looking to the future, I hope that negotiations on a comprehensive adjustment program to deal with India's more deep-seated problems can be concluded quickly. In addition to fiscal consolidation, its key elements should be a sweeping liberalization of trade and investment and a dramatic reduction in rules and regulations and in the role of the public sector generally.

Given the heavy emphasis likely to be placed on structural reform and India's low level of per capita income, I hope that the possibility of India's use of resources under an enhanced structural adjustment facility (ESAF) has not been ruled out. My authorities would support a degree of access to ESAF resources if the measures to be taken warrant it.

There is no doubt that the next few years will be difficult for India. The projections show financing gaps persisting into the medium term. Some of these gaps can be closed with official financing, but the authorities will have to rely increasingly on private capital flows, including foreign direct investment. All these factors reinforce the need for the Indian authorities to ensure that their commitment to adjustment is unambiguous and sustained.

The severity of the present financial crisis has generated a welcome sense of urgency about the need to reorient economic policies and launch India on the same sustainable growth path as other Asian economies. I hope that the Fund can give the authorities its full support for their intention to meet this challenge.

Mr. Abbott made the following statement:

The economic situation in India is by now well known. External reserves have been depleted, and large-scale exceptional financing will be required to sustain foreign payments. Although the symptoms of the crisis have come to a head quickly under the pressures of the Middle East crisis and election uncertainties, the roots of the problem are long-standing.

We are encouraged that the leadership of the new Government has moved decisively to stabilize the economy and has made clear its intention to embark on a medium-term program of structural reform to modernize the economy, strengthen its competitive position, and integrate India into the world economy. As Mr. Arora expressed it in his statement, "What is involved here is not merely specific policy measures taken to redress this or that imbalance, but a radical and comprehensive change in what the Finance Minister has called the 'mind-set.'" We believe such a change is in India's own development interest, and the staff outline persuades us that nothing less will serve to restore external viability and growth.

As an emergency measure, imports have had to be compressed. The effect on activity has been predictably disruptive. Lost markets in the U.S.S.R. have spotlighted the need for exports to perform in a competitive environment. An inward-looking trade regime has left the traded goods sector with limited flexibility and deprived the internal market of the vitality that comes from vigorous competition. Heavy government intervention has reinforced these tendencies. Detailed industrial regulations frustrate private initiative and increase dependency on government. The Government's fiscal problems are aggravated by a proliferation of spending requirements for subsidies, transfers, and subventions to public corporations.

We are pleased that in their policy statement, the Indian authorities have said that they will continue to undertake further structural reforms covering the areas of industrial deregulation, foreign investment, financial and capital markets, taxation, and policy with respect to public sector undertakings. These measures are essential to enhance the international competitiveness of the economy, restore external viability, and ensure that India's growth momentum is strengthened.

The centerpiece for translating these policy "themes" into concrete actions will be the new fiscal year 1991/92 budget to be introduced later in the week. We look forward to seeing a clear elaboration of the authorities' plans. Fiscal consolidation will be essential. Measures to meet the announced deficit target of 6.5 percent of GDP are indispensable. It is disappointing that this target has become more difficult because measures anticipated in January 1991, at the time of the original CCFF, could not be legislated. Controllable spending and revenues, however, appear to be coming in closer to plan. Regardless of the source of the slippage, however, meeting the original objective has become even more important in light of the further external deterioration since January 1991. More ambitious targets will be needed for subsequent years. Implementation of the structural reform agenda will make medium-term fiscal consolidation both easier and more productive.

The staff discussion of the medium-term external financing scenarios is sobering. In the cautious phrasing of Fund documents, we are told, "Fund exposure arising from the proposed and earlier purchases is not without some degree of risk." Presumably this degree of risk will increase with the anticipated upper credit tranche arrangement later this year. A "manageable" medium-term prospect, the staff reports, "is predicated upon a strong adjustment program, an eventual re-establishment of access to commercial borrowing, and significant exceptional financing in the interim." As the Indian authorities recognize, half-measures will not suffice. A self-reinforcing virtuous circle needs to be set in motion, and full, vigorous, and early implementation of the announced reform agenda is the best assurance that such a result will be achieved.

Foreign investment policy is an area of particular interest to my authorities. As the staff notes, foreign direct and portfolio investment represents a relatively untapped source of balance of payments financing that could respond markedly to a more favorable policy environment. We would expect that India would find private capital a far more congenial source of external financing than extended resort to exceptional financing. We are encouraged by statements by the leadership of the new Government, and we hope that a broad opening to foreign capital will follow.

The potential is real--and so are the difficulties. If I might illustrate with a specific example, just last week a major U.S. firm with a large approved investment project in India called our office to try to find out what the prospects were that India's payments situation would improve enough that their half- started project could go forward. After three years of negotiations with the authorities, the project had been approved with requirements for a minority holding of a large export component and a substantial equity commitment, with the balance of required financing provided in foreign currency. But the foreign currency financing could only be provided by Indian banks. Although the investor is eager to proceed and could meet the foreign currency borrowing requirement abroad, the project languishes because Indian banks cannot commit the required foreign currency. Breaking out of this sort of self-defeating regulatory tangle will be essential if the broad commitment to the establishment of a more liberal investment regime is to be translated into concrete deals.

With respect to the immediate matter at hand today, we believe the request for an amended CCFF in the amount of SDR 166.2 million is fully justified, and we are happy to support today's proposed decision. The additional drawing under the CCFF would be well within the compensable amounts for the shortfall year. In addition, the strong immediate actions that the new Government has taken to halt the liquidity crisis and their advanced planning for a medium-term correction of India's external payments difficulties meet the test of cooperation with the Fund.

We believe that the authorities' two-stage approach--a CCFF now, followed by a later request for an upper tranche stand-by arrangement after the necessary groundwork has been established--is sound. India faces a difficult economic adjustment in both the near and medium term. Resolute implementation of major reforms will be necessary. As India musters the necessary resolve, it will surely merit the support of the international community and the Fund in particular.

Mr. J. E. Ismael remarked that he fully supported India's request for a purchase under the CCFF, because India's circumstances entirely justified it. The staff had laid out clearly the additional external burden that had resulted from the cost of imported oil and the exceptionally large shortfall in earnings from merchandise exports and workers' remittances. In addition, India's record of debt repayment to the Fund was unblemished, and its energy policy was appropriate. The Fund's assistance would help the country meet its immediate foreign exchange needs and relieve the pressure on its international reserves. He welcomed the authorities' stated intention to negotiate an upper credit tranche arrangement with the Fund in the immediate future.

He was encouraged by the authorities' response to recent developments, especially in connection with exchange rate adjustments, Mr. Ismael commented. However, the deep-rooted economic maladjustments in India's economy would certainly call for a comprehensive and aggressive policy approach. He was pleased to know from Mr. Arora's statement that the new Government was determined to pursue tight monetary and fiscal policies, augmented by radical policy changes geared toward increasing domestic savings, growth-oriented adjustments, major structural reforms, and a reduction of structural imbalances. Those contemplated changes would provide a sufficiently sound basis for continued adjustment and an improved economic performance. Without doubt, the economy had the resilience and dynamism to respond to positive policy incentives; that kind of experience had been aptly demonstrated in the 1980s.

Mr. Goos made the following statement:

> I can also endorse the request before us. It appears to meet all the requirements for the proposed access to the CCFF, not least in view of the authorities' credible assurances that they will tackle India's balance of payments problems in the framework of a comprehensive and forceful adjustment program to be supported by the Fund.
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> Such an effort would, indeed, be essential to correct the precarious external situation. At the same time, the Indian authorities should consider a heavily front-loaded approach to restore confidence rapidly as the basis for external capital inflows, including the inflow of foreign direct investment and the reversal of capital flight. The advisability of such an approach is underlined by the staff's projection of significant external financing gaps in the medium term and the risks involved in the Fund's financial exposure. At the same time, there can be little doubt that a vigorous attack on the existing imbalances and

structural distortions would also be in the interest of India in that it would accelerate the resumption of sustainable growth.

As to specific policy issues, I can broadly endorse the thrust of the program intentions as outlined in the staff paper, including the emphasis on structural reforms aimed at the abolition of the existing pervasive regulations that hamper India's economy. The liberalization measures already implemented by the new Government are, indeed, encouraging, although, inasmuch as imports are concerned, the measures eventually need to be replaced by more efficient instruments of indirect demand control. I would encourage the authorities in the formulation of their program to specify the reform measures and their preferably front-loaded timing as precisely as possible.

As to financial policies, I welcome the authorities' commitment to maintain a sufficiently tight policy stance, as well as the measures already undertaken to that end. Financial discipline will be absolutely essential for various reasons--notably to ease the external financing constraint, to ensure the success of the envisioned structural reform program, and to contain cost and price pressures that are likely to be exacerbated by the recent significant devaluation of the rupee and the necessary adjustment of administered prices. Judging from the staff paper, I have the impression that the authorities and the staff might underestimate the inflationary pressures resulting from those measures. I therefore feel that the fiscal and monetary authorities--at least initially--would be well advised to err on the side of caution. In this context, even considering the recent tightening of credit policy, I noted with some concern the wait-and-see attitude that has been pursued with respect to interest rate policy. A much more aggressive policy than the recent modest rate adjustments directed at shorter-term maturities would be more commensurate with the difficult external situation. In the same vein, while welcoming the intended fiscal policy stance as broadly appropriate, I should encourage the authorities to consider the deficit target merely as a ceiling and to look for additional savings. In this context, the low level of the tax ratio as well as the only marginal improvement envisaged in that ratio may point to significant scope for a somewhat accelerated fiscal consolidation.

Briefly on exchange rate policy, I would invite the staff to comment on the appropriateness of the rupee rate after the recent devaluation. In this context, I noted the intention of the authorities to hold the nominal effective value of the rupee stable only for "a period." Does this imply the intention to drop later the exchange rate anchor and go for a free floating exchange rate? I would, of course, advise against such an approach--not least in light of the recent exchange rate discussions in this Board. I should like to support the proposed decision.

Mr. Landau made the following statement:

We strongly support India's request for an additional drawing under the CCFF, a request that is based on the most recent data available. This drawing will be part of a larger process initiated at the beginning of 1991 that aims at maintaining India's external viability in an exceptional period. The mobilization of the international financial community has been--and will continue to be--an important element of this process. It is also a sign of the strength of democracy in India that, during a long and dramatic period of transition, some measures were implemented to curtail a further deterioration of the situation.

After reading the staff paper and Mr. Arora's statement, I fully agree that India meets both the test of cooperation and the requirements with respect to energy policy that are prerequisites for the proposed drawing. The Government that took office in June promptly reacted to the downturn in the economy that began in January 1991--especially the serious balance of payments situation. The authorities have adopted a two-stage response to the current situation that we fully support. First, an immediate stabilization package accompanied by important liberalization measures will be instituted; and second, the preparation of broader adjustment measures and further structural reforms that will constitute the basis for an upper credit tranche arrangement with the Fund will be introduced.

The package announced by the new Government immediately upon taking office was indispensable to stabilize the situation. Given India's economic circumstances, a onetime devaluation, accompanied by a strengthening of monetary policy, was warranted. I wish to associate myself with Mr. Peretz's remarks: we fully endorse the intention of the Indian authorities to hold the nominal effective value of the rupee stable, but would have wished it to be stated in a stronger way. We also support the Indian authorities' intentions to rely primarily on tight financial policies to ensure India's external competitiveness.

These measures have been accompanied by crucial steps aimed at liberalizing the trade regime. The elimination of export subsidies adopted in conjunction with the devaluation will also help attain fiscal objectives. The introduction of an expanded system of import replenishment entitlement contributes to a limitation on import growth and constitutes a first and temporary step in the reform of the import licensing system.

The key element of the broader adjustment package will be the budget to be presented shortly. The achievement of the targeted deficit reduction to 6.5 percent of GDP will no doubt necessitate strong additional measures. Given the low level of direct taxes on income and enterprises, ambitious measures will be needed to broaden the tax base. Furthermore, in conjunction with trade liberalization, a shift from quantitative restrictions to tariffs could be beneficial in terms of maximizing revenues.

