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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 91/139

10:00 a.m., October 4, 1991

R. D. Erb, Acting Chairman

Executive Directors

M. Al-Jasser

Che P.
C. S. Clark
T. C. Dawson

E. A. Evans
R. Filosa

M. Fogelholm
H. Fukui
B. Goos

A. Kafka

A. Mirakhor

D. Peretz
G. A. Posthumus

Alternate Executive Directors

A. A. Al-Tuwaijri
L. E. N. Fernando

G. C. Noonan
J. M. Abbott, Temporary
S. B. Creane, Temporary
J. Prader
G. H. Spencer
N. Kyriazidis
M. A. Ahmed, Temporary
I. Fridriksson

W. Laux, Temporary
C. D. Cuong, Temporary

I. Martel
P. Bonzom, Temporary
O. Kabbaj
M. J. Mojarrad, Temporary
T. Berrihun, Temporary
P. Wright
Z. Trbojevic
A. R. Ismael, Temporary
M. Da Costa, Temporary
L. J. Morelli, Temporary

C. Brachet, Acting Secretary
S. W. Tenney, Assistant

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Also Present

IBRD: M. Durdag, D. Pearce, Asian Regional Office. Central Banking Department: M. Guitián, Associate Director. Southeast Asia and Pacific Department: K. Saito, Director; M. J. Fetherston, J. E. Leimone, Y. Lum, E. A. Milne. European Department: M. I. Blejer, M. Mecagni, R. Sahay, A. Singh, B. B. Zavoico. Exchange and Trade Relations Department: J. T. Boorman, Director; J. Ferrán, Deputy Director; M. E. Edo, M. G. Gilman, D. L. Gleizer, J. P. Guzman, K. M. Huh, G. R. Kincaid, M. Precious, B. E. Rourke, M. Shadman-Valavi. External Relations Department: R. R. Brauning. Fiscal Affairs Department: V. Tanzi, Director; J. Baldet, A. Ize. Legal Department: J. L. Hagan, A. O. Liuksila, J. M. Ogoola. Secretary's Department: K. S. Friedman. Treasurer's Department: D. Williams, Treasurer; G. Wittich, Deputy Treasurer; S. I. Fawzi, O. Roncesvalles. Western Hemisphere Department: S. T. Beza, Counsellor and Director; J.-P. Amselle, E. G. de la Piedra, J. Fajgenbaum, A. M. Jul, B. M. Traa, F. van Beek. Advisors to Executive Directors: L. Dicks-Mireaux, B. R. Fuleihan, M. Galán, A. Gronn, M. Nakagawa, F. A. Quirós, B. Szombati, A. M. Tanase, S. von Stenglin. Assistants to Executive Directors: J. R. N. Almeida, J. A. Costa, T. P. Enger, N. A. Espenilla, Jr., H. Golriz, S. Gurumurthi, A. Giustiniani, M. E. Hansen, O. A. Himani, J. Jamnik, J. Jonas, J. Mafararikwa, M. Mrakovcic, R. Powell, S. Rouai, S. Shimizu, C. M. Towe, J. W. van der Kaaij.

1. ALBANIA - MEMBERSHIP - REPORT OF COMMITTEE

The Executive Directors considered the report by the Chairman of the Committee on Membership for the Republic of Albania, recommending the approval of a draft membership Resolution for Albania for submission to the Board of Governors for a vote at the 1991 Annual Meeting (EBD/91/280, 10/2/91).

On behalf of Mr. Végh, the Chairman of the Committee on Membership for Albania, Mr. Posthumus stated that the Committee had reached a consensus on an initial quota of SDR 25 million for Albania, and the Albanian authorities had indicated that they accepted the Committee's proposal. He hoped that the consensus would be acceptable to the Executive Board.

Mr. Dawson said that he supported the Membership Committee's recommendations.

The Acting Chairman noted that the Joint Procedures Committee would meet immediately following the opening plenary session of the Annual Meetings to consider the report by the Executive Board--and attached draft Resolution--on Albania's application for membership. At the beginning of the second session, the Reporting Member would submit the Committee's report recommending that the Governors adopt the draft Resolution. If they did so, the country's admission to membership would be approved.

The Executive Board then took the following decision:

The Executive Board adopts the Report to the Board of Governors on Membership for the Republic of Albania in the Fund and approves the Resolution appended thereto for submission to the Board of Governors for a vote during the 1991 Annual Meeting.

Decision No. 9840-(91/139), adopted
October 4, 1991

2. MONGOLIA - 1991 ARTICLE IV CONSULTATION, AND STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1991 Article IV consultation with Mongolia and its request for a 12-month stand-by arrangement in an amount equivalent to SDR 22.50 million (EBS/91/156, 9/11/91). They also had before them a memorandum on economic reform and medium-term policies (EBD/91/269, 9/16/91).

Mr. Evans made the following statement:

Like its Eastern European counterparts, Mongolia has begun the task of shucking off its centrally planned shackles. It has done so with an enviable enthusiasm, reflected in the progress made to date in many key areas of structural reform, as is well detailed in the staff report. This more than promising start has

been tempered, more recently, by an increasing awareness of the need for appropriate sequencing of reforms and strong stabilization efforts as the effects of early reform efforts were found to have exacerbated the impact of shocks on the domestic economy.

