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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 91/121

3:00 p.m., September 12, 1991

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
	A. A. Al-Tuwaijri
G. K. Arora	L. E. N. Fernando
	Zhang Z.
	Deng H., Temporary
C. S. Clark	
T. C. Dawson	Q. M. Krosby
J. de Groote	J. Prader
E. A. Evans	G. H. Spencer
R. Filosa	N. Kyriazidis
	A. F. Mohammed
M. Fogelholm	I. Fridriksson
H. Fukui	N. Tabata
B. Goos	B. Esdar
J. E. Ismael	
	J. C. Jaramillo
J.-P. Landau	J.-F. Cirelli
	M. J. Mojarrad, Temporary
	J. M. Jones, Temporary
D. Peretz	P. Wright
G. A. Posthumus	
C. V. Santos	A. R. Ismael, Temporary
A. Torres	R. Marino
A. Végh	A. G. Zoccali

L. Van Houtven, Secretary and Counsellor
B. R. Burton, Assistant
L. Collier, Assistant

Also Present

IBRD: J. Khalilzadeh-Shirazi, Asia Regional Office; D. Papageorgiou, Latin America and the Caribbean Regional Office; E. Stoutjesdijk, Financial Policy and Risk Management. African Department: R. A. Valdivieso. Central Asia Department: H. Neiss, Director; M. A. Dieckman, O. J. Evans, D. Goldsbrough, J. S. Kahkonen, R. S. Teja. Central Banking Department: M. Castello-Branco. Exchange and Trade Relations Department: J. T. Boorman, Director; T. Leddy, Deputy Director; J. J. Clark, Jr., J. C. Di Tata, M. E. Edo, G. R. Kincaid, B. E. Rourke, B. Stuart. External Relations Department: S. J. Anjaria, Director; R. R. Brauning, H. Puentes. Fiscal Affairs Department: V. Tanzi, Director; C. Liuksila. Legal Department: R. Munzberg, Deputy General Counsel; H. Elizalde, R. B. Leckow, J. M. Ogoola. Research Department: G. Hacche. Secretary's Department: C. Brachet, Deputy Secretary; J. W. Lang, Jr., Deputy Secretary; G. Djeddaoui, B. R. Hughes, A. Tahari, S. L. Yeager. Treasurer's Department: D. Williams, Treasurer; M. P. Blackwell, W. J. Byrne, W. L. Coates, Jr., J. C. Corr, Z. Farhadian-Lorie, D. Gupta, D. K. Kar, P. R. Menon, P. S. Ross. Western Hemisphere Department: S. T. Beza, Counsellor and Director; M. Caiola, Deputy Director; C. M. Loser, Deputy Director; H. Arbulu-Neira, S. B. Brown, L. A. Cardemil, S. Clavijo, S. C. de Sosa, L. H. Duran-Downing, J. Fernandez-Ansola, T. Gudac, M. E. Hardy, W. E. Lewis, L. M. Valdivieso, L. M. Zamalloa. Personal Assistant to the Managing Director: B. P. A. Andrews. Advisors to Executive Directors: J. M. Abbott, M. A. Ahmed, M. B. Chatah, C. D. Cuong, L. Dicks-Mireaux, B. R. Fuleihan, M. Galán, A. Gronn, M. Nakagawa, D. Powell, F. A. Quirós, A. Raza, A. M. Tanase, S. von Stenglin. Assistants to Executive Directors: B. Abdullah, T. S. Allouba, J. R. N. Almeida, B. Bonzom, B. Bossone, Chen M., S. B. Creane, M. Da Costa, Duan J., N. A. Espenilla, Jr., S. Gurumurthi, K. M. Heinonen, K. Ishikura, J. Jamnik, P. K. Kafle, W. Laux, I. Martel, R. Meron, F. Moss, M. Mrakovcic, E. H. Pedersen, R. Powell, L. Rodríguez, A. Schubert, D. Sparkes, N. Sulaiman, R. Thorne, C. M. Towe.

1. REPUBLIC OF LITHUANIA - APPLICATION FOR MEMBERSHIP

The Managing Director informed the Board that an application for membership from Lithuania had been received in the Fund on September 11, 1991 (EBD/91/268, 9/12/91). The usual press communiqué would be issued.

Mr. Landau reported that in Paris that morning, gold belonging to the central bank of Lithuania, which had been held in France, had been returned to the central bank. The transfer constituted a significant step in establishing international reserves for Lithuania. Other gold holdings that did not belong to the central bank had been earmarked for transfer.

2. UNION OF SOVIET SOCIALIST REPUBLICS - REPORT BY MANAGING DIRECTOR

The Managing Director reported that the staff had met with Mr. Yavlinksy and other officials to discuss the status of the special association between the U.S.S.R. and the Fund. The authorities had no difficulty with the substance of the proposal, which they considered appropriate for the present situation. They had noted the need for its endorsement by the Union Republics, which might take two weeks. The urgent need for the Fund's technical assistance had been stressed by the authorities, and once the special association was in place--possibly before the end of the month--technical assistance could be deployed in the fiscal, statistics, and monetary areas, with special emphasis on legislation, as well as assistance in the macroeconomic policy field, possibly in the form of an Article IV-type consultation. Executive Directors would be kept informed of further developments.

3. INTERIM COMMITTEE - PROVISIONAL AGENDA

The Executive Directors continued from the previous meeting (EBM/91/120, 9/11/91) their consideration of the provisional agenda for the Thirty-Seventh Meeting of the Interim Committee to be held on October 13, 1991 (EBD/91/266, 9/6/91).

Mr. Fogelholm considered that the question of access to Fund resources in connection with the quota increase should be discussed by the Board rather than by the Interim Committee. That issue was particularly inappropriate for the luncheon agenda because of its technical nature. The Board's discussion of access policy should be postponed until after the Interim Committee meeting, and the subject should be dropped from the proposed Interim Committee meeting agenda.

The Chairman replied that he understood the reasons for Mr. Fogelholm's proposals and shared his concerns. He himself had said many times that quotas were an issue for the Executive Board. Ministers had already stated that the enlarged access policy should be maintained at least for the period immediately following the quota increase. The item had been included on the proposed agenda more as a matter of tradition than as an opportunity for the Ministers to make policy recommendations. He had no difficulty in supporting Mr. Fogelholm's proposal to delete consideration of the access policy from the Interim Committee agenda if members of the Board agreed.

Mr. Posthumus, Mr. Clark, and Mr. Spencer stated that they agreed with Mr. Fogelholm.

The Chairman said that there appeared to be a consensus in support of Mr. Fogelholm's proposal.

Mr. Jaramillo remarked that he supported moving the item on management of the debt situation to the afternoon session. He asked what procedures would be followed in choosing the speakers for the afternoon session.

The Chairman noted that, at the previous day's discussion of the agenda, the Board had expressed support for the addition of the word "sustainable" before "growth" in subitem (ii) under the world economic outlook, as suggested by Mr. Goos. Also under the world economic outlook, Directors had supported moving subitem (iii)--management of the debt situation and medium-term balance of payments prospects--to make it the first item in the afternoon. There had been a slight reservation by Mr. Fukui, but it was his understanding that other Directors had no major difficulties with that change and that Mr. Fukui was making more a suggestion than a request. In addition, the words "of developing countries" should be added to clarify whose medium-term balance of payments prospects were to be considered. It had also been recommended that item 5--global savings and productive use of scarce resources--be moved to the morning to become the third subheading under the world economic outlook. With respect to the afternoon session, there had been support for the continuation of the system of lead speakers. Given the limited time available, he suggested that Directors apprise their Ministers that not all of them should feel the need to speak on both items during the afternoon discussion. The Chairman of the Interim Committee would suggest to a few of his colleagues that they take responsibility for leading the discussion.

Directors had welcomed the extension of an invitation to the Director-General of the GATT to give introductory comments at the dinner discussion of the Uruguay Round and prospects for trade liberalization, the Chairman continued. The Director-General would speak on the same subject at the luncheon of the Joint Development Committee the following day, when he would gear his comments more specifically to the vantage point of the Development Committee.

There had been strong support for a short draft press communiqué that would not require substantive consideration by the Ministers at the dinner session, the Chairman recalled. In addition, the Secretary would circulate a note indicating the documentation for Ministers that would be circulated for each item on the agenda.

As to what precisely was intended for discussion under the item on global savings and, particularly, the productive use of scarce resources, the Chairman said, a short paper on military expenditures and the role of the Fund (EBS/91/155, 9/10/91) had been circulated for Board discussion on September 27. Military expenditures certainly were a significant component in any consideration of the productive versus the unproductive use of scarce resources. The matter of subsidies with respect to domestic and international transactions in such areas as agriculture was another important aspect that received attention in the documentation for the world economic outlook and in the staff's background paper on international trade issues. For the Fund and its member countries, the objective of the discussion was to focus public attention on the need for more productive actions and less unproductive expenditure to meet the challenges currently facing the world. Although the Fund's mandate was limited in that respect, it could do more--particularly through the surveillance exercise--to help the membership become better informed about such issues, so that member countries could make more careful judgments of their expenditures.

The current world economic outlook covered several issues that had a political dimension, the Chairman noted. He would appreciate it if Directors, in their statements during the discussion of the world economic outlook on September 23 and 25, would deal specifically with the following issues: how to press effectively for the successful completion of the Uruguay Round; the problems facing Eastern European countries and what should be done to assist them, including current and prospective financing needs; how to deal with the scarcity or misuse of savings; and how to help the membership reduce dissavings and increase, if possible, productive investments. If the Interim Committee was to set an appropriate direction for the Fund, Directors would have to help their Ministers deal with those issues properly.

Mr. Posthumus commented that the Chairman of the Interim Committee could mention in his letter to Committee members the possible addition of an item on the Uruguay Round negotiations to the agenda of the dinner discussion. That communication would provide an opportunity, especially once Directors had discussed the subject as part of the world economic outlook, to explain why it was on the agenda. Such an explanation would be helpful if the Interim Committee's dinner discussion was to be successful.

The Chairman replied that he would communicate Mr. Posthumus's sensible suggestion to the Chairman of the Interim Committee.

Mr. Spencer remarked that, with respect to the productive use of scarce resources, Mr. Evans's concern was whether the broader topic of global savings and investment was the right context in which to look at the subject of military spending. He had also been concerned because the Board's discussion of the paper on military expenditures would not take place until very close to the Annual Meetings. It might be difficult for Ministers to formulate their views on that subject properly within such a short period; therefore, it might be better to delay consideration of that paper until after the Annual Meetings and not have the Interim Committee deal with the question of military expenditures at its forthcoming meeting.

Mr. Mohammed said that he shared Mr. Spencer's concerns.

The Chairman explained that the item on the productive use of scarce resources had been suggested for the agenda because the world economic outlook documentation included a substantial amount of material on that subject. Ministers would not be expected to finalize their discussion of that topic, but, as several of them had expressed interest in the issue, it would be appropriate to give them a first occasion on which to express their views without coming to a final conclusion. The topic's inclusion on the agenda reflected the same importance it had been given in the world economic outlook exercise, nothing more.

Mr. Goos said that he shared the concerns that had been expressed by the previous speakers. However, in view of what the Chairman had just said, he could go along with the inclusion of the discussion on the productive use of scarce resources on the Interim Committee's agenda, provided that firm conclusions would not be sought from the discussions by either the Board or the Interim Committee. Rather, both discussions would be an occasion for a first exchange of views, because the issues involved were complex and needed thorough consideration.

The Chairman responded that he expected the Board discussion to better equip the Fund to do its work on surveillance. Directors might well be surprised when they saw how limited the Fund's information was with respect to important parts of members' budgets. Therefore, in the document on military expenditures that had been circulated, it had been suggested that the Board authorize the staff to ask members for more extensive budget information to assist it in its surveillance work and in the advice it offered to member countries.

Mr. Goos stated that the question whether the Fund should strive to achieve that kind of detailed understanding of all the budget items for each member country required careful study; it could lead the Fund too far away from its fundamental mandate, namely, balance of payments adjustment. He was already concerned about a number of other activities of the Fund that were difficult to reconcile with what the Fund was supposed to do. He would be open minded, but it was not a foregone conclusion that the Fund had to develop expertise on military spending in order to advise countries on expenditures.

The Chairman said that he did not want his position on military expenditure to be misunderstood. Currently the Fund was not able to identify the proportion of military spending in GNP in individual countries. Moreover, the quality of the data available to the Fund could not be reasonably assured. As a result, considerable uncertainty was introduced into the Fund's fiscal policy recommendations. He had in no way meant to suggest that the Fund should make recommendations on defense policy, such as the substitution of one form of defense expenditure for another, or that it should pass judgment on the need for a certain level of defense.

Mr. Peretz remarked that he supported the Chairman's proposals in the area of military expenditure. Those proposals were a response to the G-7 communiqué issued at the London Summit. He was therefore pleased that the issue had been included in the Interim Committee agenda to allow Ministers to discuss it. The same item was on the Development Committee's agenda, and one of the background papers raised the issue in very specific terms. In view of both those factors, he would greatly welcome the opportunity to discuss the matter in the Board before the Annual Meetings, rather than afterward.

Mr. Fukui stated that item 5, on the productive use of scarce resources, entailed a number of complicated issues. The matters involved--including military expenditures--covered a broad range, and, therefore, it would be preferable to discuss them in the Board before the Annual Meetings, as the Chairman had recommended. Because the issues were so broad, the Board's discussion could not be particularly conclusive.

Mr. Dawson said that he wished to join Mr. Peretz and Mr. Fukui in support of including the item in question on the Interim Committee's agenda; the subject had been mentioned in the communiqué of the London Summit. There was no doubt that the structure of government expenditures, including military expenditure and subsidies--disguised and overt--affected the allocation of resources and was a major factor in economic performance. Almost all Directors had said that the Fund's surveillance needed to be strengthened with respect to all members. Although in the case of the United States military expenditure might not have been dealt with overtly in recent years, in the early 1980s it had been an issue, and certainly subsidies had been a recurring theme in many Article IV discussions. Therefore, the item on productive use of scarce resources was relevant and could not be overlooked. Directors' positions at the proposed discussion might be much like the ones that they had taken during earlier discussions on the treatment and elimination of subsidies, when they had not reached an agreement. They should not expect to have any greater success in the military expenditure area, but, in terms of at least making the discussion transparent, the subject should be included in the Board's work.

The Chairman said that he would inform the Chairman of the Interim Committee of the Board's deliberations on the provisional agenda. In his communication, he would note Directors' views carefully. Following that communication, the agenda would be transmitted to members and observers in the usual manner.

Mr. Spencer asked the Secretary which documents would be provided in support of the agenda for the Interim Committee and when they would be available.

The Secretary responded that, on the world economic outlook, there would be the usual memorandum from the Managing Director, which would not be available until the beginning of October, because the Board would only conclude its discussion of the world economic outlook on September 25. Meanwhile, Directors would already have received the Managing Director's summing up of the Board meeting on that date, which would cover items 3(i) and (ii). With respect to item 3(iii) on global savings and the productive use of scarce resources, there would be another summing up by the Managing Director on the paper on military expenditures and the role of the Fund, which was on the agenda for September 27.

As to the afternoon session of the Interim Committee meeting, the management of the debt situation was on the Board's agenda for the last full week of September; the summing up of that discussion by the Managing Director would be circulated as an Interim Committee document, the Secretary remarked. The documentation for the item on recent developments in Eastern Europe and the U.S.S.R. would include the Managing Director's summing up on the world economic outlook as well as part of his subsequent note on the same subject. In addition, the Managing Director was considering circulating shortly a statement to help give some direction to the Board and the subsequent Interim Committee discussion on recent developments in Eastern Europe and the U.S.S.R.

For the dinner discussion on trade, the Secretary said, the documentation would consist of the relevant portion of the summing up of the Board's discussion of the world economic outlook, the staff paper on the Uruguay Round negotiations (SM/91/187, 9/4/91), and the paper, currently in preparation, on recent developments and issues in the world trade system. In connection with consents to quota increases and acceptances of the Third Amendment, the staff would continue to circulate status reports as needed; another status report would be prepared just before the Interim Committee meeting.

The Executive Board then adopted the following decision:

> The Executive Board agrees to transmit the provisional agenda for the Thirty-Seventh Meeting of the Interim Committee set out in EBD/91/266 (9/6/91), as amended in the light of the discussion, to the Chairman of the Interim Committee.

Adopted September 12, 1991

4. 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 468.9 million under the compensatory and contingency financing facility (CCFF) with respect to fluctuations in exports and the cost of oil imports (EBS/91/147, 9/3/91; and Sup. 1, 9/10/91).

Mr. Arora made the following statement:

My authorities would like to thank the staff and management for the speed with which India's further request for a purchase equivalent to SDR 468.9 million--21.2 percent of quota--under the CCFF has been processed. It is a gesture my authorities value as an indication of the sympathy and support of the Fund at a difficult time in our history when we are undertaking a strong adjustment program to find solutions to many deep-seated problems in our economy.

It would be helpful if this statement were read together with my statement at EBM/91/97 (7/22/91).

My authorities endorse the staff analysis contained in EBS/91/147. I will attempt to draw the attention of the Board to the main features of the reform process under way in India.

The Government that took office in late June 1991, after the completion of the general elections, has decided on the basic strategy for dealing with India's economic crisis, of which the balance of payments situation is an extreme manifestation. The Government recognizes that the crisis in the Indian economy is unprecedented in the history of independent India.

We have analyzed the factors that have led to this crisis. Broadly speaking, it is the large and persistent macroeconomic imbalances and the underlying inefficiencies and rigidities in the economy that have cast a shadow over the entire process of growth. There is clear recognition that the management of the economy has to be radically overhauled.