The authorities' commitment to embark on a broad range of structural reforms aimed at the removal of long standing institutional impediments to growth is certainly a crucial step. The actions envisaged by the authorities with respect to industrial deregulation, trade reform, financial sector reform, and public enterprise reform are most welcome and will play a decisive role in rendering the economy more competitive and improving India's medium-term growth prospects. As to energy policies, the authorities' objectives to maintain domestic prices above world market levels and to promote domestic crude oil production are consistent with the request.

I support the proposed decision. I welcome and admire the prompt response of the new Government to India's severe external situation, and we look forward to the implementation of a global adjustment package supported by an arrangement with the Fund.

The Deputy Director of the Asian Department commented that the staff shared the disappointment expressed by a few Directors in the authorities' cautious response to interest rate increases in the context of the emergency package. Nevertheless, the staff was encouraged by the sharp increase in interest rates on export credits outstanding beyond six months; the purpose of that increase was the encouragement of timely repatriation of export proceeds. In addition, the Government would consider further increases in interest rates in general, should they become necessary.

The staff fully supported the authorities' intention that the last devaluation be followed by a period of exchange rate stability, the Deputy Director remarked. The buildup and maintenance of confidence were of paramount importance, and a stable exchange rate policy would certainly be an important contribution. The authorities had no intention of switching to a floating exchange rate in the near future. However, as Mr. Peretz had already mentioned, once concrete steps had been taken to liberalize trade and reduce tariffs, the exchange rate would have to be re-examined, and the possibility existed that a further adjustment might become necessary in the medium term; however, the current exchange rate level was adequate. The real exchange rate had decreased substantially over the past few years, and India's exports should be competitive.

The question of an arrangement under the ESAF had not been broached by the authorities in their discussions with the staff, the Deputy Director of the Asian Department reported. However, it was intended that the upper credit tranche stand-by arrangement to be negotiated would, in time, be succeeded or superseded by an arrangement under the extended Fund facility. At that time, the question of an arrangement under the ESAF would also be considered.

Mr. Prader made the following statement:

The continued worsening of India's economic condition since the first CCFF request in January 1991 has shown the validity of the point made by a number of Directors when that request was presented: that nothing short of a full-fledged macroeconomic stabilization effort and reformation and opening up of the economy will suffice. The idea that the authorities would limit their actions to measures against the deterioration of the current account and the effects of the Middle East crisis is now seen to be an illusion. The situation has become so bad as to make it clear that they will have to address the underlying problems of the economy.

Although today's request for additional CCFF financing could be dealt with and approved within the confines of the criteria for a CCFF decision because India strongly satisfies all the relevant criteria, it is reassuring that the Government sees the need to go beyond such a narrow, short-term approach and intends to embark on a fundamental, comprehensive adjustment and reform of the economy. I make these comments not only in view of possible problems with respect to India's capacity to repay the Fund in the face of a liquidity crisis, but also from the standpoint of the severity of the economic and financial crisis itself.

I take note of Mr. Arora's pertinent assessment that what is involved in the economic package announced in July is not merely specific policy measures to redress this balance or that balance, but a radical and comprehensive change in the economic mindset of India--a mindset of heavy regulation and government intervention. In this spirit, we welcome the upcoming negotiations between the Fund and India on an upper credit tranche program. We hope that the Government will be able to realize fully its good intentions.

I have two additional comments. The first is on exchange rate policy, and the second is with respect to the elimination of export subsidies. The exchange rate action was intended to reduce the exchange rate of the Indian rupee by the difference between India's inflation rate and the inflation rates of its most important trading partners with the objective of keeping the real effective exchange rate below its level at the beginning of the external adjustment. That adjustment in the exchange rate would protect the international competitiveness of Indian exports by eliminating the parallel foreign market and stabilizing the recent slowdown in the repatriation of export receipts.

I welcome the elimination of export subsidies, which impose on the Central Bank the considerable cost of refinancing the credits. Their abolition should reduce the burden on both the Central Bank and the budget. It remains to be seen, however, whether the exchange rate policy and the elimination of export subsidies will suffice as export promotion instruments should domestic demand maintain its current level or rise more rapidly than expected. Does the intention of holding the exchange rate stable only for a limited period indicate that the Government foresees difficulties in this connection? I would appreciate some comment from the staff on this issue.

Mr. Fridriksson noted that the documents under consideration by the Board reflected the severity of the impact of the Middle East crisis on India. The transition of the Eastern European countries and the difficulties in the U.S.S.R. had also had significant negative effects on India's trade. Despite those shocks, it was fair to say that India's economic problems stemmed to a large extent from domestic policies. As India had traditionally followed a policy of heavy import substitution, it had been unable to exploit the economy's tremendous potential. In the 1980s, some liberalization measures had been introduced, particularly in the area of foreign trade, but they had been insufficient.

The current situation called for immediate and comprehensive reforms, both in external and domestic policies, with the emphasis on deregulation and the free play of market forces, Mr. Fridriksson commented. In the fiscal field, a major budget consolidation was needed, particularly as external liquidity had fallen to an alarming level. In that respect, the new Government's policies must, as a minimum, seek to stabilize the economy quickly, but major efforts were required before the economy could resume a stable growth path. The steps taken so far were encouraging.

The projections for export receipts appeared somewhat on the optimistic side, Mr. Fridriksson remarked. Of the factors mentioned in the document, only improved incentives were likely to bring renewed vigor to the export sector in the near future. At the same time, he noted that a slower export revenue increase than forecast did not affect the "net compensable amount."

The formulation of the necessary economic policy measures and reforms was the responsibility of the Indian Government, but--by approving the request for additional CCFF resources--the Fund could assist their efforts, Mr. Fridriksson stated. The CCFF drawing met all requirements, and he supported the proposed decision. Nevertheless, India could only benefit from the Fund's contribution if extensive adjustment of the economy, coupled with structural reforms, were to occur. It was essential that external and domestic confidence in the policies of the Government be established expeditiously. Significant financing gaps were projected for the next few years, and to close them, India would have to be able to resume normal commercial borrowing and create an environment for nondebt-creating capital inflows. In light of the information in the staff paper, at the recent meeting on country matters, and in Mr. Arora's statement, he was confident that an appropriate program would soon be introduced.

Mr. Dai remarked that he would like to join other speakers in the commendation of the Indian authorities for their strong commitment to a package of stabilization policy measures that would immediately arrest the difficult economic decline. He also commended the staff and management for their quick response to India's request for a purchase equivalent to SDR 166.2 million under the CCFF. That purchase would provide timely support to ensure that India's pressing immediate needs were met.

He was in broad agreement with the staff's appraisal, Mr. Dai stated. India's economy faced great difficulty and uncertainty. Not only were strenuous adjustment efforts required, but also the strong support of the international community, including the Fund. He welcomed Mr. Arora's statement and considered the new Government's two-stage response to the current economic difficulties to be appropriate.

He hoped that the authorities could start, at an early date, a comprehensive and ambitious program under an upper credit tranche arrangement in a relatively favorable internal--as well as external--environment, Mr. Dai said. The restoration of confidence, both at home and abroad, was crucial in the initiation of any program. Given the authorities' commitment and the necessary significant external financial assistance, India would overcome its current difficulties and emerge on a smoother path of adjustment and development. He fully supported the proposed decision.

Mr. Al-Tuwaijri observed that the India's economic difficulties had intensified since the last discussion of the stand-by arrangement in the first credit tranche (EBM/91/7, 1/18/91). The deterioration was due to the absence of comprehensive adjustment measures in a climate of political uncertainty. With the new Government in office, the time had come for a major stabilization program that would guide the economy toward external viability.

Indeed, the initial package of measures implemented by the new Government represented a step in the right direction, although it needed to be consolidated through a comprehensive medium-term adjustment program, Mr. Al-Tuwaijri commented. Nonetheless, the tightening of monetary policy, coupled with a depreciation of the exchange rate, should send the appropriate signal to both the Indian public and external creditors. In the latter respect, he shared the authorities' view that it would not have been feasible to shift domestic relative prices sufficiently through financial policies alone.

Nevertheless, the staff paper stated that the authorities intended to stabilize the nominal exchange rate after the recent 19 percent depreciation, Mr. Al-Tuwaijri recalled. Stabilization of the nominal exchange rate appeared to be a shift in the authorities' preference from gradual to discrete adjustments as highlighted during the discussion of the stand-by arrangement. He would appreciate some elaboration by the staff or Mr. Arora on the reasons behind that apparent shift in strategy, as it might provide some helpful insights for other countries. He welcomed the attempt--albeit limited--to rationalize India's complex trade regime, and he urged the authorities to intensify those efforts in the near future.

The success of any adjustment effort was predicated on ambitious and credible fiscal consolidation measures, Mr. Al-Tuwaijri remarked. Therefore, it was somewhat worrisome that even the authorities' modest and tentative fiscal measures adopted in support of the request for a stand-by arrangement had not been fulfilled. The exceptional political difficulties that confronted India explained that situation, but it highlighted the need for substantial additional measures in the 1991/92 budget. Hence, he welcomed the authorities' recognition, as indicated in Mr. Arora's statement, of the need for strong fiscal adjustment and continued tightness in the monetary stance. Furthermore, the medium-term adjustment program should deal seriously with the existing structural weakness in the fiscal position through a reduction and rationalization of public expenditures with particular emphasis on the elimination of subsidies and transfers to public enterprises, along with the introduction of a broadly based tax structure.

To unleash India's economic potential at long last would require the forthcoming upper credit tranche program to put particular emphasis on structural reforms with a view to reducing the widespread and pervasive role of the public sector--a course of action imperative for external viability, as it would induce the much-needed foreign capital inflows, Mr. Al-Tuwaijri said. The authorities' request for a purchase under the CCFF appeared to meet all the necessary conditions. He supported it and urged the authorities to intensify their adjustment measures.

Mr. Posthumus stated that India's request for a further purchase of SDR 166.2 million was justified by the calculations and met the requirements that had to be satisfied for drawings under the CCFF of up to 40 percent of quota. It was hoped that the immediate measures to stabilize the economy and the major policy reforms to be announced shortly would begin to restore the Government's credibility--damaged by the destructive decision to postpone the 1991/92 budget. Further decisive action in the short and medium term as announced by Mr. Arora in his statement should complete the restoration of the credibility that India had long enjoyed.

Interest rates on short-term deposits were slightly negative at the current annual inflation rate of 11 percent, Mr. Posthumus observed. Interest on bank deposits benefited from tax advantages--a benefit that had existed prior to the current Government's assumption of office. He wondered whether, in view of the substantial devaluation and its possible inflationary impact in the coming months, a higher and substantially positive real interest rate on short-term deposits would not have been better, and he asked the staff to comment. Positive real interest rates could help attract deposits currently held abroad.

As to external financing, the medium-term scenario indicated large financing gaps for a number of years; Fund repurchases--excluding, he assumed, the stand-by arrangement that India hoped to conclude in the fall of 1991--were, for several years, already large, Mr. Posthumus commented. The prospective level of foreign exchange reserves was not ambitious. Without doubt, India would continue to service its debt to the Fund under almost any circumstance.

In such a situation, a large exposure to the Fund and a vulnerable balance of payments might require further Fund programs for a longer time and lead to so-called prolonged use, Mr. Posthumus remarked. For India the Fund should remain a source of additional resources--available in times of need--rather than a part of regular financing, as indicated in the staff paper, which mentioned Fund support alongside aid from other sources "to fill the remaining gap." Prolonged use was unlikely to help attract substantial resources from the private sector in the near future, and, therefore, drawing substantially on the Fund in the near future would not be wise. Instead of seeing its access raised substantially, India should make an all-out effort to obtain more financing from other sources, such as official donors, the World Bank, and the Asian Development Bank.