Much has been written about the significant negative output effects on Eastern European countries arising from strong reliance on trade within the Council for Mutual Economic Assistance (CMEA) and specifically dependency on the U.S.S.R. However, in no case in Eastern Europe was this dependency as acute as it was--and to a large extent remains--for Mongolia. Mongolia was not only heavily reliant on the U.S.S.R. and other CMEA members for trade, but also its economy was strongly integrated with that of the U.S.S.R.--extending to integrated transport and electricity links. Thus, the effects stemming from dislocation in the U.S.S.R. have added to the transformation task faced by Mongolia.

The program put forward by the staff and Mongolian authorities for Board consideration is comprehensive, with a heavy emphasis on structural reform. These programmed and wide-ranging structural reforms over the next three years or so will move Mongolia's economy rapidly to a market-based system. This reflects the Mongolian authorities' determination to proceed as rapidly as possible to the full economic transformation of their economy. As the staff foreshadows, at the start of its report, should Mongolia become eligible for an ESAF arrangement, such a shift will be under active consideration. In the meantime, the stand-by arrangement will allow the authorities to continue with their adjustment efforts and help catalyze the necessary donor assistance to allow the needed structural reform.

That said, and in view of the fragility of the current situation, the priority remains to restore economic stability. Notwithstanding their efforts in the structural reform area, the cornerstone of the stand-by arrangement is the restoration of financial discipline. The stabilization effort has already commenced with the authorities having implemented a number of expenditure restraint and revenue enhancing measures. While the containment of the fiscal deficit in 1991 will be achieved primarily by mobilizing revenue, the authorities have restrained budgetary expenditures, and monetary policy has been significantly tightened.

A number of uncertainties remain, not least in relation to the developments in the U.S.S.R. and the disbursement of external assistance particularly into the medium term. In addition, Mongolia is somewhat more geographically isolated than most other countries, while its internal markets are thin and fragmented. The authorities are aware of the challenges they face but, as the staff notes, support for the political, economic, and structural reforms is broad based. The Mongolian authorities also see themselves as ideologically well placed to learn both from their East-

ern European counterparts to the west in facing their economic transformation and their Asian neighbors to the east for the dynamism that they hope in time will make them another of that region's newly industrializing economies.

My Mongolian authorities have benefitted greatly from discussions with Fund staff during the Article IV consultation and program discussions. They also value very highly the Fund's provision of technical assistance in the fiscal, statistical, and monetary areas. They look forward to continued technical assistance in these and other areas and hope that conditions can be created to allow the provision of a resident representative, as has become the norm for other economies in transition. Finally, they acknowledge, with gratitude, the leadership role of Japan and the United States in galvanizing aid support within the World Bank framework.

Mr. Fukui made the following statement:

Let me start by welcoming this opportunity to discuss the request from the Mongolian authorities for use of Fund resources under the stand-by arrangement.

The case of Mongolia is unique in that it had virtually no experience of a modern market economy until the new Government took office in April 1990. As the staff report illustrates, prices, interest rates, wages, and exchange rates played no role in the allocation of resources. Investments were heavily dependent on the availability of foreign resources, particularly from the U.S.S.R. There was virtually no market mechanism in the conduct of monetary policy; whether there was a monetary policy at all was even doubtful. Almost 100 percent of external trade was carried out with other CMEA partners, the bulk of which was with the U.S.S.R.

Therefore, the wide-ranging reforms that have been implemented by the authorities since April 1990 should be looked at as an unprecedented experiment in the transformation of an economy. This chair is strongly impressed by the authorities' resolve to carry out this reform.

Since the authorities are starting from almost zero, the initial shock will be substantial, especially in the context of losing U.S.S.R. assistance. An increase of more than 100 percent in the price level since January 1991, a further weakening of the budget position, and the accelerating expansion of net domestic credit and M2 in the first half of this year demonstrate the impact of this development and underscore the urgent need for the authorities to quickly establish the economic and legal institutions that will enable them to exercise control over the economy. They also indicate that Mongolia's reforms need to be supported by

appropriate external financing. Accordingly, this chair strongly supports the formulation of an economic program for Mongolia assisted by a stand-by arrangement.

With respect to the proposed program, I welcome the fact that priority was given to restoring economic stability and to strengthening the authorities' capability in macroeconomic management based on market mechanisms.

In the fiscal field, it is encouraging that steps to increase revenue are being taken through the introduction of a number of measures, including a 10 percent temporary surcharge on imports, an increase in excise tax rates, and an expansion of excise tax coverage. I also welcome the authorities' intention to introduce from July 1992 a 10 percent broadly based sales tax on domestic goods. More important, however, is the need to improve the system to monitor and control expenditures.

As to monetary policy, priority should be given to developing indirect or macroeconomic financial control instruments. In this context, the recent introduction of a reserve requirement by Mongolbank, as well as the increase in its loan rate for commercial banks deserves attention. The most important task, however, will be to strengthen the function of Mongolbank as a modern central bank. The fact that the branches of the former State Bank, which remain part of the new central bank, are a major source of credit expansion is a cause for concern. Strong control from the head office of the central bank is necessary.

In the external sector, I welcome the drastic devaluation of the tugrik in June 1991. This shows the authorities' firm commitment to the integration of the Mongolian economy into the international market. At the same time, given the very fragile situation with respect to foreign reserves as well as domestic prices, the authorities have chosen to take a rather modest approach in the reform of the trade and payments system. However, in order to foster a competitive export sector and to realign the domestic price structure in accordance with international levels, it will be necessary at a later stage to decrease the remaining restrictions, which insulate the domestic economy from the external world. I hope the authorities will further strengthen their reform of the external sector during the course of the program. In this connection, the staff's explanation of the medium-term objectives of the external reform is welcome.