As the staff points out, what is needed is sustained fiscal consolidation as the centerpiece of the strategy for macroeconomic stabilization. Fiscal adjustment and macroeconomic stabilization are a necessary, but not a sufficient, condition for the resumption of a dynamic growth process which alone holds the key to the alleviation of poverty. Therefore, stabilization and structural reform have to go hand in hand. In this regard, I can do no better than to quote the Finance Minister to highlight our policy goals and objectives:

> The thrust of the reform process would be to increase the efficiency and international competitiveness of industrial production, to utilize for this purpose foreign investment and foreign technology to a much greater degree than we have done in the past, to increase the productivity of investment, to ensure that India's financial sector is rapidly modernized, and to improve the performance of the public sector, so that the key sectors of our economy are enabled to attain an adequate technological and competitive edge in a fast changing global economy. (Budget speech in Parliament, July 24, 1991)

The Government has accordingly set adjustment policies in 1991/92 in the medium-term framework. Adjustment policies will focus on the following:

Macroeconomic Policies

The central government deficit is targeted to decline from an estimated 9 percent of GDP in 1990/91 to 6.5 percent in 1991/92 and 5 percent in 1992/93. The budget for 1991/92 has been formulated in the context of a deficit target of 6.5 percent in 1991/92. The budgetary process is expected to be completed by mid-September. It is noteworthy that the process of fiscal adjustment in 1991/92 will be concentrated in the last eight months of the fiscal year since the final budget could not be presented before the commencement of the current financial year.

It is not only the magnitude of adjustment--2.5 percent in 1991/92--that is significant; the quality of adjustment is equally important. The Government has begun the process of reduction of subsidies, some of which were deeply entrenched in the fiscal system; public sector enterprises are being progressively subjected to a hard budget constraint; the politically sensitive area of defense spending is being dealt with; and the process of fiscal adjustment is being aligned with structural reform, to begin with through emphasis on reduction of expenditure.

Monetary Policy

A tight monetary stance is planned to be maintained both in 1991/92 and 1992/93. The financial program envisages broad money growth of only 13 percent in 1991/92--14.9 percent in 1990/91--and between 11 percent and 12 percent in 1992/93. These are tight targets but they are needed to ensure stability of the nominal exchange rate and to instill confidence in macroeconomic management.

Structural Reform

Industrial policy

The Government has already announced a major reform package which has done away with the complex system of industrial licensing in respect of an overwhelmingly large area of industrial production. The process of domestic deregulation is well and truly under way. Policies relating to direct foreign investment have been liberalized. Majority equity participation is now open to foreign investors in a large number of industries. This decision marks a watershed in the evolution of industrial policy in India.

Trade policy

The Government has taken major initial steps in pursuit of its objective to move away from quantitative restrictions to a price-based system over a period of three to five years. Details may be seen in EBS/91/116, Supplement 1 (7/15/91).

Financial sector

The process of interest rate liberalization has been carried forward. Proposals are being formulated now to address structural problems in the financial system.

Public enterprise reform

The policy objective in this area is to bring the public sector under market discipline. A beginning has been made by offering up to 20 percent of government equity in selected public sector undertakings to mutual funds. Unviable public enterprises will be referred to the Board for Industrial and Financial Reconstruction (BIFR) for rehabilitation or closure. A social safety net is being established to facilitate implementation of market-oriented policies.

Tax reform

Action has been initiated to formulate concrete measures for tax reform, in particular reform of tariff policies with a view to increasing the international competitiveness of Indian industry. The budget for 1992/93 is expected to incorporate these measures.

My authorities expect that as a result of macroeconomic policies elaborated in the budget and of policies designed to improve the supply side of the economy, significant progress will be made toward medium-term external viability. The current account deficit would be reduced to 2.7 percent of GDP for 1991/92. A strong recovery in exports is expected in 1992/93, and a gradual re-establishment of access to private capital markets is targeted on the basis of sound macroeconomic policies and continued structural reform.

I would like to stress that politically it has not been easy to create a consensus in favor of fiscal and monetary discipline. There has also been resistance to the basic postulates of structural reforms. This should not come as a surprise to the Board, used as we are to the complexity of political discourse in an open society. The debate in India has served one fundamental purpose. It has become clear with each passing day that there is no going back to the policy framework of the past. Sometimes it may still appear that our language is the language of the past. There is no doubt, however, that our actions belong to the future.

My authorities are grateful to the Fund, the World Bank, and the donor community for recognizing India's need for exceptional financing over the medium term to facilitate the adjustment process and the movement toward a market-oriented economic system. India has an advantage in this matter. It has the institutions and the entrepreneurial vitality to reorganize speedily its structure of industrial production in response to the changing world economy. My authorities have demonstrated their strong commitment to macroeconomic stabilization and structural reform. We are hopeful that with the support of the Fund and the international financial community at large, the adjustment process that has begun in 1991/92 will be sustained in the years to come to enable India to play its part in the growing world economy.

I would request of the Board a favorable decision on the proposal placed before it. We expect that our request for a stand-by arrangement will be placed before the Board within the next few weeks. The Board will then have another opportunity for a more comprehensive assessment of trends in the Indian economy.

Mr. Peretz made the following statement:

I fully support India's request for a third drawing under the CCFF. The staff paper provides us with more recent data for import and export performance in the year to July, and while the estimate of the excess oil import costs has been revised downward, this is more than compensated for by the upward revision to the staff's estimate of the shortfall in export revenues.

I am satisfied that in this case the excess of oil import costs and the weaker than normal export performance are largely attributable to factors beyond the control of the Indian authorities. Although some of the performance criteria under the recent first credit tranche arrangement were not met, the authorities have cooperated with the Fund staff in designing appropriate measures to support an upper credit tranche drawing in the near future. All the prior actions for a stand-by arrangement have now been implemented. In view of all this, I agree that India should be eligible now for this drawing under the CCFF.

Since our previous discussion on India (EBM/91/97, 7/22/91), the Government has reaffirmed its commitment to reducing the fiscal deficit substantially--both in the current fiscal year and over the medium term. This has required cutbacks in subsidies, defense spending, and transfers to the public sector enterprises, but equally important are the measures being introduced to increase the level of revenues and broaden the tax base.

I agree with the staff that it will be important to strengthen the procedures for monitoring and controlling government expenditures, and I welcome the technical assistance the Fund is offering in this area. If problems arise in any area of fiscal reform, the authorities must--and I believe will--be willing to take compensating steps elsewhere. For example, the partial rescinding of the cut in fertilizer subsidies now needs to be counterbalanced by revenue-raising measures from elsewhere or other expenditure cuts. Revenue might, of course, be increased by further improving tax collection or, I suggest, by widening the value-added tax base.

Let me take this opportunity to urge the authorities to maintain a tight monetary policy--and if it proves necessary, they must be ready to tighten it further--to reduce inflationary pressure and to maintain the credibility of the stable exchange rate policy, which I support.

Also, while I welcome the structural reforms that have been made so far, I note that more structural reform will be needed. I have in mind further privatization of public enterprises, trade and investment liberalization, and action to increase labor productivity. I also encourage the authorities to adopt measures to strengthen the regulatory framework and the capital base for the financial sector. In this context, I hope that the Indian authorities will reconsider their decision not to privatize state banks, especially as there is an urgent need now for further capital injections into the banking sector to comply with the Basle accord ratios on capital adequacy.

India is a very poor country--judged on a per capita income basis--with a high debt-service ratio. The authorities have rightly gone to great lengths to ensure that their impeccable debt-service record is maintained. While India's serious liquidity problem results partly from factors beyond its control, it has had one beneficial side effect: the authorities have had to face up to the deep-seated structural problems that have been evident for some time. These problems are now beginning to be addressed, but there remains much to be done, especially in the structural reform area. The Indian authorities deserve our full support.

Mr. J. E. Ismael made the following statement:

I support India's request for a purchase under the CCFF. As I see it, this request, following those of January and July, is basically not a new one but an adjusted request based on more up-to-date data that have become available at present. The criteria for the purchase have been met; the export shortfall appears to be temporary in nature and largely caused by factors beyond the control of the authorities. Likewise, the requirement regarding cooperation with the Fund and balance of payments need has been met, and I am in agreement with the staff's calculation of the export shortfall. While I concur with the staff that the current request for a purchase contains some degree of risk, I am confident that, given India's proven track record, the member will be able to fulfill its obligations.

On India's economic performance, it is encouraging to note that positive real growth has been maintained, despite the adverse external developments and widening of the external balance deficit. I am also pleased that the structural adjustment measures in some areas, particularly in industry and trade, were more pronounced than previously envisioned by the staff. At the same time, I commend the authorities for their consistent, conservative approach to external borrowings, which reflects prudence in their financial policies.

The improvement achieved so far should provide a sound basis for the authorities to tackle the many problems that continue to prevail: the persistent budgetary deficit, high inflation rate, and deteriorating international reserves. I welcome the authorities' efforts to strengthen further their structural adjustment measures, including increases in domestic prices of petroleum products, the partial sale of the equity of selected public enterprises, and the sharp reduction of subsidy and defense spending. I agree that, following the recent devaluation, the nominal exchange rate should be held stable to retain confidence. The authorities' intention to maintain external competitiveness should be supported by comprehensive measures, including wider trade liberalization. In this context, and considering India's current tight financial situation, I would like to seek clarification from the staff about the reasons, if any, for the authorities' hesitation to liberalize interest rates.

I note with regret that India still maintains quantitative restrictions, particularly on imported raw materials and capital goods. I welcome the recent special import relaxation, but at the same time I urge the authorities to accelerate the removal of the remaining trade restrictions.

India has made positive strides in its adjustment efforts, and the Fund's continued support is, therefore, of special significance for the success of the adjustment program, as it will provide a solid foundation for the continued implementation of India's medium-term economic and structural reform. I look forward to the forthcoming discussion of India's request for a stand-by arrangement; I am confident that the authorities will continue their adjustment-for-growth efforts with commitment and determination.

Mr. Fukui made the following statement:

After various exchanges between the Fund and the Indian authorities, India's cooperative relationship with the Fund is now quite apparent. The authorities have planned a comprehensive adjustment program, which is described in the letter of intent accompanying their request for a stand-by arrangement. Moreover, a number of prior actions have already been implemented to surmount the deteriorating economic situation. This means that, under the CCFF decision, the conditions for purchases beyond 40 percent of quota are satisfied. Also, the total compensable amount equivalent to 61.2 percent of quota has been duly calculated and is well below the limit of 82 percent of quota which is applicable to India.

The authorities' adjustment program, which provides the basis for a stand-by arrangement, contains strong and comprehensive steps toward internal and external equilibria. First, a sharp reduction in the overall public sector deficit is a prerequisite for improving the balance of payments and recovering a desirable level of gross official reserves. I welcome the wide-ranging measures that are being planned to achieve the medium-term fiscal objectives; also commendable is the authorities' strong commitment to them. This being said, a source of concern is the delay in starting the fiscal adjustments this year, as a result of the delayed presentation of the final budget. The deficit in the first quarter is estimated to have reached about 8 percent of GDP. I strongly hope that the authorities will carry out intensively the necessary measures in the rest of this fiscal year to ensure achievement of this year's fiscal targets.

Monetary policy will act as a link between the gains from the macroeconomic adjustments and the strengthening of the balance of payments position. I welcome the tightening of monetary policy so far through increases in administered interest rates and cash reserve requirements. The authorities should be encouraged to maintain a tight monetary stance and to monitor closely the monetary situation.

Along with the macroeconomic adjustments, comprehensive and far-reaching structural reforms should be pursued to achieve sustainable growth and economic stabilization in the long run. I expect steady implementation of structural measures on many fronts, including deregulation of domestic industry and foreign direct investment, trade liberalization, price adjustments, and public enterprise reform.

Regarding program implementation as a whole, I cannot help feeling concern about the lack of definite timetables in many areas, despite the ambitious targets and comprehensive measures that are envisaged. Steady and speedy implementation of the program is imperative to restore and strengthen external creditworthiness, which is essential to revitalize foreign exchange inflows. Detailed timetables are scheduled to be formulated by the time of the first review under the proposed stand-by arrangement; however, I strongly urge the authorities to draw them up as soon as possible and not to wait until the first review.

In conclusion, the foreign exchange cash flow projection shows that India is facing an extremely difficult situation. Even after this purchase under the CCFF, the foreign exchange cash flow will continue to be tight, and a sizable financing gap will remain during this and coming fiscal years. As long as India's adjustment efforts are judged to be deserving of support, multilateral and bilateral donors should continue to extend all possible assistance. As this chair indicated at the Executive Board meeting of July 22, Japan has already extended a substantial amount of assistance to India during this difficult situation. I hope that other major donors will also continue, and even strengthen, their support for India. Undoubtedly, the importance of India in maintaining a sound international financial community is significant. I fully support the proposed decision.

Mr. Landau made the following statement:

I support the drawing under the CCFF, as requested by the Indian Government. Upper credit tranche policies are in place, and measures have been adopted to reduce the fiscal deficit. Therefore, I can approve this request before the upcoming discussion on India's request for a stand-by arrangement.

I support the stance of policies to reduce the outflow of short-term capital, restore confidence, and improve internal and external imbalances. Ambitious measures to improve competitiveness have been undertaken.

On macroeconomic policy, the Government has adopted a broad package of adjustment measures of which the budget is the centerpiece, with a planned reduction in the government deficit to 6.5 percent and 5 percent in 1991/92 and 1992/93, respectively. It is noteworthy that adjustment will be concentrated in the last eight months of 1991/92; moreover, the authorities are committed to taking additional measures to ensure that the target is achieved. A major tax reform is being undertaken to promote direct and indirect taxation, while reducing reliance on import tariffs. Trade liberalization is essential, and the authorities should reduce export subsidies.

Monetary policy has been tightened. We support the intention to hold the nominal value of the exchange rate stable, which is essential to avoid triggering adverse exchange rate expectations and a subsequent capital outflow.

On structural policy, impressive foreign direct investment and trade reforms have been introduced. However, tax reform, further trade liberalization, and effective policies for the exit of public and private loss-making firms still remain to be implemented. These measures are included in the structural benchmarks for the first review of the proposed stand-by arrangement. I approve the decision.

The Director of the Central Asia Department noted that Mr. Peretz had indicated the need for compensatory fiscal action following the Government's decision to rescind part of the increase in the proposed fertilizer price. The Government had committed itself to take action by the end of the year to offset not only the impact of the fertilizer operation, but also the possible impact of expenditure overruns or revenue overestimates in the budget, as submitted, to ensure that the targeted deficit reduction to 6.5 percent would be achieved.

The need for interest rate liberalization, as observed by Mr. Ismael, was strongly supported by the staff, the Director remarked. In particular, under the present circumstances, interest rates should be allowed to go higher. The authorities had deferred such a decision until the Narasimhan Committee submitted its report and recommendations to the Government on financial sector reform, due in mid-November.

India's tight foreign exchange situation and precarious cash flow position had led to the authorities' decision to request a purchase under the CCFF before requesting the stand-by arrangement, the Director of the Central Asia Department commented. In fact, the cash flow situation was slightly less favorable than it had appeared one month previously, while the latest data indicated a slight increase in short-term debt. The outflow of resident deposits on a net basis--including interest payments and stock changes--remained negative, although to a much lesser extent than previously. Therefore, there were signs that confidence was returning, albeit more slowly than anticipated.

Mr. Fridriksson observed that since the Board's discussion of India's second request for a CCFF purchase in July, the authorities had put in place a comprehensive adjustment program, including, among other things, significant structural reforms. One pressing problem continued to be the very tight external liquidity position.

Although the various elements of the economic adjustment program and its agenda of structural reforms deserved full attention, detailed scrutiny was not necessary at present but would await the Board's consideration of India's request for a stand-by arrangement, Mr. Fridriksson said. A wide range of actions had already been introduced, while sustained fiscal consolidation would have to be the centerpiece of the adjustment efforts. That was the basic assumption on which a successful outcome of the whole program and its financing calculations rested. The Indian authorities must show determination and perseverance in the reform process, which had to include the deregulation of the domestic financial and industrial sectors and acceleration of trade liberalization measures. The structural benchmarks for the first review under the stand-by arrangement involved mostly the formulation and announcements of timetables, prompting him, like Mr. Fukui, to underscore the importance of early and decisive action.

The balance of payments projections showed a fairly substantial unfilled financing gap from 1992 to 1995, but thereafter it was assumed that the necessary residual financing would come from normal commercial borrowing, Mr. Fridriksson noted. Closing the financing gaps would require additional assistance from the Fund and other multilateral and bilateral creditors, but above all, India must create an environment conducive to normal commercial capital inflows on commercial terms. The pace at which

India's external viability would be restored continued to be heavily influenced by how quickly commercial borrowing could be resumed, which, in turn, would be determined by the economic policies of the Indian authorities.

With the tight liquidity situation and sizable financing gaps projected for the next several years, the proposed drawing entailed some risk for the Fund, Mr. Fridriksson remarked. Nevertheless, in view of India's history of good relations with the Fund, and the economic program which had been negotiated, he supported the proposed decision.

Mr. A. R. Ismael said that he was in general agreement with the staff's appraisal that India's request met the requirements under the CCFF decision. He was encouraged by the Indian authorities' determination to restructure the economy through strong measures, which they had already taken. Moreover, the program of economic and financial adjustment described in the letter of intent was a strong one, and timely implementation should help to eliminate much of the macroeconomic imbalance and many of the structural problems facing the country. The program deserved the full support of the international financial community, and he, therefore, endorsed the proposed decision.

Mr. Jaramillo made the following statement:

> This chair strongly supports India's request for this purchase under the CCFF. When the Board approved compensatory financing purchases for India in January and July 1991, the size of the overall financing was limited to 40 percent of quota in keeping with paragraph 49(c) of the CCFF decision. That decision limits cumulative purchases to 40 percent of quota unless a member has an upper credit tranche arrangement with the Fund, or the member's current and prospective policies meet the criteria for such an arrangement. We firmly believe that the initiatives pursued by the new Administration since June of this year represent policies that meet the criteria for an upper credit tranche arrangement, and on this basis we support India's request.
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> Prior to June 1991, the impact of the Middle East crisis and political uncertainty combined with past imbalances created economic circumstances that were clearly unsustainable. In fiscal year 1990/91, the public sector deficit exceeded 12.0 percent of GDP, broad money expanded substantially, the external current account deficit widened, and inflation accelerated.
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> We welcome, therefore, the fiscal measures introduced in 1990/91 which are designed to reduce the overall budget deficit from an estimated 12.5 percent of GDP to a revised estimate of 8.7 percent in 1992/93. While we are pleased with the revenue-raising measures--such as the reduction in depreciation

allowances, higher excise duties, and increased direct taxation on corporate profits and wealthy citizens--we continue to have reservations about the maintenance of domestic oil prices at levels substantially above international prices. We believe that distorted prices for such a major and pervasive commodity as energy may prove incompatible with the pursuit of overall economic efficiency through the operation of market-determined prices. However, we recognize that the decision to sell equity of up to 20 percent in some public enterprises represents a radical departure from previous policy, and we commend the authorities for their bold action.