Mr. Filosa made the following statement:

> The present request by the Indian authorities for additional use of Fund resources is consistent with the Fund's recently amended CCFF decision. Therefore, I support the proposed decision.
>
> My overall views on the country and on the macroeconomic and structural adjustment measures that need to be implemented continue to reflect those that I expressed in previous Board meetings. While it is regrettable that significant steps in the desired direction have not yet been undertaken, I am fully aware that recent political events--aggravated by the assassination of Mr. Gandhi--have made the finalization of an upper credit tranche arrangement unattainable.
>
> I feel, however, reassured that the negotiation of a stand-by arrangement with the Fund remains a priority of the new Govern-

ment. I would, therefore, like to encourage the Indian authorities to reach an agreement with the staff quickly on a comprehensive adjustment program designed to achieve macroeconomic stabilization and to initiate a broad range of structural reforms, along the lines previously set out by this Board. In this respect, the main features of the proposed adjustment process for 1991/92 that are pointed out in Mr. Arora's statement are reassuring.

I will concentrate my remarks only on the present request for Fund resources under the CCFF, while adding a few observations to the prior actions taken so far. This request is legitimate in view of the fact that the country has experienced over the past six months a larger than expected decline in revenues from exports and workers' remittances, combined with a net excess in oil import costs--both of a short-term character. Events beyond the control of the Government, such as the trade disruptions with the U.S.S.R., the impact of the Middle East crisis, and weak demand in the industrial countries, have, indeed, contributed to a further deterioration of the country's external liquidity position. Consequently, the current balance of payments projections have significantly worsened with respect to the scenario discussed in January 1991, and a large and worrisome financing gap is envisaged for the 1991/1992 period.

In light of these past events, the authorities should be commended for having so far avoided a major disruption of the economy. The recent stabilization measures--including the increase in interest rates and a substantial devaluation of the exchange rate--should lower the external current account deficit and help stem the decline in foreign exchange reserves. Taking into account the past impeccable record of servicing its debt with the Fund, I am confident that India's record of cooperation satisfies the requirements of paragraph 49(c)(i) of the CCFF decision.

However, the credibility effect of the recent stabilization measures will have a short life if a major fiscal adjustment is not rapidly implemented. While understanding that the authorities are not able to announce the details of the proposed fiscal measures before their formal presentation to Parliament, we sincerely hope that the adjustment will be of the appropriate magnitude. Moreover, I want to emphasize once again that a sustained recovery, after an immediate period of stabilization, requires an effective and comprehensive structural reform program. As I stated in our January Board discussion, the authorities should formulate an economic program in which macroeconomic adjustment and structural reforms have equal weight and in which the two sets of measures are implemented in parallel. The appropriate solution for India's present balance of payments difficulties can, therefore, only be achieved once the discussions on an upper credit tranche arrangement have been successfully and appropriately finalized. Accordingly, I interpret today's decision as an interim step toward this goal.

Mr. A. R. Ismael said that India's internal and external positions had deteriorated since January 1991, owing not only to the unusual political and social climate of the past few months that had made it difficult for the interim Government to adhere fully to the adjustment program, but also to reductions in export volume and workers' remittances that had exceeded original forecasts and were beyond the authorities' control. Moreover, the higher oil import price and the reduced access to new commercial capital had caused the external account to worsen. He was therefore pleased to note from Mr. Arora's statement that the newly elected Government was moving quickly to deal with the macroeconomic and structural imbalances. He welcomed the realignment of the exchange rate and the trade policy reforms that had been introduced. The supporting monetary measures were also steps in the right direction.

However, India's economic and financial situation was not expected to improve much over the medium term unless a more comprehensive adjustment program aimed at achieving lasting macroeconomic stabilization and dismantling structural rigidities was put in place, Mr. Ismael remarked. He therefore welcomed the authorities' decision to undertake such a reform, with particular emphasis on the reduction of state intervention in economic activity, the elimination of unnecessary regulations, and the promotion of competition in domestic markets. He agreed in general with the approach adopted to deal with India's economic and financial imbalances over the medium term as outlined in the staff paper. India's request met the requirements for a drawing under the CCFF, and he supported the proposed decision.

Ms. Powell made the following statement:

We have no hesitation in supporting India's request for an additional purchase under the CCFF. It is clear that such a request is technically justified by the weakness of exports that has been caused by factors largely beyond the control of the authorities. In addition, India is fully cooperating with the Fund to resolve its problems.

In recent months, India's external liquidity position has come under severe strain, with international reserves declining to critically low levels. As a result, the new Government that took office in late June was faced with an extremely serious situation and a need for immediate action. Although the steps taken by the authorities have helped to stabilize the situation, India's external position remains difficult and is only likely to improve gradually, as the more substantive measures planned by the authorities take effect.

In our view, strong fiscal action, together with a continued tight monetary policy, is essential if India is to limit the inflationary impact of the recent devaluation of the rupee and planned adjustments to administered prices and, in time, reduce inflation. Fiscal adjustment is also necessary to increase domestic savings and reduce reliance on foreign financing. Both revenue and expenditure measures would seem to be required. We would place particular emphasis on a reduction in subsidies and on control and cutbacks in other types of current expenditures, including defence. We recognize that difficult political decisions will be required. Nevertheless, only substantial fiscal adjustment, together with wide-ranging structural reforms, will correct the serious imbalances in the economy and bring about a restoration of external confidence. We are encouraged by the authorities' recognition of the need for strong fiscal action and would urge them to consider front-loading such action as much as possible.

We believe that structural reforms are critically needed. They would greatly strengthen the competitive position and dynamism of the economy. Currently, India's economy is characterized by a high degree of regulation and an inward orientation that has reduced competition and limited the integration of the Indian economy with the world economy. The authorities recognize these problems and are planning wide-ranging structural reforms. We would urge them to move ahead rapidly with comprehensive reforms. The experience of limited liberalization in the 1980s would indicate that a substantive easing of regulations that inhibit the flexibility of the private sector and that limit competition and foreign investment could have a highly positive impact. Indeed, we regard structural reform as critical to obtain the needed supply response and to generate increased capital inflows, particularly of direct investment.

India faces a period of substantial and difficult adjustment. As Mr. Arora notes in his statement, what is involved is a radical and comprehensive change in "mind-set." Although the success of this endeavor will largely depend on the resolve of the Indian authorities to carry out needed changes and the response of the Indian people, the support of the international community, particularly over the near term, will be needed. The Fund can play an important catalytic role in ensuring the necessary international support for a strong and comprehensive program. We hope to see such a program coming to the Board in the near future.

Mr. Espenilla made the following statement:

We are satisfied with recent decisive steps taken by the Indian authorities to arrest a rapidly deteriorating situation. Key measures include a 19 percent devaluation of the rupee, an upward adjustment in domestic interest rates, and elimination of a costly export compensation program. We welcome the authorities' declared intention to follow up closely on these initial responses in the context of a comprehensive reform program supported by both the Fund and the Bank. We consider the current approach to be appropriate under the difficult economic and political circumstances and indicative of the authorities' willingness to cooperate. On this basis, we can support the proposed decision.

Nevertheless, we have to accept that the Fund has taken on some degree of risk in providing front-loaded financial assistance. Moreover, the medium-term scenario presented by the staff puts us on notice that Fund financial involvement can readily grow deeper unless a strong and comprehensive adjustment program is put in place early in the game.

In the comprehensive economic program to be negotiated, we would attach special importance to a credible fiscal adjustment component. We strongly encourage the authorities to shorten as much as possible the transition to a more manageable budget deficit.

Equally important, we would emphasize the quality of fiscal adjustment. In particular, while we understand the circumstance, we regret delays in adjusting administered prices. There may also be a need to review further petroleum pricing policy, especially as it negatively affects the Oil Coordination Committee (OCC) deficit. We note that the OCC deficit in fiscal year 1990/91 was significantly higher than programmed--in part reflecting higher petroleum import volumes. This increase in the deficit seems surprising given the decline of industrial production during the period.

Beyond the pursuit of tighter financial policies, the longer-term viability of the economy would depend on the courageous implementation of decisive structural reforms that would encourage the faster mobilization and efficient allocation of domestic savings. At the same time, it will be necessary to achieve international credibility to facilitate coverage of sizable prospective financing gaps from foreign investment and commercial credit flows. We are therefore encouraged to know that the authorities attach a high priority to reforms in the trade regime, industrial policy, the financial sector, and public enterprises.

> There will likely be reform sequencing challenges to be faced. Fortunately, the authorities could benefit from other countries' experience, especially in Eastern Europe. We would also caution against partial reforms that may deflect the authorities from comprehensive elimination of major distortions plaguing the economy.
>
> In the trade regime, the system of overt export subsidies and administered licensing of imports is being replaced by an expanded system of import replenishment entitlement linked to export earnings. The new system is likely to be less distortionary and more market oriented, but in the final analysis it leads to a de facto dual exchange system that inhibits optimal resource allocation. Nevertheless, we note that the authorities only see the new arrangements as a stepping stone to a more truly liberal system. In this respect, it will be useful if a firm timetable for eventual phase-out can be established.

Mr. Marino said that he would like to join other speakers in commending the Indian authorities for the stabilization measures already undertaken and for their ambitious program of structural reform that aimed to put India, as Mr. Arora had put it, in line with the trends and forces altering the structure of the world economy. He hoped that the authorities would be able to implement fully and swiftly all the adjustment and structural reform measures planned in order to produce a rapid turnaround in their external accounts--particularly the financial flows. He strongly supported the proposed decision.

Mr. Jaramillo said that he fully supported India's request for a purchase of SDR 166.2 million under the CCFF. The staff paper showed that India's economy was currently experiencing a difficult situation that adverse external conditions had made even more difficult. Measures to correct the current imbalances had been delayed as a consequence of the internal political situation during recent months. Despite those difficulties, the new authorities had initiated their reforms by devaluing the rupee considerably, tightening credit policies, raising interest rates, and arranging credit operations through gold pledges. They had also adopted temporary measures to compress imports to manageable levels. A more comprehensive adjustment package for the medium term was being prepared. It should not only provide a lasting solution to the current imbalances, but also enhance growth prospects. As Mr. Arora had pointed out in his statement, those measures were not merely intended to correct certain imbalances, but also constituted a radical and comprehensive change in the management of the economy.

Despite the courageous measures that had already been taken, foreign exchange shortfalls on a cash basis were expected, Mr. Jaramillo observed. Those shortfalls would be aggravated by commercial banks' curtailment of credit lines--as unfortunately had happened in so many other countries during moments of uncertainty. According to the staff paper, the shortfall would amount to over SDR 400 million. India was requesting authorization to purchase SDR 166.2 million. Under the circumstances, that purchase seemed fully warranted in order to give the authorities time to implement the difficult economic decisions that they were envisaging. Furthermore, India's long record of timely honoring its external obligations further encouraged his support for the purchase despite the credit that front-loading implied.

Mr. Goos remarked that he shared Mr. Posthumus's concern about the risk that India might become a prolonged user of Fund resources, not from the perspective of the Fund in the use of its resources, but owing to the risk for India itself if it had too long a financial involvement with the Fund. He wondered whether the Deputy Director of the Asian Department could also comment on the extent to which structural reform measures should be front-loaded and specified as concretely as possible in terms of their timing. He also wondered whether the low tax ratio could be increased and the pace of fiscal consolidation accelerated by the resultant ratio.

The Deputy Director of the Asian Department responded that the amount of the upper credit tranche arrangement that was to be negotiated was not in the medium-term scenario. Also excluded were any World Bank structural adjustment loans that would be negotiated. The level of foreign exchange reserves would remain fairly low in that scenario, even though that level required a substantial buildup of about $1 billion in the second half of the current financial year.

On the issue of prolonged use, it was hoped that, with successful adjustment and a further opening to the world market, India's exports would perform well, the Deputy Director commented. Private investment capital would therefore be attracted, and India would regain full access to the capital markets--both to medium- and long-term commercial bank loans and to bond issues.

The structural measures would play a key part leading to a favorable outcome of the medium-term scenario and, therefore, they would be important elements in the stand-by program to be discussed with the authorities, the Deputy Director stated. Structural measures would cover all major areas and would be specified as concretely as possible, with the timing for the implementation as specific as possible. Structural benchmarks would be treated as review clauses.

Tax reform would certainly be an important element of structural policies, the Deputy Director said. However, the authorities and the staff had in mind a comprehensive reform of the tax system that would take time to prepare and implement. Therefore, that angle could not be used to accelerate the fiscal adjustment in the near term. Instead, expenditure restraint and improvements in the system of revenue collection would be necessary.