With respect to the structural area, the rapid speed with which the authorities have established a legal and regulatory framework, such as the Foreign Investment Law and other legislation covering banking, corporations, bankruptcy, monopolies, and private property, was quite impressive. Also, the fact that the authorities took further steps to decontrol prices, leaving con-

trolled prices on only 17 goods, is encouraging. I welcome the staff's explanation of the further price liberalization that is envisaged early next year.

As I have stressed, it is essential that the international community provide Mongolia with appropriate financial support, particularly at the initial stage of its reforms toward the development of a market-based economy and its process of integration into the international community. Given the distance Mongolia has to cover, the importance of such assistance is manifest.

In light of these considerations, my authorities have extended especially positive support to Mongolia's reforms. Following the Summit meeting of the Group of Seven in London that stressed the importance of international support for Mongolia, a donors' meeting was held in Tokyo, co-chaired by Japan and the World Bank. The outcome of that meeting was very positive, as reported in the staff's memorandum on economic reform and medium-term policies. With the additional commitment from major donors, including a ¥2 billion nonproject grant and a ¥4.8 billion loan pledged by my authorities, the financing gap for the program period is almost filled. Given the monumental task the Mongolian authorities are undertaking, the importance of timely international support cannot be overemphasized. The proposed stand-by arrangement will help lay the basis for Mongolia's external viability in the future.

With these comments, I support the proposed decision.

Mr. Prader made the following statement:

The combined effects of central planning and Mongolia's strong dependence on the U.S.S.R. for both trade and extensive bilateral concessional assistance have created a task for the Mongolian authorities that is much more difficult than that faced by any country in Central and Eastern Europe. Mongolia has not only to overcome the deficiencies of the former irrational system, but it must also cope with exogenous shocks stemming from changes in the U.S.S.R. Sudden cuts in U.S.S.R. trade and financial assistance make the task of reform more urgent and much more difficult--indeed, impossible--without adequate temporary external financial assistance.

Before commenting on the program to be supported by the proposed stand-by arrangement, let me review developments in 1990 and the first half of 1991. Like the other economies in transition, Mongolia displayed the by now familiar picture of planning production with sharp upward price jumps and rising unemployment. However, for Mongolia, the picture was different in two respects. In Central and Eastern Europe, the production decline was generally

more severe than the employment decline, causing labor productivity to fall; the data from Ulaanbaatar show that the pattern in Mongolia has been the opposite. Second, judging from the performance of fiscal and monetary policies in the first months of 1991, the Mongolian authorities did not attach as much importance to financial restriction as did the governments of the Central and Eastern European countries.

To be more specific, we have doubts about the appropriateness of some of the fiscal policy measures taken during the first half of 1991. Given the loss of U.S.S.R. assistance, the deterioration of the fiscal position probably could not have been prevented, but we are not altogether convinced that it was necessary, under the circumstances, to double certain wage and benefits expenditures. Such a move is bound to generate further price pressures and create later pressures for additional compensation to cover the increased prices. We urge the authorities to approach any further moves of this kind with caution. At the same time, we welcome the steps taken in May toward redressing the fiscal imbalances, which can be seen as an important signal that the authorities are prepared to deal appropriately with the budget deficit in the future.

The stance of monetary policy was also ambiguous at best. Net domestic credit expanded during the first half of 1991 at an annualized rate of 175 percent, which indicates a rather accommodative monetary policy. Such an expansion cannot have been due to demand of the public and the Government, especially when the budget imbalances are so large. The growth rate of credit to the private sector is equally worrisome, even though it started from a low level. It is doubtful that the number of creditworthy projects can have grown as fast. A more realistic explanation of the expansion of credit to the private sector is inadequate risk assessment by the banks. Such practices can only worsen the problems stemming from old bad loans and endanger the functioning of the financial system.

The rationing system introduced in response to shortages of basic consumer goods is nothing more than a very short-term measure. Although rationing is a reasonable response, when the basic needs of the population are at stake, it must be kept in mind that rationing addresses the effects and not the causes of the problem. The only possible long-term solution to any shortage problem is to target income support to the needy, while allowing prices to rise and evoke a supply response.

Despite all these reservations, we are greatly impressed by the amount of legislative work that has already been done in Mongolia. Considering that Mongolia began its reforms much later than the countries of Central and Eastern Europe, it has made a lot of progress. Much remains to be done, but the program of

economic stabilization and structural reform currently under consideration provides an adequate framework for achieving further progress.

However, some of the details of the program are still unclear. First, while I understand why the inflation rate will reach some 150 percent this year, I wonder why the program still targets the 1992 increase in consumer prices at 50 percent. The 1992 inflation targets in the Central and Eastern European countries are much lower. Does Mongolia's high target for inflation reflect a larger number of prices to be liberalized under the 1992 phased approach to price reform, changes in administered prices, the effects of exchange rate movements, or simply the lax stance of monetary policy? To what extent does the inflation rate in Mongolia depend on the rate of inflation in the U.S.S.R.?

Second, we support the authorities' intention to strengthen budgetary performance, but we do not have enough information about the planned package of tax measures to judge its adequacy. In recent years, government expenditures were well above 60 percent of GDP, and this year they should even reach a record-breaking level of 77 percent. In 1992, the share of government spending is expected to fall by some 17 percentage points, but the resulting level of 60 percent of GDP still leaves room for further spending cuts. I wonder why spending cuts do not play a large part in the fiscal consultation. Also, if the planned tax measures do increase budgetary revenues before the end of 1992, as they are supposed to, how can the GDP share of budgetary revenues fall from 62.7 percent in 1991 to 48.5 percent in 1992?