The adjustment in administered interest rates and cash reserve ratios, together with the maintenance of the expansion in broad money below the nominal GDP growth rates, indicates that the strong fiscal measures will be supported by appropriate monetary management. It is crucial that the fiscal and monetary stance complement each other if the benefits of the recent devaluation are to be sustained and the exchange rate stabilized.

In the external sector, the immediate effect of the devaluation and the supporting stabilization policies seems to have halted the outflow of nonresident deposits and the pressure to liquidate outstanding short-term credit by certain external creditors. However, the two other critical and necessary results--namely, the expansion of exports owing to an enhanced competitive position and the increased flows of private capital--may be realized only in the medium term. In the interim, the authorities will find themselves with a cash flow situation that can only be described as tight. Also, the staff project that despite drawings under the CCFF and the possible purchases under a pending stand-by arrangement, there will remain a substantial external financing gap. Even after additional assistance by other multilateral and bilateral creditors, a residual financing gap exists. We therefore urge members of the aid consortium to bring to the upcoming meeting in late September sufficient resources to ensure that the Indian authorities' strong adjustment effort is adequately supported.

Critical to the success of India's adjustment program is the maintenance of the bold initiatives taken in structural reform. We commend the authorities for their actions taken in the areas of financial and industrial deregulation and the new approach to foreign direct investment. Public sector price reform measures and trade reform measures are particularly welcome, given the highly regulated economic environment of the past. Greater revenue flexibility and an improved fiscal performance will surely result from the tax reform measures, which will emphasize greater expenditure control and close existing revenue loopholes.

It is clear, however, that the benefits of current policies will only accumulate in the medium term. In the interim, we urge the Indian authorities not to deviate from the adjustment path they have bravely chosen to follow and to recognize the need to deepen the adjustment process in the near future, primarily in the area of structural reform. We do not perceive India as a particularly heavily indebted country, and its debt-servicing record is impeccable. In this context, it is essential that the Fund play its role of both short-term creditor and catalyst for other financial flows to support one of its most creditworthy members.

Mr. Al-Tuwaijri made the following statement:

In response to severe economic difficulties, the new Government has introduced commendable policy measures that could constitute the foundation for a comprehensive adjustment effort. Indeed, the July 1991 budget initiative indicates a serious attempt to stabilize the economy and points toward a major reorientation of economic management.

Although a stand-by arrangement has not yet been proposed for Executive Board consideration, the request for additional compensatory financing must be assessed in light of the authorities' policies for which they intend to seek Fund support. The prospective stand-by arrangement should be viewed as a holding action that strengthens the authorities' initial policy measures, as well as a bridge to a more comprehensive and far-reaching medium-term adjustment program.

It is evident that strong and sustained fiscal action is the essential ingredient for any stabilization effort in India. Therefore, I welcome the authorities' renewed commitment to reduce the Union Government's deficit. I am particularly encouraged by the cuts in subsidies that have been implemented, as they underscore the authorities' commitment to fiscal consolidation, and I urge the authorities to further reduce subsidies as well as transfers to public enterprises. Nevertheless, I am somewhat concerned that the fiscal package represents a collection of ad hoc measures, some of which will yield only one-time benefits. Consequently, it is imperative to implement a major tax reform that allows for sustained fiscal consolidation and ensures that the state deficits will decline in conjunction with the union deficit.

As Mr. Arora notes, a credible and ambitious fiscal package is a necessary but not sufficient condition for resolving India's economic difficulties. It goes without saying that broad-based structural reforms and deregulation of the economy are long overdue. Therefore, I welcome the initial measures introduced, as they highlight the change in the authorities' attitude toward economic management. Indeed, the virtual elimination of industrial licensing as well as the easing of restrictions on foreign direct investment are welcome. I am also encouraged by the authorities' intention to reduce the restrictions on capital imports. However, I encourage the authorities to liberalize trade in consumer goods. This is essential if domestic consumer industries are to become competitive.

As the authorities recognize, the success of structural reform in India is predicated on an ambitious and bold program of public enterprise reform. While I welcome the authorities' intention to scale back public sector involvement in industry and to provide enterprises with greater autonomy, I am concerned that the authorities' reform program falls short of what is needed. Indeed, as the authorities acknowledge, exit policies represent the key to capturing the efficiency gains from all structural reforms. It is therefore essential that concrete plans to introduce exit policies be spelled out. I urge the authorities to initiate such measures expeditiously.

The proposed policy package represents another step in the right direction. While the authorities have taken many commendable measures, much remains to be done. As the staff paper notes, the proposed Fund support of India's adjustment measures entails a degree of risk for the Fund. This highlights the importance of firm and timely policy implementation and a willingness to undertake additional measures when needed. In this context, I note the heavy emphasis placed on the first review of the program, given that most policy measures will be spelled out by that time, and I encourage the authorities to accelerate the implementation of these measures. Nevertheless, given the serious difficulties that the Indian economy is confronting, I can accept the staff's judgment that the conditions for a CCFF purchase beyond 40 percent of quota are met. I support the proposed decision.

Mr. Filosa made the following statement:

When the Board approved the first two purchases requested by India under the CCFF, this chair was convinced that all criteria established by the decision were fulfilled. Today, we have to decide on a third purchase under the facility that would increase India's total purchases to 62 percent of quota. As on the previous two occasions, this chair believes that the main criteria for allowing this purchase under the CCFF are met and, therefore, I approve the proposed decision.

First, the oil import excess and the shortfall in earnings from exports and workers' remittances are beyond the control of the authorities. Second--a factor which allows India's purchase under the CCFF to exceed 40 percent of quota--the policies India has set out, and has already started to implement, comply with upper credit tranche conditionality.

On the calculation and causes of the excess in oil import costs, and the shortfall in merchandise exports, I have little to add to the detailed explanation presented by the staff. Regarding the energy policy implemented by India, I believe that the measures taken so far comply with the requirements spelled out in the decision. However, I urge the authorities to correct, as soon as economic conditions permit, the distortions that remain in the price structure. I am, in fact, concerned that cross-subsidization of energy products will continue, mainly because of social considerations. Its adverse economic impact, however, suggests that the Indian authorities should move quickly toward a better relative price structure for energy products.

I agree with the staff that the shortfalls in exports and remittances are essentially due to reasons beyond the control of the authorities, even though for some items the shortfalls could be seen as the consequence of the import compression measures adopted by India in the face of political emergency.

Although the discussion on the proposed stand-by arrangement will provide the opportunity to discuss in detail our views on the policies India is adopting, let me briefly say that, since policies are the second element relevant to our decision today, I agree with the key objectives of the program and I am satisfied with the range of policies that the Indian authorities intend to implement to achieve these objectives. My overall approval of these policies rests on the consideration that India has been able to agree at a very difficult political juncture on a wide range of policies to start correcting both macroeconomic imbalances and the structural distortions of its economy noted by this Board on previous occasions.

I am particularly pleased that beyond further tightening of monetary policy, which was the main instrument of financial restraint used at the time of the severe political crisis, India is planning to introduce fiscal measures with a strong structural content, trying to make major changes in the regulation of domestic activity, and implementing important reforms in trade, public enterprise, and the financial sector. I am also reassured by India's exchange rate policy, which will not be directed toward the objective of seeking competitive advantages vis-à-vis neighboring countries but, on the contrary, will be geared to conferring stability to the exchange market.

Despite the comprehensive program of action that India has announced to correct the dramatic situation that emerged a few months ago, its external position will remain extremely fragile, in which case external financing will continue to be of critical importance. In this effort, the Fund's exposure in India will increase significantly, as will the risk to which its resources would be subjected. It would be an even greater risk, however, for the Fund not to extend its support to a country like India with such an excellent record of cooperation with the Fund--a record recently confirmed by India's prompt response, in the form of a courageous and comprehensive adjustment program, to the dramatic circumstances facing the country.

Mr. Clark said that he agreed with the staff's assessment that India met the conditions for purchases under the CCFF beyond 40 percent of quota, and therefore he could support the authorities' request for an additional drawing. The recent measures taken by the Indian authorities, and the comprehensive adjustment program outlined by Mr. Arora and in the memorandum of understanding, provided a firm basis for the stand-by arrangement which India would also be requesting. Although that request had not yet been considered by the Board, India clearly met the test of cooperation. As such an assessment was all that was necessary for the decision to be taken that day, he would reserve comments on the program and the challenges that faced the Indian authorities until the Board formally considered the stand-by arrangement request, the following month.

Mrs. Krosby made the following statement:

We echo other Directors' approval of the Indian request. In fact, the Indian Government is making impressive progress in organizing and implementing a comprehensive stabilization and adjustment program.

We are prepared to support today's request for an additional purchase of SDR 468.9 million under the CCFF. This drawing is well justified in terms of the compensable shortfall and of the macroeconomic, structural, and energy policies that are being adopted, which satisfy the requirements for a CCFF drawing beyond the 40 percent of quota threshold.

This will be the third drawing by India under the CCFF this year. We believe that the very difficult payments situation combined with the forceful and wide-ranging policy actions being taken by the Indian Government fully justify this timely and exceptional show of support by the International Monetary Fund.

The circumstances justifying this drawing are exceptional. We believe that the procedures for granting approval of this drawing should also be considered exceptional. The guidelines for approval of a CCFF drawing above 40 percent of quota require policies that would meet the criteria for an upper credit tranche arrangement. Our strong preference would be that this policy conditionality requirement be met by simultaneous Board consideration of an upper credit tranche arrangement and of the CCFF request. Approval of the CCFF purchase prior to approval of an upper credit tranche arrangement should be considered an exception to standard policy, not the norm.

The Board has reviewed India's economic situation and its economic program in some detail recently, so on this occasion I will confine myself to a few general remarks. The macroeconomic policy core of the stabilization program is tough and orthodox: exchange rate adjustment, monetary tightening, and fiscal correction. There are excellent reasons to believe that these measures will have the classic effect of initiating early relief from the immediate liquidity crunch India now faces.

The broad range of important structural adjustments that have been initiated, or that are being developed, will provide the follow-through for an enduring correction of India's payments problems and lay the groundwork for sustained growth and development by removing many of the underlying inefficiencies and rigidities referred to by Mr. Arora.

The industrial, trade, and foreign investment liberalizations that have already been announced have excited widespread interest in the business community in my country among firms eager to participate in the expanded opportunities these reforms will create. We urge the Indian authorities to quickly flesh out and extend these announced programs so that they can achieve their fullest beneficial impact as soon as possible. We look forward to a more detailed examination of these programs when the new stand-by arrangement is considered after the Bangkok meetings.

Mr. Posthumus said that he had no problem with the approval of India's request, and he supported the proposed decision. One of the main macroeconomic policies of the Indian program was to reduce the fiscal deficit from 9 percent of GDP in the past two fiscal years to 6.5 percent of GDP in 1991/92. While that goal was ambitious, perhaps it could be even more so. Subsidies in the program for 1991/92 continued to represent 10.1 percent of total central government spending and 1.9 percent of GDP.

An earlier and larger cut in subsidies should be considered. In addition, India continued to make transfers to chronically loss-making public firms. Total transfers to central public enterprises were 1.3 percent of GDP in 1991/92. He understood that India would, by the time of the first review under the stand-by arrangement, formulate specific policy proposals for rationalization of those enterprises. That first review was expected by the staff to take place in March 1992. He found that proposal too little and too late; the situation was too serious to wait until that time, and he suggested that the Indian authorities and the staff expedite the process.

He would discuss the role of the Fund in financing the gap at the time of the forthcoming discussion on India's request for a stand-by arrangement, Mr. Posthumus observed. He noted that, according to The Washington Post, the Indian Minister of Finance recently stated that if capitalism was to succeed in India, it would require "a lot of time." He did not know what the Minister meant by referring to capitalism, but if it was more market orientation, then he had the impression that the Indian economy and society were ready for that, and perhaps releasing private initiative might have surprisingly early results.

Mr. Mojarrad commented that it was highly encouraging to read the staff assessment of the performance of the new Government, which had resolutely set a comprehensive course of economic policy in India. The measures taken thus far had already resulted in demonstrations of a measure of confidence in the new direction. The authorities had a formidable task ahead of them, but he was confident that the macroeconomic expertise of the authorities, combined with a large pool of trained manpower and large market potential, could bring high returns to continued firm implementation of the new policies. It was, however, quite clear that India would need substantial and timely provision of exceptional financing from the international community to ensure the success of the adjustment strategy. The impressive structural changes already introduced in recent months should be a sufficient signal to the international financial community that the authorities were not only attaching high priority to macroeconomic stability but were earnest in their attempts to implement comprehensive structural reform measures. He was in broad agreement with the staff's appraisal and supported India's request for additional compensatory financing.

Mr. Marino made the following statement:

> India's already weak economic situation, worsened by the Middle East crisis, shortfalls in external financing, and delays in the implementation of corrective measures owing to political developments, has now been severely affected by a significant shortfall in merchandise exports and remittance earnings; these adverse economic and political developments are reflected in India's further deterioration of its overall economic performance.

To redress these disequilibria, the new Indian authorities adopted a set of immediate stabilization measures aimed at restoring confidence. These measures are being complemented by a comprehensive adjustment program. Central to this program is a substantial fiscal consolidation. We welcome the authorities' intentions to restore fiscal discipline and to implement far-reaching structural measures. However, we would like to reiterate a concern, expressed earlier this year when the request for the first purchase was discussed, about petroleum price policy since the price of petroleum products in India will remain well above comparable world market prices.

We would like to voice a general concern, also expressed on many opportunities in this Board, about the adverse effect on allocational efficiency of overtaxing essential commodities or key economic sectors. We understand the importance of improving fiscal and external accounts, but the negative effects of artificially high prices of petroleum products and of a distortionary tax on banks' interest earnings might offset some of the benefits stemming from the structural measures.

We welcome the well advised Indian decision to maintain nominal exchange rate stability through a tight monetary policy. This will enhance external competitiveness while maintaining stable domestic prices. We commend the authorities for the steps already taken toward lifting import and exchange restrictions.

We support India's request for a third purchase under the CCFF, which meets both upper credit tranche and CCFF guidelines. Our decision is based on our confidence in the commitment of India's new authorities to embark on a far-reaching program with Fund support in order to restore economic viability for India. This purchase will give the new Government some additional room for maneuver to successfully implement its ambitious and comprehensive structural adjustment program.

Mr. Jones said that, like other speakers, he supported India's request. The purchase came at a critical time for India, and it should help the country weather the immediate balance of payments pressures. However, the real issue for India was the continuation of its adjustment effort, and he welcomed the assurances provided by the staff and Mr. Arora that the authorities had already begun in earnest to follow that path. He endorsed the decision.

Mr. Deng stated that he supported India's request. For the past six months, India had been experiencing severe difficulties in economic performance. The adverse effects of recent external developments on the economy had been felt strongly in the external sector, where the excess cost of oil imports and the resultant shortfalls in exports had caused a further deterioration in India's external liquidity position. That disturbance in India's adjustment efforts, which resulted in delays in implementing comprehensive adjustment measures, was largely beyond the control of the authorities. It was, therefore, crucial that the authorities remained firmly committed to economic adjustment through decisive policy actions in order to restore external viability, as well as confidence in the country's economic developments as a whole.

The package of stabilization measures which the authorities had initiated in response to the deteriorated situation were broadly based and focused correctly on those areas where major efforts were needed to bring the economy back on track, Mr. Deng observed. Particularly important were policy measures in the fiscal area, where the achievement of fiscal targets was the key to sustained external adjustment. In that regard, the Central Government's deficit target was a clear indication of the strong commitment of the authorities' adjustment efforts.

He was pleased that most of the expenditure measures undertaken by the authorities were on track, and he commended the authorities for taking the important step of eliminating export subsidies, Mr. Deng continued. However, he encouraged the authorities to take a broader range of revenue and expenditure measures to further consolidate the fiscal position and to ensure that performance was in line with fiscal targets. On the monetary front, the current tight policy stance should be continued to support policy measures in the external sector as well as to maintain India's competitive position.

Sustained economic recovery required the implementation of a comprehensive structural reform program, Mr. Deng remarked. Action by the authorities in that direction, shown particularly by recently announced trade reforms, was a very encouraging development. Therefore, he endorsed the authorities' policy measures contained in the stabilization program, and he believed that they deserved the Fund's continued financial support.

Mr. Prader commented that India was an interesting test case, because it belonged to the number of countries that had performed well under Fund-supported programs, had implemented a wide range of impressive reforms and adjustment measures, and at the same time had promptly paid their debts. He wondered whether commercial bank financing would come forward promptly; if not, the issue of Fund financing would arise, leading to the more fundamental question of whether commercial banks were recognizing good performers under Fund-supported programs.

Mr. Goos said that he was impressed by the strong and comprehensive program that had been agreed with the Indian authorities. He wondered whether the staff could provide further information on the latest stage of the discussions on the formulation and implementation of reform measures. He understood that there were a number of those measures pending to which he attached particular importance because they would eventually determine the success of the program. He referred in particular to the reform of the public enterprises, which was critical to the credibility of the fiscal adjustment strategy, and similarly to the still excessive import tariffs, which would have to be taken up in the context of a comprehensive tax reform package.

Finally, he wished to associate himself with those speakers who were concerned about the hesitation of the Indian authorities to liberalize interest rates, and those who had advised the Indian authorities to reconsider the decision not to privatize the state banks, Mr. Goos concluded.

The Director of the Central Asia Department explained that structural measures had been taken and were planned in all major areas. However, the initial focus was on industrial reform, trade reform, and tax and tariff reform. In industrial deregulation, the bulk of the complex licensing system had been dismantled, and the next stage would involve the liberalization of imports of capital goods. Further trade reform measures were under discussion with the World Bank in preparation for a structural adjustment loan, which would be discussed by the World Bank Board by end-November. The tariff and tax reforms, which were complementary, were being prepared for implementation as part of the 1992/93 budget beginning in April. Tariffs would be reduced, and concomitantly the base for domestic taxes would have to be increased to offset the revenue shortfall and to provide a lasting basis for continuing fiscal consolidation.