The authorities' commitment to a stable exchange rate, accompanied by tight budgetary and monetary policies, was appropriate, the Deputy Director of the Asian Department considered. However, it could not be absolutely rigid. The level of the exchange rate would have to be reassessed in the context of trade liberalization and tariff reform. In addition, if there should be a major speculation, it might simply not be possible to maintain the exchange rate.

Mr. Goos said that he welcomed the plan for a comprehensive tax reform. However, given the precariousness of the external situation, he wondered whether it would be possible to raise existing fees or taxes until the reform could be implemented. Previous speakers had stressed that the restoration of confidence in India's economy was urgent, and a bold effort in the fiscal area would do much to achieve that objective.

The Deputy Director of the Asian Department replied that efforts would be made to improve revenue performance, and temporary measures were a possibility that would be explored. The staff had also suggested the inclusion of additional items in the turnover tax to remove exemptions and streamline tax administration. Nevertheless, the major effort to increase revenues would be a longer-term undertaking.

Mr. J. E. Ismael recalled that the Deputy Director of the Asian Department had stated that further foreign exchange rate adjustment might be needed, although not in the immediate future. The two recent such adjustments had been taken at two-day intervals. Although the total size of the two devaluations was appropriate, the manner in which they had been implemented had had the spillover effect of throwing Nepal--a landlocked country with a 30 percent to 40 percent import-export dependency on India--off-balance. However, had the devaluation been carried out in a series of smaller devaluations in short intervals, one after another, the spillover effect on Nepal would probably have been chaotic. He would appreciate the staff's or Mr. Arora's comments on that issue and how it could be avoided in future cases. A once-for-all devaluation would certainly have been preferable for India as well as Nepal, although it probably was more difficult to garner domestic support, owing to political considerations.

A second question concerned India's intention to negotiate a stand-by arrangement, Mr. Ismael said. Because a stand-by arrangement was expensive, he wondered whether an arrangement under the ESAF would be more appropriate. When the Board had discussed the SAF and ESAF, India had committed itself not to make use of them. But, in the meantime, the situation had changed. Under the current circumstances, India should be released from its self-imposed restraint.

The Deputy Director of the Asian Department explained that a stand-by arrangement was preferable to an arrangement under the EFF because, as the cash-flow table in the staff paper showed, an early liquidity injection was urgent. The stand-by arrangement could be negotiated more expeditiously than a three-year EFF program. Otherwise, one could abstract from the immediate needs of the cash flow, and a straight extended arrangement would certainly be a logical situation. As to an arrangement under the ESAF, again the staff would have to prepare a three-year program, which experience in other countries indicated would take longer to negotiate than a short-term stand-by arrangement. An arrangement under the ESAF also involved extensive coordination with the World Bank, which usually made the process appreciably longer than a stand-by arrangement.

Domestic politics had led to the implementation of the devaluation in two stages, the Deputy Director of the Asian Department said. Mr. Arora might have further comments on that matter.

Mr. Posthumus commented that the Deputy Director of the Asian Department's response on the issue of prolonged use made him even more worried, because an extended arrangement usually entailed much higher access than a stand-by arrangement. The danger of sliding into prolonged use was difficult to explain without precise figures. The Deputy Director of the Asian Department had remarked that exports were expected to grow. However, the figures that had been estimated in the medium-term outlook were already high.

Mr. Peretz said that he agreed with the Deputy Director of the Asian Department that the logical progression would be a stand-by arrangement first, which could perhaps be followed by an extended arrangement later, if the measures needed for it had been taken. He also agreed that, under those circumstances, an arrangement under the ESAF should be considered alongside it. His recollection of India's commitment not to make use of the ESAF was that it had been a conditional commitment, assuming no fundamental change in the balance of payments. There had now been such a change; therefore, he wondered whether the commitment continued to hold.

Mr. Arora noted that, as Directors had correctly pointed out, India faced not simply a difficult balance of payments situation that had been aggravated by the Middle East crisis and other factors, but also a problem that was deeply rooted in domestic policies, the solution of which had a much longer-term horizon. Recognition of that problem had prompted the authorities to adopt the current economic reform measures, even though there was a minority Government that had to rely on parliamentary support and was facing criticism from within and outside the ruling party. Nevertheless, both the Prime Minister and the Minister of Finance had said that unless India moved to a more open economy, its economic problems could not be solved. The view that, if India undertook a medium-term adjustment program supported by an arrangement under the EFF, it would become a prolonged user of Fund resources did not take into consideration India's past experience. When India had undertaken an extended arrangement in 1981, it had not completed the available purchases, because it had not been needed then, owing to the improvement in the economy. Any future Fund program would be reviewed every year, at which time Directors could comment on the adjustment effort and any deficiencies it had, see the financing gaps that remained, and decide on the allocation of further Fund resources. The same procedure would apply to India's request to the World Bank. He therefore hoped that the question of prolonged use would be seen in that perspective. A stand-by arrangement was intended to support medium-term adjustment programs, and India should be entitled to one with the support of the Board.

A few Directors had raised the possibility of an arrangement under the ESAF, Mr. Arora noted. India's economic situation had deteriorated, and the balance of payments situation was serious. India's commitment not to request an arrangement under the ESAF--a commitment it had long kept--was no longer appropriate; however, it would be guided by the consensus of the Board. Nevertheless, a case could be made for an arrangement under the ESAF, so that the interest burden would be lessened somewhat.

India was determined to hold the exchange rate stable, Mr. Arora said. The Government's strong fiscal and tight monetary policies would assure exchange rate stability. There would eventually be adjustments, but not for the next six months to a year.

On monetary policy, although the increases in interest rates might appear to be incremental and small, in practice the interest rates being charged were typically in the range of 21 percent or 22 percent--high positive rates of interest, indeed, Mr. Arora commented. Although the staff had been disappointed that the authorities had not done more to raise the rates, in reality monetary policy was as tight as it could be under the circumstances.

As to the method of devaluation, he recalled that the 1966 devaluation--57 percent by India's calculation, 37 percent according to the Fund's--had led to tremendous political upheaval as a result of which the Government of that time had lost practically the whole of north India in the election that followed, Mr. Arora remarked. Therefore, concern had been expressed that a once-and-for-all devaluation might have some political fallout. As it happened, both the market and the political arena generally had not reacted too adversely. However, it was unlikely that a sizable once-and-for-all devaluation would need to be made in the future, provided India adhered to its adjustment program. If such a devaluation were to become necessary, India would keep in view what had been said about the effect on Nepal.

Mr. Posthumus said that there were a number of examples of prolonged use--cooperation with the Fund in the form of different programs for a period of six to ten years. He did not oppose prolonged use per se; however, he would advise India not to drift into such a situation. He could agree to a series of arrangements, but he would suggest that access not be too high, because high access currently meant a large repayment later. If there were a vulnerable balance of payments situation subsequently, it would become necessary to come back to the Fund earlier.

The Executive Board then approved the following decision:

1. The Fund has received a request by the Government of India for a purchase equivalent to SDR 166.18 million for the compensation of an excess in oil import costs and an export shortfall under Section V of the Decision on the Compensatory and Contingency Financing Facility (Decision No. 8955-(88/126), adopted August 23, 1988, as amended).

2. The Fund approves the purchase in accordance with the request.

Decision No. 9778-(91/97), adopted
July 22, 1991

2. CONDITIONALITY IN FUND-SUPPORTED ADJUSTMENT PROGRAMS - ISSUES AND REVIEW OF EXPERIENCE

The Executive Directors resumed from the previous meeting (EBM/91/96, 7/19/91) their consideration of a staff paper on selected aspects of conditionality under stand-by and extended arrangements (EBS/91/101, 6/20/91; and Sup. 1, 7/2/91), together with a paper on selected operational issues related to the use of Fund resources (EBS/91/108, 7/3/91; and Cor. 1, 7/3/91). They also had before them a staff paper on public expenditure management processes and fiscal conditionality (SM/91/136, 7/5/91).

Mr. Kabbaj made the following statement:

We welcome this review of selected aspects of conditionality under stand-by and extended arrangements, together with two useful companion papers on selected operational issues related to the use of Fund resources and on public expenditure management processes and fiscal conditionality.

These papers obviously address very important and far-reaching issues, and, like other speakers, we would have preferred to devote much more time to them, and possibly to have the opportunity to discuss them separately, particularly the one on fiscal conditionality.

With respect to the coverage of the review, we welcome the return to the cross-country analysis, which has not been used since 1987, when we reviewed the experience of member countries under arrangements approved in 1983. Although the selected countries approach may allow a better focusing on specific issues, we feel that that approach could be questionable in terms of objectivity as far as the selection of countries is concerned. In our view, only the cross-country approach offers such objectivity, especially if it covers a period of more than three years, which is a long enough time period to allow for the coverage of a sufficiently diverse group of countries--including exporters of fuels, other primary products, and manufactures, as well as countries with a diversified export base.

Regarding the commitment of Fund resources for the countries under review, the average access of 51 percent of the member's quota is well below the maximum access allowed by our guidelines. Although we recognize that this maximum access is not a target, we feel that the catalytic role of the Fund was stretched to the limit, especially if we consider that few large countries benefitted from a much higher access.

We welcome the fact that four countries--Chile, Korea, Mauritius, and Thailand--no longer have arrangements with the Fund because of the strength of their economic situation, and we noted that these four countries undertook major structural reforms prior to, or during, the period of the Fund arrangements covered in this review. We would have appreciated tentative appraisals by the staff on present prospects of graduation for other countries under review.

This being said, we commend the staff for the efforts it has made to make this review as comprehensive as possible, and we recognize the limitations that are inherent in the approach followed, and which could derive from the unavoidable generalizations and the loss of a longer-term historical perspective. We hope that the next review could benefit from the contribution of an evaluation unit, the possible establishment of which is under study.

We fail to understand why the approach followed would not be conducive to the discussion of structural reforms, and we regret that that is so. It should be evident by now that financial adjustments alone cannot durably redress difficult situations. The circumstantial evidence presented in the case of the four graduated countries already mentioned, as well as of those which have been performing better since 1988, clearly show that structural reforms were instrumental in the outcome. We suggest that for the next review the World Bank be associated with the consideration of these issues, perhaps in the form of an annex to the main paper, and we note in this regard the intention of the staff to issue a paper on the subject in the future.

I commend the staff for having given this time more prominence in the paper to economic growth, which, after all, should be the ultimate objective of Fund-supported programs, and to the global economic environment, which could help or hinder the attainment of the objectives of these programs. On the question of growth, the experience of the Fund shows that full observance of performance criteria and other conditionality paraphernalia has not always resulted in sustained growth--far from it. We also appreciate the note of caution given by the staff to the conclusion to be drawn from "the program versus actual" comparison, which was the cornerstone of similar exercises in the past.

It is heartening to note from the staff paper that in the period under consideration, programs supported by Fund arrangements tended to be more successful than in the early to mid-1980s in meeting their objectives for economic growth, inflation, and the balance of payments, and that the improvement was particularly strong for economic growth. We feel that this was made possible by a better understanding by the Fund of the economies and realities of developing countries. After all, the Fund was not involved as a lender on such a large scale in these countries before the early 1980s. The outcome of programs is judged by comparing them with the objectives set. If the objectives were not realistic in the first place--and in our view they were not in many cases in the early 1980s--the outcome could not be good. This is not to say that the Fund has relaxed its conditionality, rather, that it has become more aware of members' constraints. A second reason for the better results is the behavior of the global economic environment, on which developing countries are heavily dependent. Table 2 of the main staff paper clearly shows that this environment was definitely more hospitable during the period under review. Output and world trade volume were significantly higher. Nominal and real interest rates were lower, and the terms of trade for nonfuel exporters--which constituted the majority of Fund borrowers--were more favorable. On the negative side, financing by commercial banks all but dried up, although that was largely offset by official borrowing and rescheduling, and the situation of oil producing countries deteriorated.