Third, a major problem typically left over from the days of central planning is nonperforming bank loans stemming from the fiscal actions of previous governments. At the present stage, it is generally accepted that, unless those nonperforming loans are adequately dealt with, monetary policy will be seriously constrained, since decision making by the commercial banks will still be dominated by the desire to minimize possible losses from those loans. We wonder how serious this problem is in the case of Mongolia and what plans Mongolbank has for dealing with these problem loans during 1992.

Fourth, as my constituency includes the country that pioneered the voucher method of privatization, we welcome Mongolia's decision to use it. In Mongolia's case, however, there is one crucial difference, namely, the possibility of trading with the vouchers. I wonder whether the staff could comment on why the Mongolian authorities chose this alternative, and what conditions govern this trading. Are there any estimates indicating the possible inflationary impact of this trading?

Finally, the problem of financing assurances remains unresolved. During recent Board discussions on key issues affecting Eastern Europe, some Directors stressed the need to approve only programs with adequate financing prospects. Although Mongolia's financing gap will persist for years, we agree with the staff that prospects are good that the gap will be filled by additional commitments from multilateral and bilateral donors. The delays in disbursing financial assistance to some Eastern European countries seem to be absent in the case of Mongolia, and we expect no major financing problems if the reforms can be kept on track. This allows us to support the proposed decision.

Ms. Creane made the following statement:

We welcome this opportunity for the Board to conduct its first review of the Mongolian economy. The program currently under consideration--including the measures already taken--clearly demonstrates the Mongolian authorities' commitment to move toward a market-based economy. We would also like to call attention to the staff's exceptional efforts in working with the authorities to design a thorough and detailed strategy for economic reform and adjustment. As we are in agreement with the staff's analysis and conclusions, I can limit my intervention to a few comments.

The operative word with respect to the economic reform program for the first year seems to be inflation: its causes, effects, and targets for reduction. We are pleased to note that the authorities recognize the dangers of keeping demand high through expansionary financial policies, despite the steep decline expected this year in output, and that they have forged ahead with tight fiscal and monetary policies as a result.

In this transitional period, as the authorities reassert control over credit and monetary aggregates, administrative controls over credit growth, particularly with respect to that extended by branches of Mongolbank, are warranted before more indirect methods may be phased in. The statistical base would probably also have to be strengthened considerably before indirect controls could be effectively employed. It would seem clear that additional methods of monetary control above those included in the staff report would eventually be needed, and we welcome the plan for Fund technical assistance in this area.

We welcome the recent increases in interest rates, but the resulting levels are still very low with respect to the current inflation rate. Achieving positive real interest rates--not expected until mid-1992--will be essential before private sector savings will respond. Given that the staff assumes domestic private savings will finance most private sector investment, the implication is unfortunately that private sector investment is not

likely to pick up for some time. Despite being technically freed in May 1991, commercial bank interest rates have barely moved since then. Therefore, we hope that the measures planned and taken to improve Mongolbank control over financial flows will have the added benefit of stimulating commercial banks to raise deposit interest rates considerably.

An important factor in meeting the program's inflation targets, given the total financing of the government budget deficit in the first half of the year through domestic banks, will be succeeding in having the Government register a net repayment to the domestic banking system in the second half of 1991 and no access to bank credit in 1992. To achieve this goal, the authorities will have to closely implement the planned package of fiscal measures outlined in the staff report. Given the large increase in wages and benefits in early 1991, we would draw particular attention to holding tight on further wage increases as essential for both budgetary and incomes policy reasons. As tight wage restraint is important to the success of the program, we hope that the authorities' wage restraint will be successfully passed on and adopted by those public enterprises with newly freed labor constraints. In this context, we were pleased to note the broad public support for the economic reform program, as well as the authorities' intention to keep the public informed.

On structural reforms, the authorities seem to be moving apace on measures that will have a lasting impact.

In the light of the dangers of moving too rapidly in removing price controls without dismantling monopolies, the authorities have, perhaps wisely, chosen a phased approach to decontrolling prices and state orders. However, at the present stage, the price decontrol seems to be complete--ahead of schedule--while the removal of the state from the distribution process is still dependent on the privatization and reform of the public enterprises. We welcome the steps taken and planned to sell off firms, establish the legal basis for private economic activity, and introduce a hard budget constraint for public enterprises through the removal of subsidies and automatic access to credit. However, we strongly consider that these efforts should be accelerated substantially to be completed ahead of the three-year target. We also wonder whether the stock market, designed to speed up the privatization process, was introduced as expected in September 1991.

Given the starting point for this program, the midterm review will be unusually thorough. One issue to be addressed is the exchange rate regime. Although we consider that the underlying tight financial policies are the most important focus for the authorities at the present stage and that a certain transition period is to be accepted, we urge the authorities to move quickly

to a unified exchange rate and note that this would be more in parallel with the actions already taken on domestic prices. We are pleased to note that the authorities have adopted a responsible policy of restricting new borrowing to concessional terms and directing it to export industries. We were also relieved that the financing gaps for 1991 and 1992 are virtually closed.