Public sector enterprise reform was also on the agenda, but activity would take place mainly during the course of the following year, the Director added. An important condition for successful public sector enterprise reform was a solution to the thorny problem of exit policies, allowing loss-making firms to shrink or to close, on which political consensus had yet to develop.

Mr. Goos asked whether there had been any difficulty in agreeing on structural reforms with the Indian authorities. It was regrettable that public sector enterprise reform would take so long, particularly given the high subsidization of public enterprises, as mentioned by Mr. Posthumus. The letter of intent stated that the World Bank's structural adjustment loan was explicitly dependent on progress in public sector, as well as tariff, reform. He wondered whether the structural adjustment loan would be postponed, which would raise the question of balance of payments financing, or whether the World Bank was willing to waive the requirement of public sector enterprise reform.

The Director of the Central Asia Department stated that tariff reform would be a major element of the World Bank's structural adjustment loan, and public sector enterprise reform would also figure prominently. Some progress would result from budget tightening; a substantial reduction in transfers to public enterprises was included in the present budget, and the next budget would include steps to implement the same strategy. Meanwhile, the authorities would continue to make significant adjustment efforts.

Mr. Arora said that Executive Directors' support of the requested drawing under the CCFF was appreciated, especially in view of India's critical cash flow situation. He assured Directors that their concerns would be conveyed to his authorities. One major point that had been made was the necessity of strict and rigorous implementation of the required policy measures, with no slippages. The second point was that no comprehensive structural reforms had been announced, and Directors had urged further action, notably trade and investment liberalization and financial sector reform, including liberalization of interest rates. In that connection, the latest measures taken by the Government had freed interest rates charged by the financial institutions from all control; but more would have to be done in the same direction. Third, there was great concern about the need for stronger fiscal consolidation.

On privatization, it was important to recall India's long history of state regulation, Mr. Arora commented. Such regulation had been seen not as a tactical measure but as a moral end. There was considerable difficulty in avoiding an element of continuity in policy formulation, especially when many high-level officials had put in place the very policies that they were now planning to abandon--despite strong political opposition.

More important with respect to bank privatization at the present stage, perhaps, was ensuring the banks' capital adequacy and ascertaining that the conduct of their commercial operations was based on sound principles, Mr. Arora remarked. Also, the possibility of greater foreign bank participation in India could increase competition. More progress would be made in that manner than through outright privatization at that point. Nevertheless, the authorities realized that there would have to be a change from the ways of the past in areas such as privatization and capitalism.

He agreed with speakers who had commented that monetary policy was very important, not only to uphold the nominal exchange rate but also to ensure that inflation was under control, Mr. Arora said. There had been no policy letup in India, despite a tremendous outcry about restrictions on credit to the private sector.

The timetable for the implementation of policy measures was part of the Memorandum on Economic Policies for 1991/92-1992/93 (EBS/91/143, 8/27/91), Mr. Arora noted. For example, bank credit to the Government would be monitored closely. In light of the smaller than proposed subsidy reduction, the authorities planned compensatory action on both the expenditure and revenue sides. The appropriation and expenditure bills had already been passed by Parliament, with no addition to expenditure, and the revenue bill would be taken up the following week. On the exchange rate, the authorities were concerned that the devaluation would add about 2.5 percentage points to the inflationary process, which had to be contracted.

The Executive Board then took the following decision:

1. The Fund has received a request by the Government of India for a purchase equivalent to SDR 468.9 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.

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

Decision No. 9816-(91/121), adopted
September 12, 1991

5. PERU - 1991 ARTICLE IV CONSULTATION; ACCUMULATION OF RIGHTS; AND OVERDUE FINANCIAL OBLIGATIONS - REVIEW FOLLOWING DECLARATION OF INELIGIBILITY

The Executive Directors considered the staff report for the 1991 Article IV consultation with Peru and Peru's request for a rights accumulation program for 1991-92 (EBS/91/141, 8/22/91) and a staff paper on the further review of Peru's overdue financial obligations following the declaration of Peru's ineligibility to use the Fund's general resources on August 15, 1986 (EBS/91/151, 9/9/91). They also had before them a statistical annex (SM/91/175, 8/26/91).

The staff representative from the Western Hemisphere Department made the following statement:

Since the staff report was issued last month, Peru has continued to maintain fiscal and monetary discipline and has taken additional measures to advance the process of structural reform. The Government has continued to avoid the use of domestic credit, the monetary liabilities and net domestic assets of the Central Bank are below the program limits, and net international reserves have increased further on the strength of private capital inflows. Inflation is running higher than was expected at this stage of the adjustment process, partly as a result of recent large increases in public sector prices undertaken to bolster public finances. However, a tight monetary policy has contributed to a deceleration of inflation from 9 percent a month in June-July to 7 percent in

August, and a further deceleration is expected in the coming months. The recent declining trend in domestic currency interest rates--from high levels--may be an indication of improving expectations regarding inflation.

Tax reform measures have been taken in recent weeks with the objective of increasing fiscal revenue and reducing distortions. Following the reform of the value-added tax adopted in early August, the Fiscal Affairs Department assisted the Government in developing draft laws for the revision of the income tax, the transformation of the net wealth tax into a tax on gross assets, and the introduction of an inflation adjustment to the business income tax. These three laws are to be submitted to Congress shortly, and approval is expected by the end of this month.

In addition, the authorities have started to make progress in rebuilding the system of tax administration, with substantial assistance from the Fiscal Affairs Department. Evasion of the value-added tax is being addressed through an aggressive program of temporary closure of businesses. Work is now under way to put in place a new system of computerized tax information, and employees of the tax administration were tested for technical proficiency.

During the last week of August, the Government enacted decree laws in other key areas. The Foreign Investment Law places foreign investors on an equal footing with domestic residents. The Privatization Law extends the continuing effort to privatize public enterprises and establishes a Privatization Council that will be in charge of its implementation. The Petroperu Law has ended the state oil company's monopoly on oil imports and provides for the privatization of many of its other activities. Later this month, Parliament is expected to enact a new Foreign Trade Law that will provide a comprehensive framework for trade liberalization measures adopted during the past 13 months and a timetable for future actions; it will include the elimination of the special 5 percent tariff for the state steel company and the establishment of a single, unified tariff.

With regard to the financing of the program, following the most recent discussions with bilateral and multilateral creditors and donors in Washington on September 9, 1991, the composition of the external financing for the program would differ from that described in the staff report in certain ways. The major changes include the following:

First, expected disbursements from the international financial institutions have been increased by $134 million in 1991 and reduced by $18 million in 1992, reflecting an increase in total disbursements from the Inter-American Development Bank during the two-year period and greater front-loading of those disbursements.

Second, while total disbursements from bilateral creditors in the context of the Support Group are now projected to total over \$1 billion in 1991-92, the amount that is expected to be in the form of budgetary and balance of payments assistance that would serve to cover the official financing requirement is estimated at about \$700 million.

Third, on this basis, at this stage total disbursements of budgetary and balance of payments assistance in support of the program will be lower than outlined in the original scenario presented early this year by some \$100 million in 1991 and \$400 million in 1992.

Fourth, Peru intends to make a request to the Paris Club and other bilateral creditors for debt relief that is consistent with the program's financing requirements, that takes account of the expected disbursements described above, and that reflects the delays in arranging the financing. Creditors are well aware of the need for extraordinary cash flow relief. The modalities of such relief will, of course, be decided in the actual rescheduling discussions between Peru and its bilateral creditors, including the meeting scheduled with the Paris Club for Monday, September 16. The staff will report to the Executive Board on the outcome of that discussion.

Fifth, Peru also intends to seek debt relief from other bilateral creditors, including the reprogramming of debt for export agreements with Eastern European creditors and the restructuring of medium-term obligations to Latin American creditors that are currently being serviced through the ALADI payments mechanism. Argentina has expressed willingness to roll over maturities falling due in the fourth quarter of 1991, and other possibilities of this kind will be explored.

Sixth, as regards the international financial institutions, Peru has made arrangements to pay the new arrears to the World Bank that have arisen since March 1991, as well as all outstanding arrears to the Inter-American Development Bank (IDB), within the next few days. The IDB is expected to make an initial disbursement under its trade sector loan by the middle of next week, followed by an initial disbursement under its financial sector loan in late October or early November. Peru will continue to pay obligations falling due to all three multilateral financial institutions, and arrears to the Fund and the World Bank are expected to be settled by end-1992.

In summary, it would appear that the program's external financing for 1991 is within reach, and for 1992 there has been significant progress in completing the necessary arrangements. Efforts to close the financing gap will continue. The staff will report to the Executive Board following next week's discussions in the Paris Club, and the financing outlook will be a major focus of the program review that will take place before the end of this year.

Extending his remarks, the staff representative reported that the process of paying arrears to the World Bank and to the IDB had been set in train at that point.

Mr. Végh made the following statement:

After a long period of intensive consultation between Fund management and staff and the Peruvian authorities, a rights accumulation program for Peru, covering the period September 1991-December 1992, has finally been submitted to the Executive Board for its consideration. The reason for the protracted waiting period lies mainly in the absence of external financial support, notwithstanding the agreement between the new Peruvian Government and Fund management on the economic program implemented during the period from August 1990 to February 1991, and which was intended to go to the Executive Board early this year. Let us also remember, from the viewpoint of the other test of cooperation within the strengthened arrears strategy--namely, the settlement of new obligations falling due--that Peru has been making payments equivalent to 100 percent of all new maturities during the past two years.

From January 1991 to the present, the Peruvian Government has continued to take further measures in line with its program of economic stabilization and structural reforms. At this moment, the track record of policy implementation has been quite impressive, with significant prior actions in the different areas. The staff report contains a detailed description of these measures and my authorities agree with the thrust of its analysis and policy recommendations. Let me, therefore, single out only a few points for emphasis:

First, trade and payments liberalization has proceeded at a rapid pace and it is fair to say that the Peruvian economy is today a small open economy in the academic sense of the word. As import tariffs have been drastically reduced and the structure simplified, more than 80 percent of imports now enter the country at the lower 15 percent duty level, while the rest are subject to a 25 percent rate. The exchange rate system has been unified, and the exchange rate is a floating one. Surrender requirements have been eliminated, while profits may be freely remitted abroad and import licenses eliminated. This reform has been supplemented by significant changes in the administration and operation of the ports. In this connection, the breaking of the union monopoly has helped to reduce operating costs in a significant way and to eliminate other rigidities prevalent in the shipping and insurance businesses.

Second, fiscal consolidation has been at the core of the authorities' efforts toward financial discipline and monetary restraint. As mentioned in the staff report, the Government has been working on both the expenditure and revenue sides with the active cooperation of the Fiscal Affairs Department of the Fund. The primary balance of the nonfinancial public sector is expected to shift from a deficit of 1 percent of GDP in 1990 to surpluses of about 0.5 percent in 1991/92. Tax revenue has been increasing, notwithstanding a largely decimated tax administration, and it is projected to reach 8 percent of GDP in the fourth quarter of 1991. Even though tax revenue levels for 1991 are still only slightly above 50 percent of the GDP proportion achieved in 1985, as improvements in tax administration take hold and a simpler tax structure, less cumbersome for the taxpayer and more neutral from the point of view of economic efficiency, is put in place, additional revenue collection is to be expected in the next few years.

Third, as far as energy policy is concerned, the new Government adjusted the price of oil products at the beginning of the program in August 1990, and since then has made further adjustments to keep domestic prices compatible with world prices. At the same time, the Government has removed monopolistic situations and other rigidities that were an obstacle to foreign investment in the petroleum sector and that explained the decline in domestic oil production from close to 200,000 barrels a day in the mid-1980s to a figure slightly above 115,000 barrels a day in 1991, barely above the level of domestic consumption. It is expected that the new legislation will expand the supply of foreign capital and know-how in the energy and mining area.

Fourth, as the staff appraisal makes clear, attainment of balance of payments viability over the medium term will require further measures to reduce the projected debt-service burden to sustainable levels more in line with projections of GDP, exports, and international reserve holdings. The rights program with the Fund, the simultaneous agreements with other international financial institutions, and the external support provided by the group of nations chaired by the United States and Japan--the two main trading partners of Peru--the Paris Club, and other bilateral creditors constitute necessary steps to consolidate economic stability and medium-term external viability. Board approval of the Peruvian program is a very important first step toward this goal and a demonstration that the arrears strategy, based on a cooperative international solution, is operational, even in the face of competing simultaneous demands for conditional resources. For this reason, my authorities particularly wish to express their appreciation for the work of the management and staff during this trying past year and for the support now being shown by the international financial community.

Mr. de Groote made the following statement:

It is no exaggeration to state that Peru, being ineligible to use the Fund's resources for over 5 years now, represents a very difficult case. Even after having remained current for the past 2 years on its obligations to the Fund falling due, its share in the total volume of arrears to this institution, some 17 percent, still exceeds its quota share, some 16 percent, in the total number of arrears countries. The causes of this dismal situation are captured strikingly in a few figures appearing in Table 2 in the staff report: 15 years of economic decline can be read from this table just by glancing over the five-yearly averages for such indicators as real GDP growth, inflation, public sector and external current account deficits, and external debt. It is with a feeling of relief to find that Peru, at the outset of this new decade, has finally started trying to break the negative trends and vicious circles of the past 15 years. Since the country has witnessed something of a gradually intensifying financial explosion together with an implosion of the real economy, it can evidently not be expected to make good on the damage in the next few years. Whatever optimism may reign today, as this Board, we hope, accepts the proposed decisions and gives the green light to a second rights accumulation program, the road ahead will be long and difficult for economic policymakers in Peru. This should serve other countries as an example that it is best not to delay adjustment for too long. It also validates one of the elements of our strengthened cooperative strategy, which is to try and prevent countries from reaching such a deplorable state.

The rights accumulation program maps out the objectives and strategy for the coming 18 months or so. This chair is in broad agreement with the staff appraisal and therefore supports the proposed decisions. Let me just highlight a few general aspects mentioned in the staff report which I regard as crucial for the success of Peru's macroeconomic and structural adjustment effort over the next several years, before addressing some specific questions to the staff. First, the staff document mentions in several instances the need for technical assistance in such areas as tax and tax administration reform, public sector reform, and monetary policy and financial sector reform. The multilateral institutions have a prime role to play in this respect, at least for the following two reasons. One is that these institutions have the best expertise to meet the challenging task that Peru is facing, which is one of fundamentally rethinking the role of the state in the economy, the same task the economies of Eastern Europe are facing. It entails both increasing the state's role in certain areas, for instance tax receipts to pay for an efficiently functioning administration, and at the same time decreasing its role in other areas, for instance in industry. The second reason for a close involvement of the multilateral institutions is that successful reforms implemented on the basis of sound technical advice will contribute to the success of Peru's long adjustment effort, which in turn will ensure that the country can keep servicing its debt to the multilateral institutions over the years to come. The long-term balance of payments outlook indeed reveals the important share the multilateral institutions take up in this respect.

A second general issue that deserves to be highlighted is the urgent need for Peru to design domestic policies conducive to enhancing savings and investment. This is an issue that received prime emphasis in the spring 1991 World Economic Outlook. Peru, with its urgent need to restore its capital stock, may well represent the textbook case here. Increasing public sector savings by reducing budget deficits, increasing private sector savings by reducing macroeconomic instability and financial sector distortions, creating a stable macroeconomic environment to attract external or flight capital and stimulate private investment, are all on the menu of Peru's economic policymaking in order for the country to attain its medium-term objective of 5 percent real GDP growth annually without exerting undue pressures on the balance of payments.

Still in the same context, the most recent world economic outlook document, in dealing with factors limiting capital flows to developing countries, treats at some length the question of the external debt burden as an obstacle to investment. This brings me to my third general issue, which is also extensively discussed in the paper before us, Peru's heavy debt burden requiring exceptional efforts from creditors. Let me just say that I fully share this principle for the case of Peru, which is why my country has participated in the Support Group. However, I wonder whether the burden of exceptional effort is not being placed asymmetrically on official creditors, including in this category the multilateral institutions. Indeed, as is noted in the staff report, Peru's obligations to private creditors are expected to be resolved only during the successor arrangements to the present rights accumulation program, with arrears on these obligations continuing to build up meanwhile. I wonder whether, given the exceptional nature of Peru's case, one has to wait another two years for the commercial creditors to act. While it is true that Peru's debt to private creditors constitutes only about a third of the total, it still could come to represent a serious overhang in the immediate period ahead, acting as a disincentive to inflows of foreign capital and domestic investment and ultimately putting the whole adjustment effort at risk. Is it really unfeasible for private creditors to step in earlier and have them too make an exceptional effort in the case of Peru? Or do official creditors alone have to pay the full risk premium on Peru's adjustment program over the coming 18 months? Is their debt really so senior as to justify their exclusive effort?

As to my specific questions for the staff, let me first continue on this issue of foreign financing. The medium-term outlook hinges on a sufficient capital inflow to sustain both the debt service and a current account deficit excluding this item, at least until 1997. This scenario, however, still incorporates large residual balances. Given these circumstances, is it appropriate to envisage a 5 percent annual real GDP growth rate from the middle of the decade? What would be the current account outlook if one were to take a 2.6 percent annual growth rate objective? This is, after all, the rate realized on average in the second half of the 1970s, before the devastating decade of the 1980s, and it would moreover fall in line with the population growth rate, thus at least stopping the per capita GDP decline. Would such a target not be more feasible, given the legacy of the previous decade and the financial burden of the medium term?

A second question concerns the exchange rate. While I fully agree with the usefulness of a floating exchange rate regime for Peru under current circumstances, I wonder whether the staff could already give some indication of the appropriate timing for a regime change. Indeed, if Peru is successful, capital inflows might turn out to be unexpectedly high, putting the exchange rate under upward pressure and thus jeopardizing the needed price competitiveness of its export sector. Likewise, if Peru is successful, this will certainly show up in a declining inflation rate which will lessen the need for further depreciation to guard price competitiveness. Has the staff, therefore, any inflation or reserve target in mind which could trigger such an exchange regime change? The reason for this change is, of course, that it could further enhance the credibility of Peru's adjustment effort.