The judgment of the staff is nevertheless that only about 40 percent of the annual programs could be seen as generally successful. We concur with the staff that, apart from the global economic environment, there is a need, if we are to improve on this unsatisfactory performance, for "further improvement in the understanding of the relationship between fiscal and credit policies and macroeconomic objectives, and the need to take account of the effects of other policies, in particular structural reforms, on the efficacy of policies." But, above all, we also believe that the program design has to be realistic and has to take into account the implementation capacity of the country and its sociopolitical fabric and historical trends. This necessitates the provision of commensurate financing, allowing for a reasonable period of time for the adjustment--especially its structural components--to take place. It is in no one's interest to decide in Washington that almost everything has to be solved in three years, if the country and its population are not prepared or able to carry out such an undertaking. Also important is the need to give a real content to the targeting of budgetary subsidies to the poor if the conditionality of the Fund is to be perceived differently in borrowing countries. Finally, the debt problem remains overwhelming for most of these countries, and it should continue to be addressed vigorously in Fund-supported programs.

Otherwise, we have no special comments on the staff's suggestions contained in the main paper--with the qualifications we have already mentioned--except to endorse the staff's finding that developments in the terms of trade apparently affect the ability to implement fiscal and credit policies as planned, a concept with which we are very familiar, and the staff's conclusion that the recent emphasis on contingency planning is appropriate. Similarly, we endorse the view that there may be a trade-off under different exchange rate regimes in achieving various macroeconomic objectives, and that variables such as inflation, growth, and external debt are all relevant in this regard.

We have consistently cautioned against a link between the provision of technical assistance and the effects of such technical assistance on the implementation of Fund-supported programs. The reforms envisaged under such technical assistance are usually far-reaching, and even when they are implemented in full, they are not likely to produce immediate results. In any case, we continue to believe that technical assistance should be provided without active interference by operational personnel of the Fund; otherwise, the dialogue with the country would lose its desirable serenity.

We welcome the emphasis put in Fund-supported programs on the need to promote private capital inflows in the context of the strengthened debt strategy, and for more explicit treatment in staff documents of regulations and restrictions on capital flows and policies for attracting private capital flows.

Concerning the issue of prolonged use of Fund resources, we find appropriate the distinction being made between members that have made adequate progress in improving their external positions, and those that have not. We agree that the continued involvement of the Fund in some cases has definitely contributed to the success of the adjustment effort. We therefore support the continuation of the present approach, which is based on the inappropriateness of adopting rigid rules for prolonged users or major changes in the policies on prolonged use. The present case-by-case approach is working well. Apart from the progress registered by some countries which led to a clear abatement of the problem, Fund exposure has been sharply reduced to this category of countries, and thus we would not favor the more stringent guidelines proposed by the staff.

On first credit tranche conditionality, we share the views expressed by Mr. Al-Jasser, Mr. Finaish and Mr. de Groote, and we have no problem with the staff's proposals regarding the extended Fund facility. We can go along with the proposed decision.

Mr. Abbott made the following statement:

The papers present a number of interesting issues worthy of Board attention. Although the papers are all related, it is unfortunate that three such meaty papers have been scheduled for the same discussion.

The first paper on selected aspects of conditionality under stand-by and extended arrangements raises some important issues concerning the design and implementation of Fund-supported programs. We recognize that the paper's methodology--using program versus "actual" comparisons, and focusing on just a few key variables--has its limitations, but the paper nevertheless points to some important conclusions.

A first such conclusion is the necessity of designing programs that are based on realistic assumptions about the external environment and the country's own growth prospects. As the crisis in the Middle East has recently illustrated, it is sometimes very difficult to forecast international economic conditions with any certainty, even over the relatively short term. Likewise, the interaction between macroeconomic and structural policies and economic growth is less than clear, particularly when new structural policies are being adopted. Yet, overly optimistic assumptions about the external environment or the dynamism of the domestic economy not only complicate the attainment of a program's fiscal targets, and hence the fulfillment of the monetary program and basic program objectives as well, but they may also lead to false expectations about the level of domestic economic activity and undermine the authorities' commitment to the program. When in doubt about the appropriate program assumptions, it would seem prudent to err on the side of pessimism, as experience suggests that it is easier to implement a program when the external environment or growth response is better than expected.

In this connection, we consider the recent emphasis in Fund-supported programs on contingency planning appropriate. At times this may be achieved by building contingency planning directly into the stand-by or extended arrangement in question.

Here I have in mind not only contingency plans for adjusting to the possible effects of less favorable terms of trade, but also a clearer identification up front of specific additional measures to be taken if it appears that program targets will not be achieved. At the same time, the contingency window of the CCFF should not be overlooked.

Programs also need to be balanced in terms of the fiscal and monetary policy mix, as well as the macroeconomic and structural policy mix. It is hardly surprising to find a strong association between the implementation of fiscal and credit policies and the achievement of inflation and external objectives. But it is interesting to see that good macroeconomic policy implementation is also associated with stronger than expected growth as well. As a corollary, it appears mistaken to believe that policy deficiencies in one policy area can be adequately compensated for by more restrictive policies in another. For example, experience suggests that programs in which fiscal policy has been lax and which rely upon credit restraint to contain inflation do so at the expense of lower output growth.

We welcome the increased emphasis in recent years on the structural policies which complement sound macroeconomic policy. We agree, however, that the institution needs to develop a deeper understanding of the ways in which structural change can affect the efficiency of macroeconomic policies and the attainment of macroeconomic objectives. Initially, there was a tendency to assume that the medium-term framework of an extended arrangement was the appropriate vehicle for incorporating structural policy change. While many structural changes do require a longer period to design and implement, certain structural charges can and should be incorporated into stand-by arrangements, as well.

One important area of structural change that should be pursued in stand-by and extended arrangements alike is financial market liberalization. We have had the impression, however, that the staff assessments have sometimes viewed financial market liberalization as a mixed blessing, having benefits for the development of efficient capital markets, for savings and investment and debt management, but complicating the task of monetary management. The solution here is to put aside this ambivalence and at the outset seek ways of adapting monetary management to a more liberalized environment.

With regard to program implementation, we endorse the paper's call for more prior actions. We also agree with the need for Fund technical assistance on fiscal policy, as well as the other traditional areas of Fund expertise, and we are concerned about how the usefulness of such assistance could be enhanced. In this connection, it would be useful for the Board to review Fund technical assistance and consider how its efficacy could be increased.

Concerning the issue of exchange rate policy, we believe that the review of exchange rate arrangements is extremely useful. One lesson that comes through very clearly is that any evaluation of the appropriateness of exchange arrangements must be made in the context of the full program. The effects of exchange policy--whether it is a fixed rate, an adjustable peg, a real exchange rate rule, or a free or managed float--depends on both the goals of the program and the execution of the entire program. This is hardly surprising, since the whole macroeconomic approach to internal and external balance is to find a policy mix that will simultaneously achieve multiple objectives. Design of the policy mix is complicated precisely because of the complex interactions within the economy.

To put this lesson in another way, the experience of the programs reviewed here indicates that a single objective can be most successfully achieved if it is single-mindedly pursued. A real exchange rate rule, for example, has worked very well for achieving a current account objective; but that success has generally come at the expense of many of the other objectives of stabilization. Inflation control, in particular, has been weak. Likewise, fixed exchange rules have tended to be associated with relatively good inflation performance, but consistently poor results on external adjustment and mediocre growth.

The staff appropriately draws these lessons together by emphasizing that there are trade-offs among the different elements of the programs. Again, this is a not surprising and orthodox conclusion, but it is worth keeping in the forefront of our thinking.

The trick is to find ways to improve the trade-offs. Here, our experience points in a clear direction: well-designed fiscal adjustment, effectively implemented, is likely to have the biggest payoff in improving outcomes for growth, inflation, and external adjustment under all exchange rules. In most of the countries with programs, fiscal actions have such a large impact on both real resource allocation and financial flows that other polices cannot easily compensate for fiscal weakness.

There are a couple of aspects of exchange policy experience about which I would appreciate a little further elaboration from the staff. The fixed exchange rate cases reviewed had very large external deficits, both current account and overall balance, that were proportionately much larger than countries with other exchange arrangements. This indicates fairly clearly that external financing was not a major constraint. Reserves must have been high or external support readily available; or perhaps size is a consideration. Small countries with foreign-assisted lumpy development projects sometimes display outsized but manageable external deficits. Do these considerations limit the applicability of the fixed exchange rate experience?

Also, there is an unelaborated suggestion that a real exchange target makes fiscal management more difficult. I am not sure what is intended by this suggestion, but I would expect that a fully indexed exchange rate--with erratic inflation--will be a particularly explosive mix for a country with a large foreign currency denominated external debt. I would have enjoyed having seen this issue reviewed a little more, either in the exchange discussion or in the fiscal discussion.

In fact, indexation problems did not get much systematic review. In the fiscal section, it would have been useful to have had some clarification of primary or operational budgets as a guide for program formulation. Performance criteria are, of course, set in nominal terms. However, national authorities and staff analysis sometimes suggest that there is tolerance for slippage on nominal targets if some indicator of real fiscal adjustment shows improvement. This is an extremely important aspect of nominal anchoring that would be worth evaluating.

The inflation results are quite strong. Tolerance for weak inflation objectives builds in a high probability of program failure. I agree with the staff suggestion for firm inflation objectives, the establishment of a track record, and possible prior actions. On prior actions, I would only caution that crash programs can bring temporary price improvement, so we would want to be sure that the prior actions were part of a durable anti-inflation package. The review indicates that we need to devote further attention to how we might design policies that foster private capital flows. We are developing experience that demonstrates that sound policies foster net private capital inflows. More work is needed in this important area, so that we may offer more concrete policy advice.

The paper on public expenditure management processes and fiscal conditionality builds a strong case that effective public expenditure management is an important part of realizing program goals. It does not lend itself easily to formal conditionality, however. Would it not be possible to handle this issue in the Letter of Intent? A clear statement that the authorities undertake to strengthen public expenditure management in order to implement the policy commitments in the program would focus attention on this, and fix responsibility. It would also provide an opening to seek technical assistance, or even program assistance, from one of the multilateral development banks.

With respect to the paper on selected operational issues, we agree that program monitoring--through quarterly targets for main variables--has been helpful in promoting the success of policies underlying first credit tranche purchases. Thus, we support the staff conclusion that monitoring arrangements should be included as a standard element of first credit tranche programs in the future. We also agree that the provisions for floating of purchases under the CCFF and extended arrangements open the possibility that program countries with high use of Fund resources could draw the first tranche with a liberal justification, and upset the balances between phasing and performance, and adjustment and financing, under the program. Therefore, we can also support the staff's recommendation that these provisions be reconsidered at the time of the access review.

With respect to contingency provisions outside of the CCFF, we note that the contingency mechanism of the CCFF was designed explicitly for the purpose of allowing the Fund to take external developments into account. If a program veers off track due to adverse exogenous developments, this would give rise to additional needs that should appropriately be met by a combination of adjustment and financing. It would be fully appropriate for additional financing to be provided to sustain the momentum of the reform effort. I would like to add that, had contingencies already been incorporated routinely in programs before August 1990, it is unlikely that the CCFF would have been modified to allow the oil import element. We fear that the fact that few or no purchases have been made with respect to the contingency element of the CCFF suggests that there is some apprehensiveness about using it.

We welcome the review of prolonged use of Fund resources, and we would encourage the staff to include this subject more frequently in conditionality reviews. The issue of preventive measures, including closer scrutiny of prolonged users of Fund resources, was a key element in the strengthening of the arrears strategy and an essential part of our efforts to protect the financial integrity of the Fund. While we recognize that there are some difficulties in identifying prolonged users, it seems that data indicate that there has been little change in the numbers.

We also agree that it is not always easy to assess whether prolonged use is necessarily a negative or positive factor. In some cases, such as Mexico and Chile, continued Fund involvement has provided the basis for economic success. However, in the vast majority of cases prolonged use has been associated with inadequate performance, and in some cases even with the buildup of large arrears.