Mongolia has already come farther in stabilization and structural reforms than other members. In this way, Mongolia has already amply demonstrated its keen desire to push forward in adopting a market-oriented economy. We support the authorities' request for a stand-by arrangement.

The Director of the Southeast Asia and Pacific Department noted that consumer prices had been doubled on January 20, 1991. While wholesale prices had been raised at the same time, they had not been doubled. That action was taken to restore the relative price balance in Mongolia, which had become somewhat distorted following the increase of wholesale prices a few years previously. As a result of the previous increase in wholesale prices, the enterprises had been either incurring large losses or not making sufficient profits. Thus, it was hoped that the maintenance of an appropriate balance in relative prices would help to restore the profit margins of the enterprises. However, the change in prices had met with widespread protests from the public in general. As a result, the Government had allowed wages and pensions also to be doubled. In addition, the Government had doubled the outstanding balances of savings deposits by households. That series of policy measures had caused a large budget deficit, as well as credit expansion related to both the budget deficit and borrowing by enterprises.

During discussions with the authorities in May 1991 on that series of policy actions, the staff had pointed out that the measures taken were not adequate in terms of managing the situation with respect to supply and demand and economic reforms in general, the Director continued. The authorities had indicated agreement with the staff, and since May 1991, the authorities had changed their stance of policies with respect to the budget, and monetary and exchange rate policies.

With respect to whether the goal of containing the rate of inflation to 130 percent for the current year and to 50 percent in 1992, was sufficiently ambitious, it should be noted that the rate of inflation of 130 percent in 1991 largely reflected the doubling of prices that had been implemented in January; the underlying rate of inflation was much lower, the Director went on. However, over time, the deregulation of prices would be reflected in changes in relative prices as well as some upward adjustment. In addition, prices would be affected by the currency devaluation of July 1991, and the tax increases that were to be implemented in October 1991 and in 1992. Unfortunately, all those factors indicated that the underlying rate of inflation would pick up. In the light of current circumstances, the staff considered that the effort to contain the inflation rate to 50 percent while

implementing appropriate fiscal and monetary policies would pose a major challenge for the authorities during the coming year.

Given the close economic relations between the two countries, Mongolia's inflation rate would certainly be affected by developments in the U.S.S.R., the Director considered. However, at the present stage, the traded goods prices of imports from the U.S.S.R. were set in dollar terms and converted into Tugriks by state corporations. Most of these products were among the items still subject to price control domestically. For other goods imported from the U.S.S.R., prices had not been rising at a very rapid rate.

With respect to the timetable for price liberalization in the remainder of 1991 and 1992, the authorities were focusing on the effort to make price deregulation meaningful, the Director stated. To that end, the authorities intended to demonopolize the state trading corporations, both those dealing with domestic transactions and those involved in foreign transactions, which would entail eliminating or limiting the scope of mandatory state orders. The effort to make price deregulation meaningful would also entail a public relations campaign to inform the public that prices had been deregulated and that enterprises were free to adjust prices without being penalized. While such an announcement might seem elementary at first glance, it would provide an important signal that was essential to the success of Mongolia's economic reform program.

The list of commodities for which retail prices were controlled had been halved in September 1991, and the authorities planned to continue gradually reducing the list of the 17 commodities remaining, the Director said. However, as the current list included a number of very sensitive items, the staff would need to discuss the timetable for deregulation at the time of the first review under the stand-by arrangement, which was scheduled to take place in early 1992.

With respect to the fiscal budget, it would not be appropriate to focus excessively on the GDP ratio at the present stage for two reasons, the Director considered. First, unfortunately, the data base for GDP still had serious limitations. Second, 1991 was a very unique year in terms of both revenue and expenditure. As large structural changes were under way, a number of temporary measures were being implemented. For example, in January, the Government had doubled the outstanding balances of household savings. That action which was paid for by the budget had increased government expenditure by a very large amount. In addition, as a result of the price doubling, the Government had received windfall gains as a result of the revaluation of the stocks of consumer goods held by the government stores. Hence, both revenue and expenditures had been inflated by one-time policy actions. Nevertheless, with respect to the general direction of policy, the Government was trying to streamline investment expenditure, as well as subsidies, and reduce the ratio of expenditure to GDP over the medium term. On the revenue side, the authorities had tried to switch two new important taxes: income taxes for profit transfers and import duties for price differentials.

While the authorities were carefully reviewing nonperforming bank loans and assets of the banking system in terms of the reform of the banking system, no decision on those matters had yet been reached, the Director noted.

Although the authorities had spent a great deal of time explaining the voucher system with great enthusiasm, the staff did not have any information on why they had chosen to implement the particular type of scheme used, the Director of the Southeast Asia and Pacific Department said.

Mr. Prader asked whether the staff was working under any assumptions regarding the impact of inflation in the U.S.S.R. on Mongolia. Recent reports on developments in the U.S.S.R. were a cause for concern, in particular with respect to anticipated high rates of inflation. He wondered whether the Mongolian authorities had any plans for dealing with the possible spillover effects.

The Director of the Southeast Asia and Pacific Department responded that the assumptions used by the staff were based on the accounting rate used to translate dollar prices applied to U.S.S.R. goods into tugriks, which remained at Tug 7 to the dollar, and the prices of goods imported from the U.S.S.R. in tugrik terms remained broadly unchanged. While that assumption might appear to be somewhat unrealistic in light of the official exchange rate, it represented the actual mechanism at the present stage. With respect to the future impact of inflation in the U.S.S.R., the adjustment program, which focused on domestic financial discipline, would contain the spillover. Nevertheless, the authorities would closely monitor the exchange rate while developing the exchange system, the Director of the Southeast Asia and Pacific Department stated.