A third and final question relates to foreign trade. Opening up the Peruvian economy is among the major challenges for the country's authorities, not only because it entails a radical change with the past but also, and more important, because it offers the prospect for the country to grow out of its debt. As a member of the Andean Pact, Peru will be part of a regional market by early next year, at least, that was agreed upon in December of last year, as one of the annexes to the spring World Economic Outlook informed us. This same annex mentioned several other trade integration initiatives in the Western Hemisphere. Does the staff feel that these initiatives will benefit Peru in the medium term, or might they on the contrary harm the country, given the apparent speed with which these initiatives are being taken and the heavy heritage of strong anti-export biases in the country?

With these remarks, I would like to congratulate the Peruvian authorities for the courage they have already displayed in embarking on the ambitious task of rejoining as soon as possible the international financial community.

Mr. Dawson made the following statement:

Through this request for a rights accumulation program, Peru is now in the final stages of reintegrating itself into the international financial community. Developments have reached this point owing to the efforts of many--including the international financial institutions, the Support Group donors, Peru's Latin American neighbors, and, of course, Peru.

The quality and strength of the Peruvian Government's stabilization and structural reform program--which Peru has been pursuing for more than one year--are impressive, and the program deserves our enthusiastic support today. To best put the progress and content of the Peruvian economic program in perspective, it is worthwhile to consider how far Peru has come.

The staff report does an excellent survey of developments over the past decade, and I will only point to a few particularly somber notes. Years of intensely misguided policies brought about a sharp deterioration in the fiscal accounts--a situation illustrated by the perverse relationship whereby the combined public sector domestic borrowing requirement was larger than the money supply in domestic currency. The result was hyperinflation--prices increased by over 7,500 percent in 1990--and severe recession--real GDP fell by more than 16 percent over 1989-90. Over the same period, terrorism and narcotics traffic further complicated economic activity. The cumulative effect was a drop in real per capita GDP of 30 percent by the end of the past decade, an accumulation of more than $20 billion in external debt--of which two thirds was in arrears--and a subsequent loss of international credibility.

Halfway through 1991, it is now clear that a rebound in the Peruvian economy is taking place. The latest data now suggest an economic growth rate of close to 3 percent, a deceleration in the inflation rate--albeit to a still high level--to about 400 percent on average, and a strong improvement in international reserves. Meanwhile, Peru has persisted in keeping current on obligations to the Fund falling due since 1989, and subsequently was able to adopt a similar policy with respect to the multilateral development banks, although with some deviations.

The basis for the improved economic situation is the economic reform program, which is founded on zealously tight financial policy as well as a dramatic range of structural reforms. Although a tight fiscal stance is key to nearly every economic program, in Peru the prohibition of the use of domestic financing by the public sector over the program period is very much the program's focal point on which other policy aspects depend. Given that all nonessential expenditures have already been cut, rescheduled, or postponed, the key to the program's success will be raising the extraordinarily low level of tax revenues--less than 8 percent of GDP--by pushing through necessary tax reforms to allow a structural improvement in the revenue base. It is crucial, therefore, that the authorities follow through by pushing the tax legislation as well as the delayed improvements in tax administration.

The staff report catalogues the ambitious list of structural measures already taken, of which I would point to the massive increases in fuel and utility prices, reforms in exchange rate policy, removal of labor market rigidities, liberalization of trade, and removal of international payments, capital market, and investment restrictions as being among the most notable. We fully support the staff's recommendations for further steps needed in all these areas, as well as in the banking sector. One area where we would be keenly interested in seeing a more accelerated timetable is the privatization of nonfinancial and financial sectors. The authorities have started down the right path to privatization, but given the obvious benefits for economic efficiency, as well as for the fiscal accounts, a much more rapid pace of advancement would seem warranted, achievable, and more closely parallel with other ambitious aspects of the economic program.

As the staff report notes, Peru's external accounts, in both the short and medium term, will require continuous and substantial levels of exceptional foreign assistance. Questions about Peru's potential for raising these funds and about future capacity to service Fund obligations could continue in the period ahead. However, given the decrepit economic conditions the current

Government found on arrival--including the massive debt levels--the exceptional efforts and accomplishments of the authorities since taking office, and the consequences of inaction on our part, we believe it is important, and the time, to move forward in support of Peru's efforts to boost its credibility and re-establish relations with the international community, and we strongly encourage others to join us. Even with international support, Peru is likely to suffer considerably, at least through the medium term, as it attempts to regain its footing. As strong as the progress has been to date, we would be unreasonable to expect a complete absence of missteps in the future. The burden is firmly on Peru to keep closely to its program and to maintain payments on current obligations to the international financial institutions--but with the support of the international community to recognize and back up this effort with financial resources.

We were, therefore, pleased with the result of the Support Group's recent meeting, which we view as an important step in the process of international reintegration. Contributions totaled nearly $1.1 billion dollars, not an insignificant sum for a support group effort, particularly given nearly universally tight aid budgets. The Support Group included generous donors such as Japan--the co-chair of the Group--Belgium, Canada, France, Germany, Italy, the Netherlands, Spain, Switzerland, and Sweden, as well as the participation of the United Kingdom.

Unfortunately, the very large size of these donations, as well as the tight budget conditions in Peru, made it difficult for all of the total contributions to be in a form that could be used to close the fiscal financing gap, despite all contributions being additional to existing baseline aid levels. If a larger amount of the donations could have been concessional, fast disbursing, and nonproject related, the remaining gap would have been that much smaller.

In addition to the funds raised in the Support Group, several Latin American countries--specifically Chile, Colombia, Mexico, and Venezuela--have come forward with a short-term bridge to facilitate the financial arrangements. Unfortunately, one snag in the workout is that the ALADI medium-term credits have not been fully refinanced as originally anticipated--but as the staff notes, some relief has recently been provided, and we are still hoping for an overall positive resolution. As we mentioned before, the international financial institutions have shown considerable generosity. The Fund and the World Bank have now both adopted special rights accumulation-type programs, and the IDB has recently increased its 1991/92 loan pipeline. At this point, I would like to fully support Mr. Végh's praise of the exceptional efforts made by the Fund staff and management in developing the program to this point. The final step of the reintegration process will take place next Monday, when the Paris Club is expected to consider Peru's request for a rescheduling. It is to be expected that members will treat this request with pragmatism and generosity in light of the exceptional nature of the Peruvian problem as well as the exceptional effort of the Peruvian authorities--soon, it is hoped, to be acknowledged by a Fund-endorsed rights accumulation program.

In conclusion, we believe that the economic program under consideration today is exceptionally strong, would be a highly appropriate case for the second rights accumulation program to be endorsed by this Board, and, with further flexibility, pragmatism, and sacrifice, should set Peru firmly on track to resume relations with the international community.

Mr. Jaramillo made the following statement:

The Peruvian case before us today is extraordinary not only because of the deterioration observed in the economy during the last few years but also because of the tremendous effort required to bring it back to a path of stable and sustained growth. That effort has been under way for over a year, since the new Administration began to formulate and put into practice a program designed to address the severe prevailing imbalances, pave the way toward normalization of relations with external creditors, and create the conditions that would make the resumption of growth a viable option.

This chair warmly supports the Peruvian request for accumulation of rights, as we are convinced that the authorities have not only been collaborating closely with the Fund to solve Peru's arrears problem but are also in the process of implementing a courageous program against overwhelming odds. It is clear that without the support of the international financial community, the authorities' task will be all but impossible. However, with this support, and with continuing efforts by Peru to keep its program on track, this economy will return to stability and, albeit slowly, regain its momentum of growth.

The authorities' program is a combination of strict demand-management policies coupled with structural reforms in virtually all sectors of the economy. We are in broad agreement with the main thrust of the staff report describing this program and its expected outcome. Nevertheless, there are a few aspects which are not entirely clear and others that carry some degree of uncertainty and thus should be considered with care by the authorities.

Our first concern is the envisaged level of investment. According to the program, investment should fluctuate around 14.5 percent of GDP during 1991-92. This is a low figure by regional standards and certainly compared with Peru's own historical record. If sustained growth is to be brought about in the medium term, higher investment seems desirable. Nevertheless, given the amount of domestic savings and of expected external funds, higher investment rates do not seem feasible under present conditions. This highlights the importance for Peru of not only consolidating its fiscal stance to rebuild public savings but also diminishing its external debt burden. With the equivalent of over 60 percent of exports of goods and nonfactor services accruing as debt service during the program years, Peru's call for exceptional treatment of its ongoing debt arrangements with the international financial community appears understandable in light of investment needs over the medium term.

Regarding the program's policy mix, it seems clear that fiscal restraint has to be at the heart of the adjustment process. Although higher fiscal revenues are necessary, the required adjustments in the tax system will take some time to be put in place and still further time to produce results. We encourage the authorities to proceed firmly with the programmed revenue-generating reforms. Delays could exacerbate difficulties that are already present.

In this regard, tight monetary policy--coupled with expectations that, not surprisingly, take time to adjust--has given rise to very high real interest rates, described by the staff as in excess of 100 percent a year. This has induced sizable capital inflows which, under Peru's circumstances, seem welcome from a balance of payments point of view, but which have created a dilemma for the authorities. Without the authorities' intervention, the local currency tends to appreciate, given the flexible exchange rate system, thereby undermining domestic competitiveness. Notwithstanding the caveats regarding the accuracy of price indexes under the hyperinflationary conditions faced by Peru in the recent past, the indications provided by the staff regarding the real exchange rate point in the direction of an overvalued currency.

It can thus be expected that the authorities will have to intervene to some degree in order to support the exchange rate. But by doing so, the achievement of monetary targets becomes a problem. The staff seems to suggest that, in this case, some form of "sterilized intervention" would take place, by which deviations in monetary growth resulting from exchange rate support would be neutralized, at least in part, by the Central Bank, presumably through open market instruments. This in turn would put pressure on interest rates, further inducing more capital inflows. Fiscal adjustment, as envisaged, is fundamental to overcoming this destabilizing circularity, thus the importance of avoiding slippages or delays in implementing the urgently needed revenue-generating measures.

Apart from this "circular problem," our concern lies also with the quasi-fiscal deficit. With real domestic interest rates upwards of 100 percent, losses incurred by the Central Bank as a result of this type of sterilization can be quite large, undermining monetary and fiscal efforts. Peru is not alone in this policy dilemma; several other Latin American countries, including my own, face situations that are qualitatively similar. A host of solutions can be attempted, ranging from some degree of nominal appreciation or further fiscal tightening to outright controls. But, given Peru's imbalances, these approaches seem particularly difficult, and they underline the importance, already stressed, of the fiscal restraint included in the program.

The excessively high levels of real interest rates are a cause for concern for other reasons as well. Foremost among them is the stability of the financial sector. The hoped-for success in disinflation, coupled with nominal interest rate stickiness, could lead to portfolio problems as nonperforming assets tend to mount. It is thus important to achieve lower interest rates as inflation abates. If the fundamentals are in place but markets are sluggish to react to new conditions, pushing the market in the right direction--by suasion or other means--could be called for to induce a faster response. Consequently, we believe that the authorities should monitor real interest rate developments closely and even consider influencing their behavior if they do not show signs of adjustment in face of improved circumstances.

The very high intermediation margins of, according to the staff, about 8 percent a month are another worrisome aspect. The staff report does not shed much light on this issue, but aside from uncertainty, such levels must be the result of misguided intervention in credit allocation, excessively burdensome reserve requirements, the lack of competition in the financial sector coupled with gross inefficiencies, or a combination of these and other factors. Presumably, these problems will be tackled within the structural adjustments being contemplated in connection with the financial sector loans to be obtained from the IDB and the World Bank. It is important that these problems be addressed to reduce the difficulties that the program faces, and we encourage the authorities to act accordingly. Finally, we wish to express our admiration for the courageous turnaround the Peruvian authorities are inducing in their economy.

Mr. Fukui made the following statement:

This discussion of Peru's rights accumulation program is an important occasion not only because this is the second case following establishment of the rights approach but also because of the amount of arrears that have to be dealt with. In this sense, the Peruvian case is symbolic and could be regarded as an important cornerstone of the Fund's arrears strategy. The Board should take into consideration the fact that the successful outcome of the arrears-clearing operation for Peru will substantially enhance the credibility of the Fund's arrears strategy, particularly the effectiveness of the rights approach.

The proposed program is comprehensive and ambitious, and I believe that it deserves the strong support of the Board. Moreover, the adjustment measures the Peruvian authorities have implemented since the Fujimori Administration came into power about one year ago are remarkable. There could be no better confirmation of the authorities' resoluteness in the pursuit of bold economic adjustment in the coming period than the measures they have already taken. I believe that the Peruvian authorities have already established a good track record of economic adjustment.

Not only have the authorities taken decisive measures, but they seem to have been successful in stabilizing the macroeconomic situation, thereby producing a more favorable environment for continued economic adjustment in the period ahead. The monthly inflation rate, which reached a peak of 397 percent in August 1990, decelerated to an average of 6.7 percent a month in March-May 1991. Although the staff reports that it accelerated again to 9 percent in June, I was encouraged to learn from the staff at the recent meeting of the Support Group that the rate had decelerated again in August.

Market-determined interest rates show a wide positive spread between deposit and lending rates. Also, the real interest rate has been kept positive. These developments confirm the recovery of the intermediation mechanism in the financial sector.

On the external front, there was a positive accumulation of international reserves; exchange rates have been unified and are determined by market mechanisms. Although the appreciation of the Peruvian currency in recent months is a source of concern, I support the authorities' exchange rate policy.

All these developments indicate that the austere economic measures taken by the authorities since last summer have begun to take hold in the domestic economy. Interestingly, the Peruvian case might be another example of successful economic stabilization through so-called shock therapy.

The most important lesson to be drawn from past attempts to stabilize the domestic economy is the importance of maintaining tight domestic policies, in particular tight fiscal and wage policies, beyond the initial stage of the stabilization process. Peru should not forget this lesson. There is no room for premature relaxation of fiscal, monetary, and wage policies.

As to the targets and measures incorporated in the rights accumulation program, they are ambitious and comprehensive, and I fully endorse the components. The authorities should continue to implement decisively the adjustment measures in the program in both the macroeconomic and structural areas. There is no other way for Peru to re-establish financial relations with the international financial community. In this connection, an argument could be made as to the financing assurances of the proposed program. It is regrettable that, despite the efforts made so far in the context of the Support Group for Peru, the financing gap up to the end of 1992 is still unfilled.

Nevertheless, because Peru has already established a remarkable track record on adjustment and has kept current in its payments to the Fund for the two years since August 1989, I believe there is enough justification for approval of a Fund-monitored program for Peru, which is a first step toward normalizing the relationship between Peru and the international financial community. Otherwise, the Fund will be sending the wrong signal to Peru and will make continued adjustment more difficult because domestic political pressures will increase. At this stage, the international financial community needs to take a pragmatic approach in its support for the authorities' adjustment efforts, given the symbolic importance attached to this exercise in the context of the Fund's arrears strategy. Further efforts should be sought on every front, including the Support Group and the Paris Club.

In this connection, my authorities believe that the international financial institutions should also be ready to be pragmatic and flexible. In the event the program is not fully financed, owing partly to a lack of adequate support from bilateral donors, the Fund might consider more flexibility on the accumulation of rights by Peru, possibly by shortening the period envisaged in the current proposal, depending on Peru's performance under the program. After all, strict monitoring will be necessary for the financing aspect of the program. The Board should be kept informed by the staff on this point, and a pragmatic approach should be sought through the efforts of all the parties concerned.

Finally, as the staff's long-term outlook indicates, Peru's balance of payments situation will remain difficult for the foreseeable future. The authorities should recognize that strict implementation of the rights accumulation program and perseverance with their commitments is the only way to restore external viability and that this process will be a long and difficult one. I support the proposed decisions.

Mr. Kyriazidis made the following statement:

In the light of the dramatic state of Peru's economy as described in the staff report for last year's consultation, the picture presented by this year's report constitutes a remarkable improvement. The new Peruvian Government has indeed shown courage in establishing rapidly the measures that are central in dealing with the situation, namely, the unification of exchange rates under the floating system, a significant process of fiscal adjustment, the elimination of domestic financing of the public sector, the liberalization of interest rates, and the removal of barriers to trade. As indicated in the staff report, the authorities will need to display, in addition to courage, fortitude and perseverance in order to consolidate the positive results achieved and put into practice the formidable list of reforms which, in the staff's view--a view this chair fully endorses--are still required to place and maintain the Peruvian economy firmly on the road to adjustment that may eventually lead to stability and growth, as well as to the normalization of Peru's relations with the international financial community.

I am in full agreement with the staff's analysis and recommendations. I also agree that the recent actions of the Peruvian authorities, as regards both adjustment and the timely settlement of obligations falling due since September 1989, clearly meet the criterion of cooperation with the Fund. I, therefore, can support the proposed rights accumulation program as well as the proposed decision on the review of arrears.

What I find, however, very worrisome is the fact stressed by the staff that, beyond the program period for which financial prospects are reasonably reassuring, even in the event of successful implementation of the adjustment program over the medium term, external viability will continue to be an elusive target at least throughout the 1990s because of the extremely heavy debt overhang. I cannot but fully endorse the staff's view that the international community should support through adequate financing arrangements the efforts of the Peruvian authorities for a considerable period of time. As the staff points out, if adequate financial support is in fact not consistently forthcoming, a number of the crucial assumptions on which the medium- and long-term scenario is based cannot be fulfilled. However, given the size of the financing requirements for the entire decade forecast in the staff scenario and the grave uncertainties surrounding them, I wonder whether it would not be useful to also envisage alternative scenarios based on lower GDP growth targets.

Substantial debt relief and concessional new money will certainly be essential in any case. Like Mr. de Groote, however, I am somewhat unhappy with the strategy outlined by the staff inasmuch as it appears to put a disproportionate share of the burden on official creditors, including multilateral financial institutions. Therefore, I too would like to ask why we should have to wait another two years for commercial creditors to act. The accumulation of arrears is certainly not a substitute for debt relief inasmuch as it tends to increase the perceived burden of the debt overhang and raise the feelings of uncertainty and risk. In the exceptional circumstances of Peru, it would seem to me reasonable to require commercial creditors not to postpone their contribution until the eventual successor program, by which time they may expect that an improvement in the country's situation will permit them to obtain better terms than now. After all, this institution under the rights accumulation program is making some very important concessions: it is tolerating the maintenance of past accumulated arrears for another two years and is committing itself to refinance them, on completion of the rights accumulation program, under a successor program. The Fund has the right to request similar gestures from commercial, and not only official, creditors.