Therefore, we believe that the Fund should attach some priority to reducing prolonged use. While it would not be appropriate to introduce special access limits for prolonged users, we could still be guided broadly by the need to reduce this kind of exposure. In some cases, access under a new program for a prolonged user might be higher than scheduled repurchases, particularly if progress has been more than satisfactory. But there should be a clear presumption that if performance is inadequate, access should be limited. We therefore support the staff recommendations regarding highlighting prolonged users' prospects for continued need for Fund resources in program consideration, and making further access dependent on extremely strong justifications, such as programs that emphasize prior actions.

Mr. Dai made the following statement:

I welcome this opportunity to review the Fund's conditionality. I also wish to thank the staff for its efforts in preparing a very informative paper for the Board discussion, in which the comprehensive analysis and assessments will serve to further the study on today's agenda of related issues.

I would like to say a few words on the cross-country analysis approach adopted in this paper. As pointed out by the staff, this approach has its merits and limitations. While it permits general conclusions to be drawn about the effectiveness of Fund-supported programs and about broad trends in the main variables, it is not easy to draw strong conclusions on cause-and-effect relationships, because of the complexity of cross-country studies and the particular situations faced by individual countries. In my view, a better solution might be expected by supplementing the cross-country approach with case studies, which could help gain insight into a particular case and, on the basis of comparison and analysis of many individual cases, thus obtain more objective and balanced conclusions.

I will limit my comments to just a few points in the main paper. Regarding the effectiveness of Fund-supported programs, the staff's findings indicate that an improvement was made in the period under review compared with the previous period, with about 40 percent of the programs generally being successful in meeting program objectives for growth, inflation, and the balance of payments. However, as there are still some 60 percent of the programs unable to achieve their objectives, I tend to agree with the staff's view that an important question still remains as to how the proportion of successful programs can be raised.

In order to improve the record, we must first identify those factors which contribute to the success or failure of the programs by summarizing past experiences, and, based on that, we can draw conclusions from country analyses and establish guidance for future program implementation. However, it is unclear from the paper what the major causes were that led to the program results in the period under review. More in-depth analysis in this regard would be useful.

It goes without saying that a close association exists between the implementation of fiscal and credit policies and the achievement of the inflation and external objectives. Nevertheless, I also agree with the staff that the association between the policies and program outturns was far from perfect, reflecting the complexity of the relationships between them. This is because there are so many factors--economic and noneconomic--that influence or determine the achievement of program objectives. The Fund's conditionality is merely one of many factors, and in certain cases may not be among the decisive factors. Furthermore, although the rationale underlying the Fund's policy advice is correct in general, the conditions to which it is applied differ greatly from country to country. A theoretically sound program that produces successful economic outturns in one country may not be workable in another country.

The success of a Fund-supported program lies in whether the program is tailored to the specific circumstances of the country, taking fully into account its economic realities--including the level of development, the economic structure, the institutional framework, and the social and political background. Therefore, the program can be effectively realized only if it fits the reality of a particular country. The practicality and, thus, the correctness of Fund programs, are subject to the specific conditions and circumstances of each individual country. Simplistic theoretical conclusions or concepts do not always apply universally in today's complex world.

With regard to the link between fiscal and credit policy and growth performance, it is understandable that the relationships are even more complex. As I mentioned above, the factors determining or affecting economic growth are numerous, and direct transmission mechanisms and interactions between various factors are diverse and complicated. In general, better growth performance would facilitate implementation, particularly with respect to fiscal policy, as stronger growth provides a solid foundation for a strong fiscal position.

Nevertheless, sound fiscal policies play a very important part in stabilizing the economy and stimulating growth, but these relationships are not always straightforward. Sometimes robust growth is accompanied by poor fiscal performance. The contrary also holds true. The case in point is the recent experience of countries undergoing economic transformation, where progress in fiscal constraint was accompanied by a counterproductive effect on economic growth and employment. I share the staff's view that an important element in program formulation should be a careful assessment of the economy's growth prospects. Particular attention should always be given to economic growth in program formulation.

The terms of trade are undoubtedly an exogenous factor of great importance. As pointed out in the staff paper, developments in the terms of trade affected the ability to implement fiscal and credit policies as planned. This is particularly the case for countries that are heavily dependent on foreign trade, especially the primary product exporting countries. In this regard, I fully support the staff's view that the recent emphasis in Fund-supported programs on contingency planning is appropriate.

Here, however, I would like to emphasize the importance of taking into account other exogenous factors, such as disturbances in the international financial markets, political instability, and natural disasters, which could have a damaging effect on the achievement of program objectives. This has always been called for by the developing countries, which have urged the Fund to adopt a more flexible approach toward conditionality in a very uncertain world environment.

I support the staff's point that exact quantitative criteria for assessing the main macroeconomic objectives is overly demanding. Moreover, I am not in favor of imposing quantitative criteria for policies of structural reform. For many structural measures, it is more meaningful to assess quality objectives, rather than quantitative targets.

On program design and implementation--particularly with regard to the Fund's policy advice for member countries to implement adjustment measures--I would like to emphasize that the Fund should still stick strictly to its traditional role, which is consistent with its mandate. And, in any case, caution should be taken to avoid any direct involvement in matters not relevant to the fundamental purposes and functions set out in the Articles of Agreement. To complete the present review, I can go along with the proposed decision, and I hope that the review of the Fund's conditionality will be conducted on a regular basis.

Regarding conditionality on the use of Fund resources in the first credit tranche, China made drawings in the first credit tranche twice in the 1980s. The first time was in 1981, and the second in 1986. According to our experience, both drawings supported our external position, and within in a short period of time we succeeded in reversing the unfavorable balance of payments situation in both cases. Nonetheless, as far as conditionality was concerned, the two cases were quite different. While the first case was more liberal, the second drawing tended to be much harsher. I wonder why there was such a change in the Fund's attitude. In fact, after several years of economic reform and policies of opening, China's economy was much stronger in 1986 than in 1981, but the conditions for drawing were less favorable. I believe that this was mainly due to a general trend of tightening conditionality after the 1982 debt crisis. With the intensification of conditionality and the diminution of the concessional nature of Fund credit, the first credit tranche becomes less and less attractive.

The Fund's policy on the use of its resources in the first credit tranche should preserve that tranche's liberal nature. The conditionality guidelines adopted in 1979, which confirmed that phasing and performance criteria are not applied to the first credit tranche, should remain unchanged. Since it does not appear that first credit tranche transactions put the Fund's resources at undue risk, it is inappropriate to tighten conditionality in the first credit tranche on the grounds of safeguarding the Fund's resources without regard to the temporary and moderating features of the first credit tranche. The distinction between the policy toward the first credit tranche and the upper credit tranches should be maintained. Therefore, I do not agree to increase or intensify conditionality in the first credit tranche. It should be cautioned that quarterly targets or benchmarks are not to be transformed into performance criteria under the excuse of strengthening the monitoring system. In my view, quarterly targets or benchmarks should be used selectively on a case-by-case basis. I do not see a compelling reason to adopt new measures by adding such monitoring arrangements as a standard element of the first credit tranche program in the future. I also do not agree to apply prior action clauses to first credit tranche drawings. Since the first credit tranche is moderate in size and for short-term use only, the program in this case should generally not be overly ambitious. Its main objective should be to help member countries overcome temporary external imbalances. It may not be appropriate or feasible to cover a wide range of macroeconomic objectives and medium-term structural reform goals.

Mr. Peretz made the following statement:

The papers before us cover a great deal of ground. Let me begin with the review of conditionality. It is on the face of it difficult to reconcile the staff's view that the guidelines on conditionality continue to be appropriate with the information in the paper that only about 40 percent of the annual programs approved in the review period could be seen as generally successful, and that only 4 of the 21 countries covered no longer need arrangements with the Fund. It may indeed be that there is little that we can do to improve our approach to conditionality, but the low success rate of Fund programs should make us think carefully before accepting this proposition.

Many of the specific findings of the paper come as no surprise. It would have been very surprising if there had not been a strong association between the implementation of programmed fiscal and credit policies in the attainment of program objectives, and there are a number of other findings that confirm our expectations. But there are also findings that some might find more surprising. I would draw attention in particular to the very high correlation between the observance of fiscal and credit targets and the meeting of growth objectives in programs. This simply confirms the view, however, that there is no trade-off between adjustment and growth, and, indeed, that adjustment is the essential precondition for growth.

I was also struck, but not surprised, by the fact that more problems were encountered in meeting inflation objectives in cases in which the rate of inflation was targeted to remain relatively high. The implication that I would draw from this is that high, stable inflation is something of a contradiction in terms; and that the more ambitious the target on inflation, the greater the likelihood of its being achieved. This is a conclusion that might usefully be reflected in program design.

One other general point that I would make concerns the importance of structural measures for long-term improvement of economies. I note that all of the four countries included in the review that have attained external viability undertook structural reforms supported by the World Bank over the period of their Fund-supported programs. I would emphasize the importance of close collaboration with the World Bank on structural issues, including financial sector reform, which is discussed in this paper, and on which the World Bank has some highly developed policies. I would also urge that more attention be paid to detailed questions of sequencing, which is only briefly mentioned in the paper. This may be particularly relevant for the timing of financial liberalization and the relationship between exchange rate policy and trade liberalization.

The section of the paper on fiscal policy and the accompanying background paper stress that fiscal policy is central for the success of Fund-supported programs. Given this, my answer to the first of the questions in the background paper is that the Fund should do everything that it can to assist members in improving their public expenditure management systems. Indeed, it seems to me that there must be a fundamental question as to whether the Fund should ever extend resources to countries which do not have adequate public expenditure management systems. I am sure that the authors are right in pointing to policy slippages as the cause of fiscal programs going off track in many cases, and I would support strong and detailed conditionality with respect to fiscal policy to address this. But I am also sure that there are countries in which the political will to adjust is strong, but the administrative capacity is lacking. In these cases, for the sake of both the success of the program and for protection of Fund resources, establishing at least a minimum standard of public expenditure management should be an essential precondition for Fund-supported programs. I would be quite prepared to see a reallocation of the Fund's budgetary resources to technical assistance to such countries in order to allow such a condition to be satisfied.

Before leaving the question of fiscal policy, let me just make two other points. First, I think that it would be worth including in programs proposed actions to be taken if fiscal targets appear to be slipping during the year. This might be particularly useful for countries that have had difficulty in adhering to fiscal targets in the past. Second, I think that the Fund will need to pay some attention to the composition of expenditure, including military expenditure, in coordination with World Bank public expenditure reviews and the formulation of public investment programs.

I found the section of the paper on exchange rate policies very interesting, and it obviously provides some empirical background for other recent work. But I also found the section unsatisfying, in that it groups together some exchange rate systems that are very different in practice. I would be interested, for example, in further examination of the effectiveness--in cases in which the exchange rate is clearly overvalued--of an initial step devaluation, supported by tight fiscal and monetary policies, followed by moves to establish the exchange rate as a nominal anchor. I am not quite sure whether this policy approach would be classed as an adjustable peg or a fixed exchange rate. It includes features of both. The only other comment that I would make on the country experience as set out in Table 13 of the paper is that it would seem to reinforce the case against the adoption of real exchange rate targets, especially in countries that already have a serious problem with inflation.

I agree in general with the conclusions of the section on interest rate policies and financial sector reforms. As I said earlier, I think that this subject might usefully be examined in conjunction with the World Bank. I was also strongly attracted by the idea of performance criteria covering quasi-fiscal losses of central banks; the transfer of losses--or loss-making activities--to central banks is a pernicious practice. As with public expenditure controls, we should perhaps insist on at least minimum standards of central banking practice--a degree of transparency and a proper legal framework--before committing Fund resources under programs which, after all, always involve performance criteria in the monetary area. Some further thought might be given to ways of dealing with this.

More generally, I think that the conclusion on page 63 of the paper that "shortfalls in external financing alone probably do not cause problems for program implementation" is true only in a very narrow sense. We are, after all, concerned with the period 1985 to 1988, when all programs had to be fully financed without recourse to arrears, and when the financing gaps of some heavily indebted countries could only be assumed to be filled by some quite heroic assumptions about the extent of adjustment that would be possible. I would hope that when we come to consider the programs of the period 1989 to 1991, we will be able to conclude that a somewhat more realistic approach to the calculation of financing gaps has in turn resulted in a greater success rate for programs.