In response to a question by the Acting Chairman, the Director of the Southeast Asia and Pacific Department said that the Mongolians were primarily interested in exchanging local currency for convertible currencies, in particular the dollar. While rubles probably could be obtained on the black market, there was virtually no demand for that currency.

Mr. Fogelholm made the following statement:

Like the lead speakers, I welcome this first Article IV consultation with Mongolia. It is clear from the staff report that the authorities, like those of other former command economies, are facing a daunting task. Currently, Mongolia is undergoing a significant economic contraction, and its transition to a market economy is made even more difficult by the adverse external developments that affect its international trade and financing opportunities.

I am in broad agreement with the staff appraisal, and have only a few remarks. First, on interest rate policy. The staff seems to take a relatively low-key approach in this area, in that they only "note" the modest increase in the central bank rate

undertaken recently, and "note" the authorities' commitment to achieve positive real rates by mid-1992. In view of the need to stimulate the confidence necessary to attract foreign financing, to mobilize domestic savings, and to achieve an efficient allocation of resources, I am moved to urge the authorities to speed up the process of generating positive real interest rates. Or are there some specific reasons that we are unaware of that dictate a more gradual approach?

Second, on exchange rates and price liberalization, the staff advocates a more rapid introduction of changes, and I agree. To bring about a rapid supply response and to avoid distortions in the allocative process over the medium term, the official exchange rate for nonbarter transactions should be applied to all transactions as soon as possible. Also, acceleration of the timetable for price decontrol and elimination of mandatory state orders would seem important for the creation of a competitive environment.

With regard to the use of Fund resources, I note with some concern the staff's opinion on the amount of risk involved in the Fund's exposure, irrespective of the willingness of the authorities to adopt strong adjustment policies. However, the information given in the supplement to the staff report that monetary and budgetary measures have been implemented on schedule, and that price control is actually ahead of schedule, is most encouraging. Moreover, with the exception of a small amount in 1992, the relatively large financing gaps which appeared in the staff report, have been eliminated by commitments made at the recent aid group meeting; and this gap is expected to be covered at the donor meeting next spring. In view of the financing prospects, and the authorities' commitment to continuing their reform efforts and even accelerating them, if necessary, I can go along with the requested stand-by arrangement.

Mr. Bonzom made the following statement:

Let me first join other speakers in welcoming Mongolia as a member of the International Monetary Fund and the opportunity we have to support Mongolia in its process of transition to a market-based economy.

We are in broad agreement with the thrust of the proposed program. Indeed, its emphasis on financial discipline is much needed if Mongolia is to reduce its excessive vulnerability to outside developments. The continuation of an ambitious--albeit phased--program of reforms is also required to allow Mongolia to recover its full growth potential. I would like to briefly address those two related points.

Some slippages occurred until April 1991 in both fiscal and monetary policies. We welcome the corrective stance that has been recently taken in those two areas. Specifically, the authorities are conscious of the risks that would stem from price-wage spiralling inflation, and they have taken useful steps to encourage wage restraint. Prioritization of capital expenditures is another welcomed method for containing public spending.

Positive developments have also taken place on the revenue side of the budget. A further and important step will be the introduction of a broadly based sales tax by mid-1992.

The recent tightening of monetary policy was clearly needed, particularly in view of the explosion of net domestic credit during the first semester. It seems, however, that commercial banks can be somewhat slow in their response to interest rates moves by the central bank. Therefore, closer attention may have to be paid to the transmission mechanisms of monetary policy, especially if savings are to be encouraged. I wonder whether the staff could comment on this issue.

At first glance, the program of structural reforms may appear to be somewhat gradual. However, due consideration has to be given to Mongolia's very special circumstances, in particular--as Mr. Evans pointed out in his opening statement--the extremely close financial and commercial links with the U.S.S.R., which accounted for some 90 percent of its foreign trade, and the impressive record of the past few months. A strategy has been elaborated, private sector activities have been authorized, prices have been partly adjusted and decontrolled, and the statistical framework has been improved.

The authorities should see to it that, in the phased approach they have understandably chosen, no bottleneck is created in one area of reform that could delay other progress or increase the costs of adjustment. In particular, the establishment of a firm legal framework for private property and activity, and of a modernized financial system--including the completion of the central bank reform--will prove crucial.

However, the prompt response of the private sector to the first measures that have been implemented is a further indication that the situation is improving.

We note the steep depreciation of the tugrik and look forward to the midterm review of the stand-by arrangement, when exchange rate developments and policies will be examined.

In conclusion, let me stress that we welcome Mongolia's first steps in its reform and adjustment process. The authorities'

determination must be commended, and we wish them every success in their endeavors.

Mr. Wright made the following statement:

I join other speakers in welcoming the proposed stand-by arrangement. However, as a number of other speakers have noted, Mongolia is a very poor country undertaking a wide-ranging and fundamental economic and social reform program. The economy will be dependent on aid flows for some time. I agree with the staff that, should Mongolia become eligible, a program supported by the ESAF would better address its needs. Meanwhile, Mongolia should be careful to restrict the amount of nonconcessional debt it undertakes in the near future.