My Italian authorities have been increasingly supportive of Peru: in recent years, the support extended by the Italian Government has been considerable, and Italy is now one of Peru's largest bilateral donors. For 1991-92, Italy has already committed $141 million, of which grants constitute 29 percent, for assistance to Peru to be disbursed within the program period. My Italian authorities are very anxious to see the Peruvian Government succeed in dealing with the country's economic and social difficulties, which are further complicated by the continuing threats to internal security. They will, therefore, continue to support the Peruvian authorities' efforts. Consistent with this position, my Italian authorities have agreed to participate in the Support Group and have committed $15 million which can be disbursed by the end of the rights accumulation program period exclusively for the clearance of past accumulated arrears, provided Peru continues to meet the test of active cooperation with the Fund.

Under the rights accumulation program, it is proposed that Peru's total entitlement will be reduced by any amount paid by Peru to the Fund that lowers the amount of overdue obligations to the Fund below SDR 623.7 million. This would appear to establish a disincentive for settlement of the overdue obligations before the end of 1992 and appears to contradict paragraph 3 of the decision on arrears. Clarification from the staff would be appreciated.

Mr. Clark made the following statement:

It is with great pleasure that we mark Peru's return to the international financial community after an absence of many years. Peru's renewed willingness to normalize relations with this institution, as well as with other donors and creditors, provides an encouraging indication of its commitment to achieve economic stability after many years of chaos. The authorities' adherence to the reform program despite substantial delays in finalizing the requisite financial requirements is commendable and bears important testimony to Peru's desire to achieve a successful recovery. The program's broad range of structural reforms and the targeted consolidation of the fiscal deficit represent important first steps toward this objective and deserve our support.

Nonetheless, and despite our admiration for the authorities' adjustment efforts, a number of aspects of the program give us some cause for concern. First, despite optimistic assumptions, the financing gaps and debt-service ratios projected over the medium term are extreme, raising doubts regarding the viability of the program. While it is true that additional access to Fund resources is not at issue today, the size of Peru's arrears, and the possibility that access in the future might be sizable, does suggest a risk to the Fund. In this regard, the guidelines on financing assurances are being stretched considerably, as the Support Group's contributions are less than that required to close the gaps over the two-year period, agreement on a commercial bank package is unlikely to be concluded in a short period of time, and the willingness or ability of the Paris Club to close the residual gap is unclear.

Indeed, one cannot help but be concerned that our guidelines on financing assurances may be inadequate or perhaps inappropriate to deal with the very difficult financing issues that arise in the context of rights accumulation programs. I would appreciate staff comment.

The second area of concern is the proposed fiscal adjustment. That most of the adjustment will have been through expenditure cuts rather than revenue enhancements, and that revenues as a share of GDP are actually expected to decline somewhat in 1991, is disturbing. While the reform of the tariff and value-added tax systems, which may have contributed to the weakness in revenues, is commendable, we have some doubt whether the revenue effort in the first year of the program is sufficiently ambitious. Therefore, we strongly support the staff's recommendation for a reform of the income and wealth taxes, and we trust that these reforms will be well defined by the time of the first review.

In this regard, I note that the tax summary contained in the statistical appendix indicates that the proposed reform of the income tax system would reduce the maximum tax rate from an already relatively low marginal rate of 37 percent to 30 percent. This seems an unusual, and possibly misguided, direction to take, given the priority that must be accorded to fiscal consolidation. I was also surprised that income and property tax revenues were not expected to be more buoyant in 1991, given the imposition of a temporary withholding tax on net wealth, and the fact that lower inflation rates would tend to reduce losses related to collection lags. Could the staff comment on this trend, and indicate whether the proposed reduction in marginal tax rates was in line with the recommendations of the Fiscal Affairs Department's technical assistance mission?

As regards the public enterprises, their performance has improved vastly since 1988, when their overall deficit was over 4 percent of GDP, to a point where their financing requirements are expected to be virtually eliminated in 1991. The effects of the 1990 price adjustments clearly demonstrate the importance of appropriate public sector pricing policies. However, while the authorities' memorandum on economic policies refers to a system of frequent price adjustments for utility and energy prices, it was not clear whether automatic mechanisms have been put in place to ensure the rapid pass-through of costs to consumers. The adoption of such mechanisms might be important in depoliticizing needed price adjustments in the future. Given the importance of ensuring that the public enterprises are on a sound financial footing, could the staff provide some reassurance that such mechanisms are indeed in place?

We also strongly endorse the authorities' intention to expedite the privatization of large-scale public enterprises. However, the staff report suggests that, at least in the near term, the receipts from such an exercise would be used to finance government operations--for example, the provision of separation payments to civil servants--rather than to reduce external debt. Could the staff indicate whether it views the de-emphasis of debt reduction in the near term as appropriate?

We strongly endorse the unification of the exchange rate system and the elimination of requirements to surrender foreign exchange receipts. Nonetheless, the authorities face an important policy dilemma. On the one hand, they can ill afford a further real effective appreciation of the exchange rate, especially given the strength of the real rate since 1988 and the already precarious state of the balance of payments. Indeed, given that the trade reform has resulted in a substantial reduction in effective tariffs and easier access to imports, the loss in competitiveness is probably understated by the usual index. On the other hand, the authorities are inhibited from intervening to offset any further real appreciation because this would tend to increase money growth and jeopardize the program's inflation targets. This tradeoff has been explicitly incorporated in the performance criteria by requiring the authorities to partially sterilize the monetary impact of higher than expected reserve inflows. This seems to be a useful innovation, and we wonder whether similar mechanisms have been utilized in other Fund-supported programs.

Despite the substantial adjustment efforts made in late 1990 and this year, it is startling to note that private fixed investment is projected to fall by 2 percentage points of GDP, while private savings are expected to decline by 9 percentage points of GDP, compared with their average of the previous six years. Moreover, despite the authorities' tight fiscal and monetary stances, the current account deficit is not expected to improve but, indeed, is projected to deteriorate significantly over the program period. These trends illustrate the fact that the longer-term costs of eroding private sector confidence through economic mismanagement and hyperinflation are extremely difficult to recoup. As Peru's medium-term viability is clearly dependent on reversing the direction of these indicators, they also demonstrate, in stark terms, the risks to both the Fund and Peru of any deviation of the authorities from their commitment to sound macroeconomic and structural policies. This chair supports the proposed decisions.

Mr. Cirelli made the following statement:

Peru's request for a rights accumulation program constitutes a crucial step in its return to the international financial community, and I very much welcome this discussion. The staff report shows the sharp deterioration of the economy following several years of total mismanagement, and the road to overcome the present imbalances and difficulties will be a long and difficult one.

I take great comfort from the way the new authorities who took office last year have rapidly and forcefully acted. They have embarked on a comprehensive and strong program, which, undoubtedly, the situation required. Shock therapy was needed. These policies have now been followed for more than one year and initial results have been encouraging, even if the impact of putting the house back in order has also produced some unwelcome developments, such as a large recessionary effect and a temporary pickup in inflation. But some signs of recovery are visible. It is important that the authorities now build on and strengthen the process they have undertaken. Careful and consistent policy implementation is more important than ever if it is to foster a prompt return of confidence of the private agents and to increase greatly needed savings. For this objective, establishing the credibility of the authorities' actions is vital.

I share the staff's view that checking inflation is the main priority at present. A sound economic recovery and the return of confidence could only be based on a large reduction of inflation. Such an objective certainly requires firm anchors. Given the present situation, and the need to reinforce the stabilization process, I can understand that the exchange rate cannot immediately play the role of an anchor, but assigning an increased role to the exchange rate for anchoring the program should not be ruled out in the future. Under the present circumstances, the success of the program relies mainly on tight internal policies, particularly monetary and incomes policy. As regards the former, I welcome the policy of monetary restraint and interest rate flexibility which is being followed by the Central Bank. Avoiding monetary financing of the public sector deficit will also be an important element in the conduct of monetary policy. As regards incomes policy, I agree that wage restraint should be enforced so as not to endanger the initial slowdown of the inflation rate.

I welcome the fact that no net use of domestic financing for the public sector is contemplated in the program, and its financing relies on external financing. But should any shortfall become apparent in external financing, the authorities should avoid using monetary financing to compensate.

The program's success will not be possible without major efforts on the side of public finance. The primary surplus of the nonfinancial public sector, expected this year for the first time, is very important in that regard.

Considerable effort should be undertaken to enhance revenues, which are at a very low level. In passing, I note that, even with decisive action, the revenue prospects envisaged for 1991 and 1992 will still be significantly lower in terms of percentage of GDP than they were five years ago. In this context, the reform of the tax system certainly constitutes a priority. Streamlining the tax system and increasing its efficiency are indispensable, but care should be taken not to reduce revenue in the transitional period of reform implementation. I welcome the assistance of the Fiscal Affairs Department in this field. On the expenditure side, I wonder whether some room for maneuver is not possible, particularly with regard to the size of the civil service, which seems significant compared with other countries.

Several structural reforms are to be implemented, given the present plight of the economy. The rebuilding of the banking sector is essential to allow the efficient allocation of resources to finance the recovery of the economy, increase savings, and enhance monetary policy implementation. Public enterprise reform is also important; it will enhance the private sector and could lead to revenue gains that will facilitate the authorities' objectives. I encourage the authorities to move, as soon as possible, in this direction. Finally, in this connection, labor market reform is also indispensable to increase the flexibility of the economy's response.

Concerning the financing of the program, the process of regularizing relations with external creditors is compounded by the large amount of arrears that have accumulated for several years, rendering this process more difficult. I basically agree with the strategy adopted by the authorities. The regularization of relations with the multilateral institutions and the public creditors should constitute the first step in the process. This means that no improvement in the relations with private creditors can be expected within a very short period of time. I understand that no payment to commercial banks could be made in the present circumstances, but this situation should remain exceptional, and the authorities should undertake, as rapidly as possible--as is their intention--a process that will eventually lead to a regularization of relations with commercial creditors as well.

The financing requirements of the program for 1991 and 1992 are expected to be $1.3 billion, part of which will be covered through the efforts of the Support Group, to which France has contributed. The Paris Club is expected to consider the request made by Peru September 16. As stated in the staff report, this request requires exceptional terms from the creditor countries. We are, therefore, faced with more uncertainties than usual as regards the financing of the program. This stems partly from the fact that Peru's long-lasting arrears situation complicates the task of the international community, and because bilateral creditors' efforts cannot automatically cover the residual financing need. It is, however, too early to know what efforts the creditors of the Paris Club will agree to make. Nevertheless, despite these uncertainties, I believe that the Fund should take action and look closely at the situation at the time of the first review.

The efforts required of the international financial community to back the Peruvian program are very important. I recognize that the situation is particularly difficult for the authorities and that internal adjustments after so many years constitute a painful process for the population. I commend the authorities for the courageous measures they have undertaken aimed at breaking the vicious circle in which Peru was locked. I encourage them to pursue strict adherence to the objectives and reforms.

A lot is also expected from the multilateral institutions. So far, they have greatly contributed to the authorities' efforts through program design and technical assistance. I join Mr. Végh in praising the efforts made by the Fund's staff and management; continued involvement will be required. While no one will disagree that the situation entails some risks, this chair stands ready to back these efforts.

Whatever the efforts of the bilateral creditors, a major source of concern is the absence of Peru's medium-term viability. The medium-term outlook and thorough analyses included in the staff report are less than encouraging. Again, this raises questions about our future involvement. But, for the time being, I see no alternative to attempting to solve the problem of arrears to the multilateral institutions. The question of future Fund involvement should be reviewed after the clearance of those arrears.

Mr. Fridriksson made the following statement:

I concur with the thrust of the staff appraisal of the economic situation in Peru, and I welcome the Peruvian authorities' readiness to enter into a rights accumulation program with the Fund. Over the past year, Peru has embarked upon an impressive transformation of the economy into an open, market-based, and growth-oriented one following years of grossly inappropriate policies, which, among other things, resulted in a 30 percent decline in per capita GDP during the 1980s.

The front-loading of the adjustment strategy is essential and attests to the authorities' commitment to accomplishing fundamental and lasting changes in the economy. This is further underscored by the fact that a comprehensive reform of the tax system is to be completed before the first program review. I also give the authorities credit for sticking to their reform policies during the first half of this year as originally envisaged, even though the expected external financial assistance was not forthcoming.

Program results obtained so far are encouraging but must be quickly consolidated. This is important in view of the turbulent economic developments in recent years and the tremendous changes which have been associated with the implementation of the program so far, the most significant of which is the process of restoring market-based relative prices.

The major risk for the short term is a rekindling of inflation. Even though the rate of inflation has been sharply reduced, it remains very high, and its early reduction to low single digits must be given high priority. As determined in the recent review of conditionality, ambitious policies--including aggressive inflation targets--are very compatible with a strong revival of economic growth. Continued monetary and fiscal restraint is, therefore, essential, and it is crucial that monetary financing of public expenditure be completely avoided. Firm implementation of the tax reform under preparation is also vitally important for the establishment of a sound fiscal policy.

Further structural reforms are required. The privatization efforts should be speeded up in general, but particularly within the energy and mining sectors where the possibilities for exports seem most promising.

Peru's intention to normalize relations with external creditors is certainly to be welcomed. In view of the extremely fragile balance of payments outlook, however, these relations may have to go beyond mere normalization, as extraordinary efforts are required to bring Peru back to a viable balance of payments situation. External debt and debt service will remain high by any standard for the foreseeable future, even if one assumes comprehensive debt restructuring. Moreover, as indicated by the staff, capacity constraints in the traditional export industries will restrain export growth for several years, and capital flows to Peru may take considerable time to recover because of the grave damage inflicted by the debt-servicing policies of the previous Government. I would agree with the staff that the persistence of financing gaps and a debt-service burden of the magnitude projected for Peru calls into question the validity of the assumptions regarding investment and growth inherent in the medium-term projection. Without a dramatic change for the better, the balance of payments outlook can pose challenging questions for the Fund when we approach the successor arrangement after the completion of the rights accumulation program.

The rights accumulation procedure was established to enable countries with protracted arrears to the Fund to settle them in an orderly fashion. The invitation to establish such programs provided in itself exceptional possibilities for the countries concerned. So as not to undermine the credibility of the policy, my authorities consider it vitally important to adhere firmly to the agreed principles of rights accumulation programs. Among those principles, one is that the Fund should not endorse programs unless the necessary financing has been mobilized. The staff states that financing for 1991 is within reach, and for 1992 there has been significant progress in completing the necessary arrangements. In other words, the process has not been completed. In this connection, my authorities are disappointed by what they regard as insufficient and late information on the financing situation of the Peruvian program.

Moreover, I wonder why the rights accumulation program only covers 14 or 15 months--or "less than two years," to quote the staff appraisal. In the summing up of the Executive Board Meeting on June 20, 1990, it is stated that Executive Directors considered a three-year period to be appropriate as a norm for a rights accumulation program--but with scope for variation in either direction. Although I think I know how the staff will respond, I would like to ask for an explanation of the rationale behind the length of the proposed program; a clear explanation should actually have been included in the report.

In the past, this chair has emphasized the importance of achieving a reduction in the arrears to the Fund during the period of a rights accumulation program. To refer again to the summing up of the discussion of June 20, 1990, it is stated that the member would be expected to make maximum efforts to reduce overdue obligations to the Fund during the life of the rights accumulation program. There then follows the provision that in cases where it appears unavoidable, rights may accumulate up to the amount of arrears outstanding at the beginning of the program. This would seem to apply to Peru, as the fragility of the balance of payments outlook suggests that a reduction in arrears is impossible within the program period.

In sum, we have before us a short and underfinanced program without any expectation of a reduction in the arrears to the Fund. None of this is to our liking, and we would particularly urge the continuation of efforts on a broad front to close the financing gap for next year. However, the case of Peru is an exceptional one. Given the apparent determination of the authorities forcefully to address the economic difficulties, and the fact that Fund endorsement of the program seems to offer Peru the only way out of its extremely difficult situation, as well as for the Fund to secure its outstanding claims on Peru, I can lend my support to the proposed decisions. It goes without saying that the "new arrears" to the World Bank and the IDB must be settled this month as promised, and I welcome the advice from the staff that the process has been set in motion.

Mr. Al-Tuwaijri made the following statement:

It is gratifying to have before us clear signs of a determined effort by the Peruvian authorities to restore normal relations with external creditors. In the same spirit, I would like to state my support for the proposed decisions.

The authorities must be commended for the bold adjustment program they have undertaken since mid-1990. This program involves a comprehensive liberalization of the economy and tight financial policies. Already, significant progress has been achieved in lowering the rate of inflation, and, in response to the firm financial policies of the authorities, private capital inflows have resumed. Nevertheless, sizable imbalances remain, inflation is still high, and it is too early to make a firm assessment of the present and prospective health of the economy. On this score, I agree with the staff that the credibility of the program is not yet firmly established. Accordingly, there is no room for the authorities to relax their efforts, and more may well be required.

I am not entirely clear as to what the authorities or staff have in mind with respect to exchange rate policy, and I would welcome some clarification. In the description of policies, we are told that "the Central Bank will maintain a unified, floating exchange rate, and its intervention will be guided by the program's reserve targets." This would seem to imply a clean float of the exchange rate and would be consistent with the staff's recommendation that the highest priority be placed on lowering inflation. However, in the staff's appraisal, it is suggested that if the exchange rate were to appreciate in real effective terms as a result of strong capital inflows, then it may be appropriate to increase reserves by more than the programmed amounts. Furthermore, this additional accumulation of reserves would only be partly sterilized. In effect, a "dirty" float of the exchange rate and a higher rate of monetary expansion are being proposed. In turn, this appears to pose greater risks for the goal of reducing inflation.

I have some sympathy for trying to avoid a sharp appreciation of the exchange rate at a time when a large external imbalance is present. Nevertheless, with the economy undergoing such a radical transformation, I am not sure that we are in a position at this early stage to make an informed judgment on the appropriate level of the real exchange rate. Also, the sterilization operations involved with the proposed "dirty" floating regime may have undesirable consequences. First, the sterilization operations will place upward pressures on domestic interest rates and thereby create incentives for yet further capital inflows. Second, the interest payments associated with the sterilization operations will put pressure on the quasi-fiscal deficit. Both of these effects will complicate the task of monetary policy. Therefore, if inflation is the short-term priority, a clean float of the exchange rate may be preferable. I would be interested in the staff's comments on this question.