Turning to the paper on use of Fund resources, I am afraid that the paper does not do much to allay my concerns about prolonged use of Fund resources. The decline in the average exposure of the Fund to individual prolonged users is welcome. But there has been only a very small decline in the number of prolonged users, if those with structural adjustment and enhanced structural adjustment arrangements are included. Also, if one adopts a slightly wider definition of prolonged use, to embrace those members which have had at least four programs in the course of ten years and have more than 50 percent of quota outstanding, the number of prolonged users has actually risen significantly, from 31 in 1985, to 43 at the end of last year.

I would agree with the staff that arbitrary and inflexible arrangements for limiting future use of Fund resources are probably not appropriate. But I would also agree with them that prolonged use should trigger an extensive and explicit review of past lending, which identifies reasons for program slippages in the past and lessons for future programs. Particular attention should also be paid in this review to the prospects for medium-term viability. I would also agree with the staff that lending to prolonged users should be based on greater use of front-loading of policy measures and prior actions, and that it should continue to be guided by the need to reduce outstanding use of Fund resources over time.

It seems to me that there is a particular problem when the Fund is essentially obliged to continue use of Fund resources for the sole purpose of catalyzing resources from other sources of financing. This applies to both Paris Club rescheduling and to commercial bank agreements that are conditional on use of Fund resources. I would welcome an investigation of possible procedures that would enable, in certain circumstances, the Fund to be involved in monitoring the economic situation and reporting to creditors without requiring continued use of Fund resources. Where use of Fund resources is involved, however, I have particular concerns. While it is understandable and acceptable that commercial banks should ask that a Fund program be in place, for example, it is not acceptable that actual drawings under such a program should be made a condition of agreements between members and commercial banks, and members should be aware of this when they enter into such agreements.

On the other subjects covered in the paper on use of Fund resources, I can be much briefer. On first credit tranche borrowings, I remain somewhat concerned that conditionality has been too light in first credit tranche programs and has tended to allow borrowers to delay implementing necessary reforms. I am also concerned about the prospect of future first credit tranche purchases occurring when members already have substantial exposure to the Fund. I therefore agree that these provisions should be reviewed in the context of the general review of access policy that precedes the Ninth Quota Review taking effect.

I agree with the staff's conclusions on the extended Fund facility. On contingency mechanisms, I broadly support the staff's conclusions, but I urge them to avoid too much complexity in the operation of contingency mechanisms. Excessive complexity causes problems both with transparency and with an excessive use of staff and Board time.

Let me conclude by reiterating one basic point, which covers both conditionality and use of Fund resources. The Fund does not serve either itself or its members by accepting weak conditionality. We are all aware of the political constraints that members face in implementing programs. But those political constraints do not get any easier over time, and if the experience of the last ten years shows anything, it shows that those who perform best are those who are prepared to adopt ambitious and comprehensive programs and follow them through resolutely. For the sake of all of its members, the Fund must continue to design and enforce conditionality that encourages this. I need hardly say that the Board must be prepared to back the staff up when it does so.

Mr. Fernando made the following statement:

The guidelines on conditionality approved in 1979 are still appropriate and need no change. The language of the guidelines has permitted the necessary degree of flexibility to adapt conditionality criteria--both in their design aspects, as well as in their operational aspects--to the many developments since then, foremost of which is our better understanding of the interrelationships between policies and economic performance. Thus, to take an operational matter as an example--first credit tranche conditionality--if the member's commitment to reform needs to be strengthened, especially where a track record of adjustment in line with Article IV consultations is lacking, guideline 7 seems to provide the latitude for prior actions before the approval of the program.

We agree that quarterly indicative targets can enhance the quality of the program, but we have difficulty with the statement on page 27 of the paper on operational issues that "the absence of phasing and performance criteria in the first credit tranche, and the possibility of full disbursement at the outset, imply a higher risk that Fund resources will be used without intended policy adjustments in fact being made." No amount of conditionality can eliminate all risks. It can only minimize the risk. It is our job to take risks. I would also note that conditionality is only one element working for the success of a Fund-supported program. The international environment, financing assurances, and the proper and timely linkage between policy actions and program objectives--in other words, the program design--are crucial factors bearing on the outcome. Prior actions and consultation procedures during the program serve to meet shortcomings in the adjustment propensity of the member. Staff concern appears to apply more to cases in which there are serious underlying disequilibria. If such is the case, a stand-by arrangement to succeed the first credit tranche drawing could be envisaged, and it does not seem reasonable to doubt in such a context that the policy content in the Letter of Intent will go by default. It is also of note that access is limited to 25 percent of quota, which is well below the average annual access levels. We feel strongly that first credit tranche conditionality should be such as to encourage members to adopt corrective measures at an early stage of their difficulties, or as a precaution against the emergence of such difficulties.

In respect of fiscal conditionality, we should acknowledge the steady refinements made to financial programming, which has already seen a broader definition of the public sector and the focus on public sector claims on bank finance. These are in line with targeting programs to yield a better domestic savings effort and private investment performance. Organizational improvements in public expenditure management should be attempted in their own right, and I am uneasy about accepting that they could compensate for policy factors. It would be worse to consider them a trade-off against lack of political commitment.

Concerning expenditure management, there appears to be more scope for organizational improvements in revenue mobilization to contribute to fiscal consolidation. While fiscal slippages have usually been associated with revenue slippages, we are disturbed that even where fiscal targets have been achieved, revenue slippages have remained a problem. While deficiencies in organization and methods would seem to impair cash management, as well as to confuse the relationship between commitments and disbursements, the larger issue that requires continued focus is policies underlying expenditure. Major slippages could arise through transfers to public enterprises, or through the impact of interest rate changes on the public debt, especially with accompanying financial sector reforms. For these reasons, and because of the differing degrees of importance of these factors among countries and the slow pace of administrative reform, we do not favor organizational improvements being marked out as performance criteria. Moreover, we cannot see such changes impacting clearly on macroeconomic outcomes in the program period of stand-by arrangements.

There is, however, greater scope for their applicability in extended arrangements, as from the outset the program period will be known and, therefore, better suited to deliver results during the program period. A predecessor stand-by arrangement to an extended arrangement would seem to provide a favorable setting for public expenditure to be streamlined through prior actions before the commencement of the extended arrangement. This is necessarily a case-by-case decision and should not be part of generalized conditionality. I would note that guideline 9 provides the flexibility to proceed in specific and clear cases. Technical assistance in this area to help meet performance criteria is useful, but it should take account of the member's previous record of the use of such assistance.

Without detracting from the observed association between attainment of fiscal targets and performance on growth and inflation, an area for closer scrutiny is the quality of the fiscal adjustment. In many instances, targets are met at the expense of outlays on human resources, maintenance of capital assets, or investment in infrastructure. Despite the good performance during the program period, doubts are inevitable concerning whether the improvement is sustainable, as the continued supply response could be impaired by bottlenecks. Even though it is left to the authorities to determine spending priorities, we would like to see the fiscal program paying greater attention to these concerns. This could take us back to the start of the process calling for realistic budget estimates, as well as a deeper Fund involvement in the development of core and noncore programs.

On the question of interest rates, it would be highly desirable to have positive real rates at an early stage. In most developing countries, the financial market is badly fragmented, the treasury bill rate is a very imperfect indicator of the underlying interest rate, the weight of state banks contributes to substantial disintermediation, and preferential credits of the central bank in the name of better allocation of credit have been a perennial source of inflating reserve money. While fully accepting the need for domestic financial assets to be attractive to hold and trade, like some previous speakers, I would put primary emphasis on the proper sequencing of financial sector reform, in combination with appropriate fiscal policies, to provide the necessary guidance for interest rate policy. These considerations are equally relevant when graduating from direct to market-based monetary control.

In high-inflation cases, the staff suggests prior actions to give greater confidence that inflation will be reduced, or to wait for actual progress on inflation before a Fund arrangement is approved. In many high-inflation countries, we have noticed the severe institutional constraints to bringing down inflation to low levels on a sustained basis. Arresting the monetary financing of the budget requires, as a first step, legislative action to grant autonomy to the central bank. The legislative agenda may include revenue-sharing arrangements in a federal constitution. Can the needed institutional and legal reforms be the subject of prior actions, considering that the executive branch may not be able to commit the legislative branch of a country; and could they be handled within a time frame that does not unduly postpone Fund assistance?

On the question of the exchange rate, the views of this chair were articulated at last year's seminar on exchange rate policies (Seminars 90/7 and 90/8, 11/21/90). Suffice it to mention that, to the extent that the external sector is a binding constraint, we would favor a flexible arrangement. The staff recognizes that, in the short run, there is a trade-off between price stability and growth. We agree that the situation is less clear for the long term, but as we emphasized earlier, maintaining public support for the adjustment effort hinges on some dividends being delivered through growth and the balance of payments. As we gather experience with social safety nets and poverty alleviation programs that co-exist with adjustment programs, we could review this position.

On the issue of prolonged use of Fund resources, for operational purposes the criteria suggested to identify such cases are five or more annual programs in the past ten years, and outstanding Fund credit exceeding 100 percent of quota. We have reservations about these indicators.

There are clear instances in which the SAF is the more appropriate vehicle to precede the ESAF; furthermore, the ESAF became operational when some countries were already in the second year of an arrangement under the SAF. External circumstances could dictate a fourth-year enhanced structural adjustment arrangement. All SAF/ESAF cases would have had a stabilization forerunner with a stand-by arrangement or a structural adjustment arrangement. For these reasons, many countries are well on the way to crossing the five-year threshold. The contribution of Paris Club and banking community procedures to prolonged use has been widely commented on by others.

The 100 percent of quota in outstanding Fund credit that has been indicated as a criterion of prolonged use is also unrealistic. SAF/ESAF maturities are of ten years, and there is a full buildup of drawings before repayments begin after six years. Similarly, the higher access limits under the ESAF reflected the fact that quotas have lagged far behind current account developments, as well as the need for more ambitious trade reform. The number of arrangements and the amount outstanding should not imply program failure or lack of members' commitment. Exogenous factors demanding time for orderly adjustment, shortfalls in expected financing, defects in program design, and uncertainties in market access for nontraditional exports are all criteria that augur for judgmental consideration in identifying prolonged users.

As for corrective measures when a country is identified as a prolonged user, such as a comprehensive review and front-loading of adjustment, it would appear that these applications stand in their own right without necessarily deriving legitimacy from prolonged use.

We think that contingency mechanisms, whether inside or outside the CCFF, should be built into programs. Such mechanisms are helpful to improve the quality of the program, and thus of Fund credit, but also because their acceptance and formulation enhances the authorities' commitment to the program.

Since the previous conditionality review in June 1989 (EBM/89/76 and EBM/89/77, 6/19/89), we have built a number of safeguards for the Fund as part of our strengthened cooperative strategy. We have improved the analytical underpinnings for programs, strengthened the assessment of borrowers' capacity to repay the Fund, and underlined the preferred creditor status of the Fund. To link this to my first point, it again shows that the existing guidelines provide sufficient flexibility for us to adapt to circumstances.

Mr. Posthumus made the following statement:

In the period 1985-88, Fund-supported programs tended to be more successful than in the early 1980s in meeting objectives for growth, inflation, and the balance of payments. I assume this is not because the targets were deliberately set lower compared with world economic outlook projections year by year. Table 2 indicates that the global economic environment was much better in 1985-88 than in 1980-84 in terms of output in industrial countries and world trade volume and, for nonfuel exporters, also regarding the terms of trade. The general conclusion must be that the global economic environment is of major importance for the implementation of programs. This is obvious, as swimming downstream is much more effective than swimming upstream, but it underlines the importance of industrial countries opening up their markets and maintaining the conditions for noninflationary growth in their own economies.

There was a fairly strong association between the implementation of fiscal and credit policies and achievement of inflation and external objectives. I fully agree that the approach to financial programming is broadly appropriate. The staff indicates that there still is a need for further improvements in the understanding of the relationship between fiscal and credit policies and macroeconomic objectives, because in specific cases the association is much more difficult to understand and establish.