There are a number of risks to the program currently under consideration: the uncertainties associated with trade developments with the U.S.S.R.; the fall in traditional sources of aid flows; and the as yet unresolved debt issue. It is particularly important in this case for there to be good coordination between the European Department and the Southeast Asia and Pacific Department to ensure that complementary policies are developed and that all appropriate lessons from Eastern Europe, especially in the area of exchange rate policy, are applied. I am confident that such coordination is already under way.

With respect to the program, I fully recognize the extremely difficult circumstances of the Mongolia economy and the limits to what can be achieved in the very short term. However, like previous speakers, I am concerned about the phased approach to price liberalization, and I agree with the staff on the need to urge the authorities to accelerate the timetable for both the liberalization of prices and the elimination of mandatory state orders. It is far from clear that this process has yet gone far enough to reduce significant interference with the allocation of resources and to avoid the need for subsidies.

I welcome the recent devaluation of the tugrik. I am not sure about the extent to which it will be possible to use the exchange rate as the nominal anchor, in view of the virtual certainty that is apparent in the staff report that further adjustments are likely to take place. Given the severe inflationary forces at work in the Mongolian economy, it is probably unrealistic to expect that no further adjustment will be needed. However, I am slightly disturbed by the suggestion in the staff report that adjustments in the exchange rate might be made to stimulate exports. This suggests a use of the exchange rate, which perhaps goes further than maintaining competitiveness in the event that domestic policies prove unequal to the task. I wonder whether the staff could comment on this point. Like

Mr. Fogelholm, I note that barter trade with the U.S.S.R., which accounts for most of Mongolian trade, is not covered by the new rate. This would seem to confer some benefits on Mongolia, but as these are likely to prove short lived, this will need to be rectified as soon as possible.

I welcome the planned development of the banking system, particularly the separation of central banking from commercial banking activities. However, the goal of achieving positive real interest rates by mid-1992 is unambitious. Mongolia needs to encourage private domestic saving and its efficient allocation. It is not clear whether--like in the case of some other former centrally planned economies--Mongolia has anything like a monetary overhang. This could complicate monetary management and the privatization effort. I wonder whether the staff could comment on this point.

As to the wider issue of resource allocation, it seems inevitable, and probably desirable, that some vestiges of the centrally planned system should remain in place for the time being. However, I wonder on what basis certain key flows, notably those of foreign exchange and domestic credit, will be allocated. In particular, I wonder whether the staff could comment on how the budget constraint on enterprises is to be hardened in the virtual absence of proper market information.

Table 2 of the staff report indicates that, excluding debt service to the former CMEA countries, the debt-service ratio will rise to 13 percent in the next couple of years. I wonder what the debt-service ratio would look like if CMEA debt was included. It is not clear what the staff means by indicating that its projections assume a satisfactory outcome to the debt negotiations. Presumably, even after a satisfactory outcome to negotiations with the U.S.S.R., Mongolia would still be highly indebted and, indeed, on the edge of insolvency.

Mr. Laux stated that he was in full agreement with the staff appraisal and could support the proposed decisions. There could be little doubt that the courageous adjustment efforts of the Mongolian authorities deserved Fund support.

Like Mr. Prader and other Directors, he was somewhat concerned about the rather gradual progress expected in reducing the rate of inflation, which was 50 percent in 1992 and 30 percent in 1993, Mr. Laux commented. Those rates of inflation appeared to remain excessively high. Therefore, he wondered whether a more ambitious pace of disinflation would not be more appropriate and, indeed, more consistent with the emphasis that was correctly being placed by the staff on the restoration of financial discipline. He strongly considered that such discipline or, for that matter, rapid

achievement of macroeconomic stability was absolutely essential for the success of Mongolia's reform efforts.

He agreed with Mr. Fogelholm and Mr. Wright on the need to emphasize the importance of early attainment of positive real interest rates, Mr. Laux continued. Achieving that objective only by mid-1992 appeared to be rather late, in particular considering that price increases in the free market seemed to have been significantly higher than the increases measured by the consumer price index.

Moreover, a strategy that relied unduly on a slowing of the rate of inflation as a means of achieving positive real interest rates could induce the private sector--in anticipation of the turn of interest rates to positive free levels--to accelerate borrowing, thereby undermining the authorities' stabilization policy and jeopardizing the inflation targets, Mr. Laux went on. From that consideration, it followed that a more active interest rate policy would also be highly advisable in order to increase the very low level of private savings and, by the same token, help to alleviate pressures on the balance of payments and the exchange rate.

Unfortunately, there was a considerable risk that such pressures might in fact materialize, as witnessed by the staff's medium-term balance of payments analysis, and those risks might even be greater than assumed by the staff, because the export projections, if anything, were on the optimistic side, Mr. Laux considered.

Obviously, the risks involved for the security of the Fund's financial resources were substantial, as explicitly acknowledged by the staff, "irrespective"--as stressed in the staff report--"of the willingness of the authorities to adopt strong adjustment measures," Mr. Laux noted. That, no doubt, was a matter for concern. At the same time, he agreed with other Directors that, at the present crucial juncture, the Fund could not refuse to lend its financial support to Mongolia's courageous reform efforts. However, the question was whether the Fund should have emphasized more its catalytic role and, correspondingly, limited its financial exposure below the rather high level of access proposed in the stand-by arrangement. More modest Fund involvement would have been in the interest of Mongolia, considering the short maturities of Fund lending and the likely continued significant need for Fund financial assistance in the years ahead. He hoped that Mongolia, in recognition of the rather high level of access to Fund resources proposed, would remain firmly committed to the targets of the program and strictly implement the agreed measures.