I share the staff's view that a rapid improvement in fiscal revenues is of the essence to ensure sustained financial restraint. Reforms in this area should, however, be of a lasting nature. This is particularly important in view of the pressures for increases in central government outlays for infrastructure and social programs. Realistically speaking, if Peru is to be successful in sustaining its adjustment over the longer term, some decompression of central government spending will be necessary. However, every effort should be made to restructure the composition of expenditures in order to contain their overall growth.

The medium- and longer-term outlook for the balance of payments is sobering. As the staff's analysis indicates, nothing less than a firm commitment by the authorities to adjustment over the longer term will be sufficient to restore external viability and attract the necessary external financial support. On this point, could the staff elaborate on the timetable for discussions with the Paris Club and private creditors, especially with respect to possible debt buy-back operations? In particular, what progress is expected to have been achieved within the rights accumulation program period?

The adjustment effort undertaken by the authorities in the past two years is indeed impressive. I urge them to face the challenges that lie ahead with the same vigor they have demonstrated so far.

Mr. Esdar said that he was pleased to join other speakers in commending Peru for its courageous and ambitious reform program, aimed at normalizing its relations with external creditors and overcoming its severe economic problems. The comprehensive and far-reaching adjustment measures implemented over a very short period of time had already shown the first positive results, as pointed out by Mr. Dawson. However, given the severity of the problems, some areas remained in which further improvement and an acceleration of the reform process would be welcome. In that regard, he shared the recommendations of the staff, and he supported Mr. Cirelli's remarks concerning the exchange rate.

The main problem of the program was financing assurances, Mr. Esdar remarked. Even after substantial donor commitments, financing gaps would not be closed fully, and it was uncertain whether the Paris Club or expected arrangements with other official creditors would provide the necessary additional relief to close existing gaps. He, therefore, hoped that it would be possible to mobilize additional financial support. However, the financial assistance of the international community could not be regarded as a kind of residual. Generally, economic programs should pay due regard to the available external resources, including debt rescheduling agreements. If financing gaps persisted, there was no alternative other than to adjust the program to existing realities. Given the extraordinary adjustment efforts in Peru, there was no easy way to overcome the situation. However, perhaps adjustment was possible in additional areas: accelerating the envisaged tax reform, further streamlining public expenditures, or adjusting administered prices. To close the remaining financing gaps through the buildup of renewed arrears would not be a solution, as doing so would undermine the common efforts of Peru and its creditors and would jeopardize the re-emerging confidence of the financial community.

The medium-term outlook of the balance of payments indicated that, despite expected significant capital inflows, Peru would continue to face large financing gaps in the projected period, Mr. Esdar noted. Given that situation, he shared the view of Mr. de Groote that it might be appropriate to review the underlying growth target of the program. A less ambitious growth orientation might lead to a more viable external position. He would appreciate the staff's comments.

In addition, the general question of the future role of the Fund in Peru was raised, Mr. Esdar continued. A permanent financial involvement to close the remaining financing gaps was not consistent with the Fund's role of provider of temporary balance of payments support.

On the length of Peru's proposed rights accumulation program, the agreed normal time frame had been reduced significantly, Mr. Esdar observed. The reduction might be justified by the strength of the program as well as by the convincing performance during the monitoring period. However, the shortening of the program period in the case of Peru should not be seen as a precedent for other cases.

The track record of the new Peruvian Government underlined the commitment to bold and extraordinary reform efforts, Mr. Esdar concluded. That commitment should also reinforce the expectation that the program could be adjusted to the financial support provided, if it was less than expected. Therefore, he supported the proposed decisions.

Mr. Spencer made the following statement:

I am in general agreement with the staff appraisal and Directors' earlier comments on the high quality and strength of Peru's rights accumulation program. Peru has clearly demonstrated an ability over the past year to implement politically challenging but economically indispensable measures, including large adjustments in key domestic prices, the unification of the exchange rate, and a tight lid on wage increases. Nevertheless, the situation remains fragile. Peru's deep-seated problems are such that substantial further policy actions, along the lines outlined in the program, need to be implemented if Peru is to have a reasonable chance of returning to a sustainable growth path over the medium term.

My comments relate more to the financing aspect than to the details of the program itself. But, like Mr. de Groote, my general impression is that the economic outlook portrayed in the program might be rather too optimistic. This view relates especially to the difficulty Peru will have in achieving significant further inflation reductions while promoting a recovery in exports and GDP growth.

To maintain downward pressure on inflation, it is unavoidable that the real exchange rate will be held up for a period as foreign capital is attracted by high real interest rates. However, the subsequent profit squeeze on exports, combined with the effects of lower border protection on import substitution activities, means that pressure will also be put on the current account and GDP growth during the disinflation period.

Could the staff comment, first, on how large real appreciation has actually been to date? Chart 2 in the staff report shows a massive increase, but the report states that the increase should be discounted to some extent. Does the staff have any more reliable indicators of the real exchange rate? Second, if there is real ongoing pressure on the traded sector, how is this reconciled with the assumed recovery in export growth from 1992 onward?

On the financing of the program, the external support has, unfortunately, been less than expected, but we have to be careful that a lack of support from elsewhere does not lead the Fund to assume an unwarranted greater share of the risk. If the duration of the rights program is two years, starting January 1991, this effectively implies a high average annual access of over 94 percent of quota in each of the two years. This level may not appear high when compared to the Zambian program, but both rights accumulation programs seem to suggest an inclination by the Fund to liberalize access further when dealing with arrears members than when dealing with members who are still struggling to keep up with payments. Any comment by the staff on this matter of relative access would be appreciated.

Looking beyond the rights program, the staff's illustrative assumption indicates average access of 50 percent of quota annually over 1993-95. Thus, under this scenario, outstanding Fund exposure in Peru could increase, net, by over 70 percent between now and end-1995, even though there seems to be little real prospect of Peru returning to external payments viability over this period. This further underscores the high degree of risk being shouldered by the Fund in this operation. The Fund is effectively accepting the prolonged and growing use of its resources by Peru for some time to come, even though, in the recent review of conditionality, several Directors were very much against such a practice.

My uneasiness, however, is moderated by the heavily front-loaded measures embedded in the program. In the exceptionally difficult circumstances faced by Peru, we can only reaffirm our admiration for the courageous actions taken by the Government since it took office last year. Nevertheless, a more even sharing of the burden would seem appropriate.

In this connection, I see some merit in Mr. de Groote's proposal, which would call upon Peru's commercial creditors to define now their contribution to the debt workout process. Under the current plan, maturing obligations to commercial creditors during the rights accumulation program period would be merely added to the stock of arrears for later settlement. There is the danger in this approach that commercial creditors would stand to benefit most from the fruits of the rights program, if it should succeed, since the market value of their claims are likely to increase; but if the rights accumulation program fails, they would be no worse off. It is, therefore, difficult to see fairness in the arrangement, and I strongly suggest that Peru should be expected to reach an agreement with its commercial creditors as soon as possible. This is not meant to exacerbate conditionality for Peru. On the contrary, the aim is to strengthen Peru's position vis-à-vis commercial creditors as well as ease the financing burden on the Fund.

Apart from the above concerns, I have no difficulty in endorsing the proposed rights accumulation program for Peru and in agreeing to the related decisions.

Mr. Torres made the following statement:

I commend the Peruvian authorities for the determination they are showing in continuing their adjustment efforts despite a very complex environment and difficulties in mobilizing the needed external financial support.

We are pleased that this Board is finally able to discuss Peru's request for the accumulation of rights. We hope that this will be a significant step in helping the Peruvian authorities in their commitment not only to reduce Peru's external and internal imbalances, but also to restore Peru's relations with the international financial community.

For many years, the Peruvian economy was subject to serious economic mismanagement and the economic indicators for 1990 still capture the impact of the economic policies taken in the past. The economic program for the remainder of 1991 and for 1992 represents the continuation and consolidation of the adjustment efforts that the Peruvian authorities initiated in 1990, aimed at reducing inflation while creating the conditions for sustainable growth. Those measures, described in the staff report--whose analysis and recommendations we broadly share--have removed rigidities and distortions and placed Peru on the path toward a market economy.

The unification and floating of the exchange rate, the liberalization of trade and international payments, the flexibilization of interest rates, the reduction of reserve requirements, the strong adjustments in fuel prices and other public services, and the steps taken to reduce price and wage rigidities deserve our commendation. We also welcome the changes adopted in the tax system, the approval of the new financial system law, the acceleration of the process of tariff reform and the recently approved foreign investment and privatization laws.

The results of the new economic program in 1991, as reported by the staff, are encouraging. The combination of tight monetary policy and fiscal discipline has contributed to the deceleration of the inflation rate and to the much-needed buildup of international reserves. There are also promising signs of increasing confidence in the private sector as reflected by capital inflows.

The transformation of the Peruvian economy has to continue in the years ahead, with strong emphasis on structural changes, without reducing the efforts in the fight against inflation. The program for 1991-92 contemplates measures in both directions. However, let me express some concerns. In the fiscal area, the nonfinancial public sector deficit for 1992 remains at the same level as in 1991, mainly owing to the behavior of the central administration accounts. Efforts will be made in the field of domestic revenues, but further reforms are needed to increase tax receipts. In this connection, we would like to know from the staff if the impact of the tax reforms that will be subject to approval by Congress next October has been considered in the projections for 1992.

The deterioration of wages and salaries is a problem that needs to be addressed in order to increase the qualifications of the labor force in the public sector, especially when administrative reforms are in place. We welcome the steps taken with respect to public sector employment policies, and we would like to learn more details about the impact of those policies on the fiscal deficit.

We also welcome the development of a privatization program and would like some comments about the resources involved and if they are considered in the figures for 1991-92. The strengthening of the finances of public enterprises and local governments has reduced transfers by the Central Government in 1991, but there appears to be no improvement for 1992. We would like to know if this fact is related to the policy of adjustments in prices and tariffs.

With respect to the balance of payments, the estimates for capital inflows reflect a significant increment for 1991 and a reduction for 1992, even though the figure remains high. Those capital inflows will be sterilized according to targets for money supply. We would like some comments from the staff about the viability of those flows, considering that they represent more than 100 percent of the accumulation of net international reserves, and what measures have been considered in the event that they deviate from estimates.

With great efforts the Peruvian authorities have been able to resume payments on debt-service obligations to multilateral institutions, and the arrears problem seems to be under control, with the clearance of arrears to the IDB during 1991, the rights accumulation program in the case of the Fund, and a similar "workout program" for the World Bank. However, the situation of Peru's external debt is far from being resolved. For the two years of the economic program under consideration today, and, given the most recent information on the projected total disbursements of budgetary and balance of payments assistance mobilized by the Support Group, there remains a financing gap of about $500 million that will require exceptional treatment by the Paris Club creditors and comparable terms from other bilateral creditors in addition to what was originally envisaged to be consistent with the financial requirements of the program. We hope that next week's Paris Club meeting will be able to yield a satisfactory agreement that can be honored by Peru.

According to the staff, the medium-term outlook for the balance of payments for the years beyond 1992 also shows the need for very favorable terms for debt relief and rescheduling agreements from all creditors. In addition, grants and disbursements from multilateral development banks and bilateral sources must, at least, be kept at the levels of 1991 in real terms in order to reduce the financing gaps. However, Peru's debt burden and the difficulties in improving the current account make it almost impossible, as shown in the staff tables, to eliminate the presence of financing gaps. The scenario presented by the staff produces a sense of frustration in a country that is beginning the long process of stabilization and transformation of its economy, and it raises the question of what is left for Peru after completing the program under discussion today. Although it is clear that all of the efforts are oriented toward Peru rejoining the international financial community, and that strong adjustment will be required for a long period of time, we consider that efforts will have to be made to improve the outlook for the years ahead. That will require not only stronger financial support from all creditors, but also increased technical assistance in order to develop and implement future programs that would alleviate the pessimistic scenario presented today.

In this regard, however, I share Mr. de Groote's concerns about the need to consider alternative scenarios. After all, it is not unlikely that we might be forced in the future to adapt the programs to financial realities, as observed by Mr. Esdar. Finally, I urge the international financial community to support Peru's efforts with the financing needed to continue on the long journey toward external viability and sustainable growth. We endorse the proposed decisions.

The staff representative from the Western Hemisphere Department commented that perhaps the most controversial aspect of the program was exchange rate policy. The staff had attempted to reflect in its report its serious doubts about the validity of the macroeconomic figures for Peru; the data indicated that almost all indicators had fallen in real terms at the same time, which suggested that the deflators were wrong, that GDP was overestimated, and that the consumer price index was inaccurate, reflecting the difficult issue of weighting. Thus, Chart 2 in the staff report should be interpreted with caution; the real appreciation of the exchange rate, while significant, was difficult to quantify.

The staff and the authorities considered that, in view of the serious distortions in the economy, it would be unwise to attempt to implement a policy of anchoring the exchange rate, the staff representative continued. To do so would convert the exchange rate into a political target and create added difficulties for credible management, in view of the extreme weakness of the fiscal situation. Instead, the highest priority should be accorded to stopping inflation, narrowing the fiscal deficit, limiting access to domestic credit, tightening the money supply, and allowing the exchange rate to float while a process of large-scale structural reforms was undertaken.

One effect of government policy had been an exchange rate appreciation, owing to temporary factors, such as high real interest rates in the initial phase, pulling in short-term capital inflows; the authorities' measures to open up the capital accounts of the balance of payments; and the re-establishment of foreign exchange deposit convertibility in the banking system, the staff representative noted. There had been a delay in reaping the effects of opening up the economy; for example, imports had not increased as expected, although tariff rates had been reduced, because of problems in customs administration.

It had been asked whether the authorities should move exchange rate policy away from the somewhat "dirty" float to a pegged exchange rate, the staff representative recalled. The present policy should continue until it was clear that expectations had settled down further, that inflation was under greater control, and that the fiscal position had some credibility. Meanwhile, the program had an element of flexibility that allowed the Central Bank to buy more foreign exchange than strictly indicated by the targets of the program and in effect to allow a pass-through of the money supply. As the process was consolidated, more emphasis could be placed on the exchange rate, allowing remonetization to take place.

On burden sharing, there was a risk that commercial banks might benefit somewhat from the rights accumulation program under the present arrangement, the staff representative commented. However, from another viewpoint, the case could be made that commercial banks and nonguaranteed suppliers, which had seen their debt traded at five cents to the dollar, were making an enormous contribution; and a solution to Peru's debt problem, involving very deep discounting, meant that the burden would fall heavily on those creditors. The staff hoped that arrangements could be put in train to deal with the debt issue--perhaps a menu of options, including tying debt reductions to the privatization process as well as a Bolivian-style buy-back at a discount--when resources for such an operation were available. The Peruvian authorities would meet with commercial bank creditors in the fourth quarter for further discussions on debt reduction.

With respect to the medium-term growth targets, the staff had questioned whether, in view of the fall in Peru's per capita GDP of 30 percent over the past few years to its 1960 level, scaling back the country's growth potential to barely the rate of population growth was politically and socially viable, the staff representative remarked. While the staff would encourage the country to make every effort to implement the full range of domestic reforms to accelerate growth potential, it was clear that the lack of foreign financing would remain a serious constraint for the foreseeable future. In the medium-term projections, the financing gaps were large, in part because the staff did not provide explicit assumptions for debt reduction but included a continued accumulation of obligations, for example, to nonguaranteed suppliers and commercial banks. Obviously, the country's growth targets would be feasible only if it received favorable treatment from bilateral creditors.

While a rise in total investment from 14 percent to 18 percent over the program period did not appear to be ambitious and could raise doubts about its adequacy to sustain the projected growth rate, it was difficult to see where further investment could be generated, the staff representative observed. However, along with structural reform, the efficiency of investment would likely improve substantially. Again, in that connection, the national accounts figures left much to be desired, They suggested that Peru had had negative growth, with investment rates that indicated severe inefficiency. They also implied that there was excess capacity in the economy that might be pulled in without requiring high levels of gross investment.

The sharp drop in national savings between 1990 and 1991 reflected the effect of shifting the inflation tax in a closed economy with a severe external bottleneck, the staff representative explained. Because of the difficult financing conditions of the economy prevailing until the stabilization program was adopted, the fiscal deficit was in effect forcing, through the inflation tax, a high level of national savings from the private sector. At present, a more normal distribution of savings was apparent, although, again, caution was necessary in interpreting those figures, which, in general, suggested trends rather than magnitudes.

The income tax rate reduction proposed by the authorities went somewhat beyond the recommendation of the Fiscal Affairs Department, the staff representative said. However, the key issue was not so much the tax system's rates as its administration. Tax evasion was deeply rooted in Peru, and restoration of the system would require elimination of the corruption that had led to the system's collapse. Meanwhile, reform of the value-added tax would broaden its coverage; and two major reforms of the income tax--key anchors of the tax program in the coming period--would involve, first, withholding at the source for payroll as well as interest income, which should produce a substantial pickup in revenue; and second, the introduction of a gross assets tax along the lines of the Mexican model, which would also generate revenue.

With regard to interest rates and the stability of the financial sector, the high real interest rates in Peru were not unusual in such stabilization programs, the staff representative remarked. For example, real interest rates had remained high for a long period following the initiation of successful stabilization programs in Bolivia, Israel, and Mexico--countries that also suffered from the same complications of short-term capital inflows and a downward pressure on the exchange rate.

Auspiciously, interest rates had recently started to fall sharply in Peru, the staff representative stated. Lending rates had dropped from 20 percent a month to 10 percent and would probably fall further, while deposit rates had dropped from 12 percent a month to 4 1/2 percent, as a result of improved coordination between the Ministry of Finance and the Central Bank as well as excess deposits by the commercial banks in the Central Bank. Possibly the Central Bank had helped to bring those interest rates down, reflecting greater confidence in the success of the stabilization program, because real interest rates could only be judged ex post. Nevertheless, the staff was concerned about the implications of high interest rates for the stability of the financial system. For that reason, the Fund--along with the IDB and the World Bank, which were also involved in the financial sector reform programs--had emphasized the need to improve banking supervision and reform so as to allow the authorities to be in a better position to face possible difficulties in the area.