Let me concentrate on fiscal policies and look at the issues raised in the paper on public expenditure management processes and fiscal conditionality. Fiscal policy, we have learned, is a major factor in establishing the conditions for economic growth, and here fiscal balance is a better contribution to growth than fiscal profligacy or fiscal stimulus, as it is usually called. Thus, indeed, public expenditure management and improved budget management are key conditions. How far should we go, the staff asks, and should we go further in fiscal conditionality than we do already? At the same time, the staff points out that the reasons for fiscal slippages are to be found mostly in nonorganizational factors.

Taking the three points for discussion which the staff suggests, my broad conclusion would be, first, that we limit our involvement in public expenditure management as much as possible; second, that in cases in which there is an obvious lack in this respect, we establish preconditions and prior actions, and third, that we focus technical assistance specifically on these prior action cases.

I think that this is in line with a general view we have taken in the last five years that structural reforms should be limited in Fund-supported programs, if possible, to prior actions, and that program designs should be as macroeconomic as possible, with structural measures limited to those which are vital to make macroeconomic policies effective.

It is an interesting finding that in programs in which terms of trade developments were weaker than expected, program implementation was worse. Of course, in these cases implementation was all the more necessary. In practice, it seems that very often adverse terms of trade developments make the gains of Fund-supported programs less, or even invisible. The appreciation of Fund programs might benefit if staff papers could attempt to analyze separately the adverse effects of the terms of trade and the benefits of the program. For structural adjustment, it is often clear that it helps the economy to flexibly overcome external shocks. Contingency planning as part of Fund-supported programs, rather than in the separate context of the CCFF, is therefore very appropriate.

We all know that 20 percent inflation is not 5 times more than 4 percent inflation, it is even worse than that. I fully support the conclusion that special attention, perhaps in the form of prior actions--in any case, through overriding actions--is necessary in these situations. Interestingly enough, that is exactly the way most programs of the Eastern European economies--which are not yet in this review--were designed.

This is another opportunity to discuss exchange rate policy. The finding that most programs with a real exchange rate rule did not limit inflation as planned, even when fiscal objectives were met, fully fits into recent Board sentiments on this matter. This is a finding of which the staff should be very mindful.

I found the discussion on the short-term trade-off among macroeconomic objectives under different exchange rate regimes interesting. Pegged exchange rates result in lower inflation, but also lower growth and weaker external positions. I would stress that the emphasis with these trade-offs should be on the short term. That is to say, in the longer term, the trade-off is likely to be very different: an environment of low inflation is conducive to growth; high growth in an inflationary environment will be short lived. This means that the trade-off should not direct our program design, not even in cases in which we have large exposure, and, hence, the Fund itself has a very concrete interest in strengthening the external accounts. The trade-off mentioned reflects to a large extent the situation in which fiscal policy is not appropriate. In such situations, the Fund does not fail to program fiscal adjustment, and rightly so. If, nevertheless, the fiscal adjustment is insufficient, the Fund should not feel pressed to choose between limiting inflation and strengthening the external accounts, because the Fund's financing assurance is obtained through the long-term effect of the short-term program which it supports.

The importance of positive real interest rates has been stressed by the Board repeatedly in the past two years. I think that we can fully endorse the staff's recommendations as laid down in the issues for discussion under point (g).

The issue of prolonged use of Fund resources has been raised repeatedly. It would be tempting to go into it in detail, but the staff conclusions are fully acceptable to us, and I will therefore not elaborate further on this issue.

I have read with interest the paragraph on contingency provisions in Fund arrangements outside the CCFF. I have in the past argued strongly for this approach, which I suspected was preferable to the approach of making contingency elements part of the compensatory financing facility. Although it seems that the jury is still out, it also seems that the first experience with this approach is broadly satisfactory. It remains important that the number of variables be limited, and I am not sure that the provision of contingencies for capital account variables meets this condition. However, the contingency provisions appear to be more flexible, easier to design and to monitor, and they are used more widely. I look forward to a review of these experiences at a later stage; it would be appropriate by that time to also consider the desirability of adding to the contingency provisions built into a program the possibility of including additional Fund financing in the event of unfavorable external shocks.

Let me express my appreciation for the substantial amount of work which the staff has done to prepare for this review of conditionality. This is the heart of the Fund's role. If I have not devoted attention to each specific aspect of this work, I can only explain this by observing that most people have the habit of not devoting sufficient attention to the working of their hearts.

Continuing, Mr. Posthumus said that he agreed with Mr. Goos that there was too much emphasis on growth in the paper, in particular in the beginning. In his view, in extreme terms, while growth targets and objectives might belong to planned economies, they did not belong to market economies. The Fund's task was to create the conditions for growth, not guarantee growth itself.

He had noted that Mr. Abbott and Mr. Peretz had said that in cases of prolonged use of the Fund's resources, it would be useful to identify the causes of program slippages, Mr. Posthumus recalled. He wondered whether the staff could identify any cases in which programs for prolonged users of Fund resources had had no slippages, and in which the programs had been consistently on track so that all the drawings could be made. In contradistinction, he knew of a few cases in which continuous efforts had been made to begin a program, which then was derailed after the first or second review of performance, so that in the end the country had not been able to have much access to the Fund's resources and would therefore not fit the definition of a prolonged user.

Mr. Abbott commented that his authorities did not share the view that growth targets belonged only in the context of planned economies. All the objectives of the Fund's programs--inflation, balance of payments, growth--were affected by the policies the Fund recommended, and that countries chose to adopt. Growth was an essential element of the objectives of almost all member countries' authorities, and the various policies the authorities developed bore that consideration in mind. Growth was not the natural outcome of a process on which the Fund had no impact. In transitional arrangements in particular--precisely the kind of arrangements that the Fund's programs were designed to affect--the transition to medium-term viability necessarily entailed some trade-offs between achieving immediately the objectives of controlling inflation, adjusting the balance of payments, and growth. The Fund had an important responsibility in the advice it provided about how to balance those objectives.

Mr. Goos remarked that he wished to associate himself with Mr. Posthumus's comments. He found worrisome the idea he had found in staff papers and Fund-supported programs that a country with a difficult balance of payments situation should nevertheless aim at attaining a real growth rate of from 4 percent to 6 percent a year. From a theoretical perspective, a balance of payments problem reflected in most cases an imbalance between supply and demand. In many such cases, such imbalances could be overcome by belt tightening and structural reform. In such a situation, with external financing constraints, how could such high rates of growth be achieved, and why should such a rate be stressed as part of an adjustment program? The Fund's chief objective was spelled out very clearly in the Articles of Agreement--namely, to provide the basis for resumption of sustainable growth. That had nothing to do with the maximization of growth within the adjustment period.

Mr. Peretz observed that the highest sustainable growth rate that a country could achieve could be seen as a desirable objective, but that was a different matter from setting a numerical objective for growth. In that respect, he would associate himself with the comments of Mr. Posthumus and Mr. Goos. Governments could however create the conditions in a market economy for growth.

Mr. Abbott said that setting numerical growth targets was not the issue. Some speakers had seemed to indicate that growth was not an objective, which he believed was an inappropriate characterization of most of the actions and orientation of national authorities. He took Mr. Goos's comments as indicating that in evaluating proposals brought to the Board, a proper balance should be struck between the desire to sustain growth, on the one hand, and to correct the balance of payments or to reduce inflation, on the other hand. Striking that balance was a legitimate concern, and differences were bound to arise in that regard in the Board's deliberations. Nevertheless, it would be misleading to suggest that the national authorities were not--and need not be--concerned about achieving sustained growth. Support for any of the Fund's programs would have to be based on the expectation of the long-run improvement of the countries concerned, and in that connection, growth was crucial. The staff paper had shown clearly that the single-minded pursuit of a single objective could meet with success, but that the outcome would not be a very balanced one; the trick was to find the proper balance.

Mr. Kabbaj remarked that he agreed fully with Mr. Abbott. Article I of the Articles stated that the purposes of the Fund were to facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy. To his mind, that meant growth.

With respect to the use of Fund resources, Mr. Kabbaj went on, the Articles also clearly stated that the purposes of the Fund were to give confidence to members by making its general resources temporarily available to them under adequate safeguards, thus providing them with the opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity. That appeared to be an indirect reference to the importance of maintaining growth. If the Fund were to change its objectives, perhaps a fourth amendment of the Articles should first be proposed.

Mr. Goos commented that Mr. Kabbaj had failed to note the important--and, indeed, critical--stress that Article I of the Articles laid on the Fund's role in contributing to high levels of employment and real income in an indirect manner, as reflected in the word "thereby." Growth was not mentioned as among the Fund's immediate concerns; it was in effect only a derivative kind of objective. The Fund's primary objective was to create the conditions for the recovery of growth. That did not suggest that the Fund should act to maximize growth in a period of balance of payments crisis. There was a clear contradiction between the idea that the Fund should promote short-term growth, and his idea that the Fund should create the conditions for the recovery of sustainable growth.

Mr. Peretz observed that the key question was whether there was a trade-off between sustainable growth, on the one hand, and low inflation and a sustainable balance of payments position, on the other. If the question were formulated in that way, it would appear that the answer which he and Mr. Goos would give would be "no," whereas that of Mr. Abbott would be "yes."

Mr. Kabbaj said that he did not mean to imply that the Fund should aim for growth for its own sake, while ignoring the measures that were conducive to it. However, the Articles also stated that those measures should not provoke disruptions in, or the destruction of, national or international prosperity. The problem was the speed at which growth was being promoted. Some were saying that adjustment should be promoted at full speed, without paying attention to what was happening with respect to growth. His view was that while adjustment was essential, due regard should be paid to maintaining growth of at least some degree, as Mr. Abbott had said.

Mr. Abbott remarked that he was not sure whether or not he agreed with Mr. Peretz's attempted simplification of the problem. While he might agree with Mr. Peretz that in the medium to long term, there was no trade-off between growth, on the one hand, and the inflation and balance of payments objectives, on the other, he could not agree that there were no such trade-offs in the short term. Most of the programs under discussion were, after all, short-term programs--those that were to be put in place during a period of transition. In that period, there were grounds for arguing that there were trade-offs. That was the basis in the world economic outlook for the inflation expectations-adjusted Phillips curve. The issue was how to deal with short-run trade-offs where a balance had to be struck. To ignore those trade-offs was to fail to take into account the body of evidence that had been built up in that connection over an extended period of time.

Mr. Posthumus observed that it was precisely because Fund-supported programs were short-term programs that the issue of trade-offs should not be raised in them. He believed that Mr. Peretz had formulated the right definition of the problem. The point was that in the framework of Fund-supported programs, growth could not be a separate target, to be used as a balance or in a trade-off between one element of the program and another.

Mr. Peretz commented that the term "sustainable growth" probably had the same meaning as the term "medium-term growth" that Mr. Abbott had used. The Fund should be concerned about sustainable growth. There was little point in pursuing a policy in a country for one year if it were to be followed by a period of economic collapse. In that respect, the focus should be on the medium term--even in the short term.

Mr. de Groote remarked that one of the main conclusions of the staff papers that appeared to be beyond debate was that effectiveness in the fight against inflation was the best way to correct the balance of payments and to attain medium-term growth. However, it could be observed that often, even in the short term, a program that failed to elicit supply-side effects through elements of structural change generally would not lead to a sustainable balance of payments position in the long run. That could be seen, for example, in the case of Turkey between 1980 and 1986-87. The program for Turkey had been extraordinarily successful because it had embedded in it at the very beginning not only demand-management elements, but also elements of structural change, such as the full liberalization of import and export trade, the elimination of many subsidies, and the dismantling of state economic enterprises. In the medium term, therefore, neither a successful balance of payments adjustment, nor the attainment of the objective of Fund-supported programs, could be secured without introducing in due time elements that acted on the supply side of the economy and which, in particular, enforced structural change.

The Executive Directors agreed to resume their discussion in the afternoon.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/91/96 (7/19/91) and EBM/91/97 (7/22/91).

3. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors, by an Advisor to Executive Director, and by an Assistant to Executive Director as set forth in EBAP/91/185 (7/18/91) is approved.

4. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director as set forth in EBAP/91/188 (7/19/91) is approved.

APPROVED: January 14, 1992

LEO VAN HOUTVEN
Secretary