As for the large operating spreads in the banking system, because of the financial disintermediation process, the scope of transactions in the banking system had been reduced, the staff representative noted. But banks remained overstaffed, and, almost universally, wages had been indexed so that costs in the banking system had become disproportionately large, increasing the spread. The reserve requirement was not responsible because it was remunerated at the average deposit rate.

The staff's appraisal had attempted to explain why the length of the program was justified, the staff representative from the Western Hemisphere Department stated. The Government had been implementing the policies for more than 13 months; in effect, the program had been ready to go to the Board and had been monitored since the beginning of the year, but the delay had arisen in putting together the financing arrangements. Admittedly, potential financing gaps remained, but, while he agreed with Mr. Esdar that the Paris Club should not be seen as a residual in the present case, the staff hoped that the results of the Paris Club's forthcoming meeting would indicate that the program was fully financed. Otherwise, discussions with the participants would continue in order to close any remaining gap, and the review under the program, scheduled before the end of the year, would allow further consideration of the issue.

The staff representative from the Exchange and Trade Relations Department said that Directors would recall that during the discussion of the rights approach, it had been recognized that for a number of members, given the high level of their arrears, the rate at which rights would accumulate would necessarily be quite high in relation to the general policy on access to the Fund's resources.

When the creditors, the authorities, and the Fund staff had begun to discuss the financing of Peru's program at the start of 1991, it had generally been felt that it would be important to clear the arrears to the Fund and to the World Bank by the end of 1992, the staff representative recalled. It was also important to note that the program would have been ready for presentation to the Board at the beginning of the year if financing of the rights accumulation period could have been arranged. If the period of the authorities' quantified economic program had covered two years, the annual accumulation of rights for Peru would be similar to the other rights accumulation program in place.

While the decision seemed to provide a disincentive to the country to make additional payments to the Fund if possible, it should be recalled that the purpose of the rights program was to clear the arrears, the staff representative from the Exchange and Trade Relations Department noted. Under the policy, the member was meant to minimize his recourse to rights. Accordingly, the member was expected to make maximum efforts to make additional payments during the period of the rights accumulation program, in addition to staying current in its obligations as they fell due. Of course, to the extent that the member made additional payments, the period of the rights accumulation program could be shortened and the day brought forward when Peru would be able to come to the Fund for a follow-on arrangement and regain access to the Fund's resources.

Mr. Kyriazidis observed that, meanwhile, there seemed to be a financial cost to the member. The Fund, through the rights approach, had made important compromises on long-held policy positions, but taking into consideration Peru's exceptionally difficult circumstances, the accumulation of rights did not provide an incentive to comply with the language in paragraph 3 of the proposed decision on overdue financial obligations, which stressed the need to give full and prompt settlement of arrears the highest priority.

The Chairman commented that, under the accumulation of rights, the basic incentive for Peru was to re-establish its creditworthiness and rejoin the international community, especially in view of the member's need for growth and international financing.

Mr. Wright stated that he welcomed the rights program, which had his wholehearted support. He also welcomed the World Bank's flexibility in developing parallel procedures to the rights approach to facilitate arrears clearance.

Like other speakers, he wished to commend the Peruvian authorities on their adjustment efforts, which they had pursued with determination and vigor despite the difficult economic and security situation, compounded by the recent cholera epidemic, Mr. Wright said. Peru's record of cooperation with the Fund under the present Administration had been stronger than any other country with arrears to the Fund.

Those efforts clearly justified a rights program of only 18 months' duration with a front-loaded accumulation of rights, Mr. Wright remarked. While Peru would not be expected to reduce its arrears to the Fund during the course of the program, the Fund's exposure would fall somewhat as Peru made repurchases under its earlier extended arrangement. He also welcomed the authorities' intention to pay the fresh arrears which had emerged to the other multilateral institutions; it was essential that Peru remain current on its payments thereafter.

The program was appropriately strong, Mr. Wright commented. There was considerable urgency to broaden the revenue base: at only 8 percent of GDP, central government revenues were little more than one third of the level in neighboring countries. In particular, very little was raised from income and property taxes. The program's revenue targets did not seem overly ambitious, although he was reassured that implementation of the first phase of the tax reforms was a condition for completion of the first review. Presumably, the emergency taxes on wealth and shares would be removed when the tax reform was implemented. There was a case for setting quantitative performance criteria for tax revenue for subsequent reviews.

Given Peru's precarious external position, effort needed to be focused on accelerating the privatization of key export industries and encouraging foreign investment, Mr. Wright stated. He would have liked to see a more detailed account of priorities in that area.

It was clear that the currency remained overvalued, although it was difficult to determine by how much, Mr. Wright observed. There was an obvious policy dilemma, given the need for tight monetary policy. He would have been interested in the staff's comments on the consistency of the present level of the exchange rate with achieving a return toward external viability. It was essential that the currently tight stance of monetary policy was not undermined by unsterilized capital inflows. He was unsure how the authorities proposed to deal with such flows, particularly if they took the form of resident holdings of dollars.

As other speakers had observed, there remained a large residual financing gap for the rights program, Mr. Wright commented. Much would depend on the attitude taken by the Paris Club the following week. He looked forward to the staff's report on the outcome of those discussions and its assessment of any implications for the financing of the program.

Many speakers had mentioned the extremely difficult medium-term outlook and the distant prospect of external viability, even on the assumption of repeated rescheduling, Mr. Wright remarked. Clearly, the international financial community would wish the Fund to be closely involved in the formulation of economic policies in Peru. Beyond that catalytic role, however, and notwithstanding Peru's excellent efforts, caution would have to be shown in the matter of the Fund's own exposure, particularly when considering whether any significant increase in exposure beyond present levels should be envisaged.

Strong policy implementation was, therefore, all the more crucial, since that would help secure an appropriate response by official and private creditors, Mr. Wright said. He particularly encouraged the authorities to make an early start on talks with private creditors. Doing so could clear the way for eventual debt reduction, although the staff's cautionary comments on how much progress could be expected in the short term were well taken. He supported the proposed decisions.

Mr. Fernando stated that he supported Peru's accumulation of rights program on the basis of the exceptional and sustained efforts made by that country to rehabilitate a shattered economy. He particularly noted the confidence placed by the authorities in the Fund's intensified cooperative strategy and the vigor with which they had adhered to the program of stabilization in the early period when external financing prospects were discouraging. The record of the authorities in meeting maturing obligations to the Fund for over two years, and the major reforms in the exchange market together with the strengthening of the role of the Central Bank, augured well for monetary discipline.

He joined other Directors in recognizing the considerable uncertainty with regard to attainment of balance of payments viability, Mr. Fernando remarked. The obvious risks, both to Peru and to the Fund--which were already very high--were even greater as the rudimentary potential scenarios for reducing the debt overhang showed that prospects in the official bilateral area would scarcely make a dent in the outer-year projections. Despite the dark clouds, Peru's determination argued for a large measure of the benefit of the doubt.

Mr. Mojarrad observed that the staff's analysis pointed to a degree of optimism for the future outlook of the Peruvian economy. The authorities should be commended for their seriousness of purpose and their record of prior action and policy implementation in the past year, particularly in the areas of fiscal consolidation and reform of trade and the exchange system. Moreover, the staff was optimistic that further gains in all areas could be expected in the coming year as additional adjustment policies were implemented.

It was clear that Peru would need substantial debt relief immediately and sizable capital inflows in the medium term if viability was to be restored to the economy, Mr. Mojarrad noted. His chair joined Mr. de Groote in urging commercial creditors as well as official creditors to make an exceptional effort to reduce the heavy debt burden so that the authorities' attempts at creating a stable macroeconomic environment would be successful, thus allowing capital inflows and stimulating private investment. His chair agreed with the thrust of the staff's appraisal and supported the decision; like Mr. Végh, he believed that approval of the accumulation of rights was an important signal that a debt strategy based on a cooperative international solution was workable.

Mr. Posthumus made the following statement:

I am prepared to approve the request of the Peruvian authorities to start a rights accumulation program. This also means that, if the program remains on track, approval will have to be given to a new arrangement with an immediate disbursement of almost 200 percent of quota.

Peru has undoubtedly reversed its course, and it has taken an impressive series of adjustment measures. But although hyper-inflation has lost its prefix, the economy is still beset by unsustainable rates of inflation. I fear that we are facing a development in which the inflationary process has taken a new course: with shortfalls in revenue, the Government has taken recourse to repeated price hikes of fuel and utilities. These nominal shocks have exacerbated inflationary expectations which have exposed the economy to speculative capital flows and at the same time suppressed real economic activity. Whether the present anti-inflation program, including the floating exchange rate regime, can face this problem seems to me uncertain.

In addition to Mr. Clark's comments on financing assurances, I would add that we do not have to worry about financing assurances for the Fund because there are arrears already. But the medium-term scenario, as reflected in the long-term balance of payments outlook (Table 11, EBS/91/141) is appalling, and it shows that financing assurances for the Fund will not be fulfilled after the rights accumulation program has been completed, and arrears to the Fund will have been replaced by a Fund-supported program.

We have assumed the catalyzing role is, to some extent, a role that is expected from the Fund, but at the same time it is an opportunity for creditors and bankers to shift their financing burden to the Fund. This role is a broadening of our formal responsibilities and purposes. This institution, like other institutions, should beware that such broadening of purposes is not at the account of its primary responsibilities. Peru needs the Fund as an advisor and in support of adjustment programs. But it goes too far, in my view, to say that "catalyzing exceptional support is likely to require continued access to Fund resources over the medium term," notwithstanding an obvious lack of financing assurances even after the rights accumulation program has been implemented. If the medium-term outlook remains as it is in Table 11, Peru's capacity to repay the Fund is in doubt. I can only say at this moment that continued access to Fund resources over the medium term, for catalyzing support, should therefore be considered very cautiously.

On a procedural matter, Mr. Posthumus suggested that the lead speaker system should be reviewed so as to ensure its manageability and efficiency. It was important to avoid a situation where a process of several lead speakers might give the erroneous impression that non-lead speakers had less interest in the country being discussed.

The Chairman said that the system of lead speakers, whereby a few speakers made substantive remarks and others added to or dissented from those remarks, should be upheld, because it led to constructive debates. Of course, the procedure could be improved, and perhaps the Board could return to the matter following the Annual Meetings.

Mr. Végh commented that, as most Directors had said, the present discussion was an important occasion not only for Peru but also for the Fund. As he had stated during the Board discussion of Peru's arrears on March 15 (EBM/91/38), the success or failure of the arrears strategy of the Fund would be decided by the critical case of Peru. In other cases, there was no hope of a solution in the near future, and the obligations would have to be written off at some time. In a few cases, success was quite probable, and Peru was the decisive one.

On the question of the appreciation of the real exchange rate, the answer provided by the staff representative was entirely correct, Mr. Végh noted. He would simply add the fact that both theoretical studies and empirical evidence suggested that in any stabilization program, whatever the exchange rate strategy--fixed rate, floating rate, or other--real appreciation in the early stages was inevitable.

While it had been commented that the level of investment was rather low, he agreed with the staff that the solution would lie in the efficiency of investment, Mr. Végh said. That point was a very important one. Without doubt, the quantity and quality of structural reforms taking place in Peru would strengthen the efficiency of investment, which in the past had been very low and even negative in some government projects. The reform in agriculture, for instance, would have a dramatic effect in completely reversing 20 years of tremendous mistakes of socialism/collectivism.

On financing assurances, he agreed that perhaps the guidelines and principles were not being followed strictly, but he reminded the Board that the same had been done for many other countries, Mr. Végh noted. In the case of Eastern Europe, on several occasions, he and other Executive Directors had expressed doubts as to whether the Fund was following strict principles of balance of payments need for Fund involvement. He was sure that the Fund had become involved in situations where the protracted use of resources was inevitable from the beginning for new users. He would argue that privileged consideration was not given to countries in arrears, and while the transformation taking place in Eastern Europe was fascinating, the silent revolution and radical transformations taking place in other regions of the world should not be forgotten.

The Chairman made the following summing up:

Executive Directors welcomed the fundamental reorientation of economic policy in Peru since August 1990. In their view, the present strategy, based on disciplined fiscal and monetary policies, maintenance of a unified market-determined exchange rate, and structural reforms to increase competition and economic efficiency, held out the best prospects for a sustained improvement in economic conditions. But Directors noted that the program was being implemented under very difficult circumstances: the Government faced major challenges from terrorism and narcotic trafficking, the social infrastructure had deteriorated sharply, and living standards of much of the population had declined. While recognizing the fragility of Peru's economic situation, Directors were encouraged by the success of the program to date, particularly in controlling the public sector deficit, reducing inflation, and opening the economy. They welcomed the close cooperation with the Fund and other multilateral financial institutions in the design and implementation of Peru's economic program and in seeking to re-establish relations with the international financial community, in the context of a rights accumulation program. They also noted with satisfaction Peru's track record of payments to the Fund and the arrangements to resume payments to the World Bank and the Inter-American Development Bank.

Directors stressed that the avoidance of use of domestic credit by the public sector was essential to the success of the program. They therefore urged that highest priority be given to the efforts to restore the tax and customs administrations, to strengthen the tax system, and to increase Peru's revenue effort, which is now unduly low through reforms of the value-added, income, and wealth taxes.

Directors considered that there was an urgent need to improve the financial performance of the public enterprises, not only through appropriate pricing policies but also by taking steps to improve their efficiency and reduce costs. They welcomed recent actions to eliminate public sector monopolies and begin the privatization of some public enterprises.

Directors noted that the fragility of the fiscal situation placed a particularly heavy responsibility on monetary policy in containing and reducing the still high rate of inflation. At the same time, major emphasis should be given to strengthening the supervision and prudential regulation of financial institutions and to reforming the official banking sector. Concern was expressed that the very high real interest rates and resulting capital inflow would complicate monetary and exchange rate management. Exchange rate policy and the maintenance of competitiveness should be kept under close review.

Directors welcomed the early decision by the Government to eliminate controls on wages and prices in the private sector. They urged that other actions be taken to increase labor market flexibility in order to help address the unemployment problem.

Directors felt that the rapid liberalization of the exchange and trade systems that had been implemented during the preceding year had improved economic prospects. They referred in this connection to the elimination of restrictions on payments for current international transactions, the abolition of quantitative controls on imports, and the simplification and substantial reduction of import tariffs. They urged the authorities to persevere in these areas.

Directors expressed concern about Peru's medium-term balance of payments prospects. Even with strict adherence to a demanding adjustment program, together with continued assistance from donors and creditors, balance of payments viability appeared elusive for some years ahead. In this context, a few Directors believed that the GDP growth prospect built into the program appeared to be optimistic or perhaps on the ambitious side.

Directors noted the efforts made by the multilateral institutions and bilateral creditors and donors, within the framework of the Support Group for Peru, to mobilize external financing for Peru's adjustment program. They underscored the need to ensure that the expected disbursements of additional budgetary and balance of payments support would become available on a timely basis, as well as to mobilize additional external financing. They also expressed the hope that Peru would receive favorable treatment at the Paris Club to facilitate completion of the program's financing arrangements. They welcomed the arrangements that had been made for the imminent clearance of arrears to the Inter-American Development Bank (IDB) and the initiation of substantial disbursements of IDB adjustment lending, as well as the World Bank's intention to accumulate potential disbursements under structural adjustment loans. In sum, the restoration of balance of payments viability will require determined implementation of adjustment policies and continued substantial financial support from the international community, including measures to make the debt-service burden more manageable.

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

The Executive Board then took the following decisions:

Exchange Measures Subject to Article VIII

1. The Fund takes this decision relating to Peru's exchange measures subject to Article VIII, Sections 2 and 3, in the light of the 1991 Article IV consultation with Peru conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. As described in EBS/91/141, Peru maintains an exchange restriction on payments and transfers for current international transactions evidenced by external payments arrears vis-à-vis certain official and commercial creditors which are subject to Fund approval under Article VIII. The Fund notes the intention of the authorities to settle external arrears with official bilateral creditors. In the meantime, the Fund grants approval for the retention of the exchange restriction vis-à-vis official bilateral creditors pending the conclusion of rescheduling agreements until December 31, 1991 or completion of the first program review, whichever is earlier.

Decision No. 9817-(91/121), adopted
September 12, 1991

Accumulation of Rights

The Fund approves the accumulation of rights for Peru as set forth in EBS/91/141.

Decision No. 9818-(91/121), adopted
September 12, 1991

Overdue Financial Obligations - Review Following Declaration of Ineligibility

1. The Fund has reviewed further the matter of Peru's overdue financial obligations to the Fund in the light of the facts and developments described in EBS/91/151 (9/9/91).

2. The Fund welcomes Peru's adoption and implementation of a comprehensive program of macroeconomic adjustment and structural reform. The Fund also welcomes the authorities' intention to pursue a Fund-monitored rights accumulation program in the period through December 1992. The Fund stresses therefore the need and the importance of appropriate and timely external financial assistance in support of Peru's adjustment efforts and to facilitate the elimination of its overdue financial obligations. The Fund intends to continue to assist Peru under the intensified collaborative approach, including in its efforts to secure the necessary external financial assistance. The Fund urges creditor and donor countries to provide such financial assistance on a timely basis in order to permit the successful implementation of the rights accumulation program.

3. The Fund notes the recent payments made by Peru and Peru's intention to continue settling financial obligations to the Fund as they fall due, pending full settlement of its arrears. Nevertheless, the Fund regrets the continued existence of Peru's overdue financial obligations to the Fund and stresses that full and prompt settlement of these arrears should be given the highest priority, and notes that efforts toward their settlement are under way.

4. The Fund will review the matter of Peru's overdue financial obligations to the Fund again at the time of the first review of Peru's rights accumulation program for Peru or within six months, whichever is earlier, in light of the actions taken by Peru in the meantime toward settlement of its arrears to the Fund and implementation of the rights accumulation program.

Decision No. 9819-(91/121), adopted
September 12, 1991

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/91/120 (9/11/91) and EBM/91/121 (9/12/91).

6. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 90/163 and 90/164 are approved.

APPROVED: February 27, 1992

LEO VAN HOUTVEN
Secretary