Mr. Al-Tuwaijri stated that he supported the proposed decisions.

Ms. Duan said that, like previous speakers, she welcomed the first Article IV consultation with the Mongolian People's Republic. As pointed out by the staff report and in Mr. Evans's opening statement, Mongolia had embarked on a major economic transformation in 1990, in an effort to move from a decades-old command economy to a market-based economy. The structural reforms that had been swiftly carried out and accelerated in many key

areas were very impressive. Institutions and policy instruments were being developed to facilitate indirect economic management, and a legal and regulatory framework was under construction to accommodate the transformation and operation of the new system.

However, it was clear that the difficulties and problems surrounding the undertaking were severe, as mounting internal and external imbalances since the mid-1980s had prevailed and continued, and were multiplied, in particular, by detrimental external developments, Ms. Duan noted. Withdrawal of U.S.S.R. aid and the disruption of trade among members of the CMEA, which had tremendously reduced and changed the traditional economic link between Mongolia and those countries, were the most serious of the shocks.

Adverse weather conditions and weakening demand for Mongolian exports in industrial countries had also contributed to the economic difficulties facing the authorities, Ms. Duan commented. Aside from the external factors, domestic policy weaknesses had fueled strong fiscal and monetary expansion. Weakened economic growth and employment in 1990 had continued into 1991. The rate of inflation had climbed to a high level, and exports had fallen by more than 40 percent.

In view of the current economic situation and to consolidate the gains achieved thus far, strong efforts were needed to stabilize the economy, reduce its vulnerability to external shocks, and prevent further policy slippages, Ms. Duan considered.

Financial discipline should be among the top priorities, Ms. Duan stated. From mid-1991, the already weakened fiscal conditions had deteriorated, with U.S.S.R. aid and import taxes falling sharply, while civil service wages, pensions, benefits, and compensation for price adjustments increased rapidly. In the second quarter of 1991, measures were put in place to cut nonwage expenditures by 10-15 percent, and to discontinue one third of the investment projects that fell short of the efficiency criteria. Those moves were a welcome step toward a strengthened budgetary position, and they needed to be expanded and firmed up.

Success in achieving a solid fiscal position hinged crucially on the mobilization of revenue, Ms. Duan remarked. Therefore, it was encouraging to note that plans had been formulated and some carried out to boost revenue. Improving tax administration should be an integral part of the process, and technical assistance in that area from bilateral and multilateral donors was warranted.

She welcomed the action taken by the authorities to tighten monetary conditions, in view of the rapid growth of domestic credit and money supply that had threatened to destabilize the economy, Ms. Duan stated. Currency issue and domestic credit expansion were programmed to decline in 1991. However, as the staff report noted, net repayment of bank credit by the Government would be a crucial factor between the success and failure of the programmed efforts. It was encouraging that the branches of the former

State Bank were recognized by the authorities as a major source of credit expansion. The central bank was moving in the right direction by divesting itself of branches and introducing equal treatment to the branches as applied to commercial banks in terms of interest rates and credit policies. That and the recently imposed loan limits should be able to contribute importantly to the cooling down of rapid monetary expansion.

As to the external sector, the impact of adverse shocks was abating, Ms. Duan noted. As trade relationships with neighboring countries were being repaired, trade diversification in terms of commodities and destinations was proceeding, and a more realistic exchange rate had been adopted. Nevertheless, intensified efforts were called for in further opening and liberalizing the trade and payments system, in order to achieve external viability in the medium term.

She fully recognized the difficult task facing the authorities and commended their firm commitment to reforms, Ms. Duan concluded. Meanwhile, international support for those efforts was indispensable. She supported the proposed decisions.

Mr. Mojarrad noted that the Mongolian authorities faced a burdensome task in transforming an economy based wholly on a government-controlled market system. Material production concepts used in centrally planned economies including Mongolia, required considerable effort to be converted into SNA. He wondered whether the staff could comment on the base for conversion and the reliability of real sector statistics.

After a 2 percent decline in 1990, GDP growth was projected to decline in 1991 and 1992 to 15 percent and 5 percent, respectively, Mr. Mojarrad continued. The budget deficit had increased as a result of a 100 percent wage increase while revenues, especially new taxes, could not keep pace due to administrative difficulties. Wage adjustment was justified in view of the fact that the high inflation rate had eroded more than 60 percent of the purchasing power of the people.

There had been less control of money and credit aggregates in 1990 and the first half of 1991, Mr. Mojarrad went on. Net domestic credit, after expanding by 11 percent in 1990, grew by 175 percent in the first half of 1991, and monetary liabilities, after a 25 percent rise in 1990, had jumped by 147 percent on an annual basis. Measures should be taken to establish Mongolbank as an independent central bank able to run a monetary policy immune to government encroachments.

Under the restructuring program, privatization should be continued by selling state-owned enterprises to the public through the newly established stock exchange, Mr. Mojarrad considered. From the perspective of efficiency, breaking up the large enterprises into smaller units before privatization, as intended by the Government, might not be advisable in all cases. To make state enterprises more attractive to private owners, the financial structure of the enterprises should be rehabilitated and their valuation should be at a level attractive to the public.

Mongolian external trade had been heavily dependent on the U.S.S.R., and relations between Mongolia and the U.S.S.R. would likely remain uncertain until developments in the U.S.S.R. assumed some degree of normalcy, Mr. Mojarrad commented. Nevertheless, every attempt should be made to diversify external trade. Efforts aimed at diversification should be made in relation to trading partners as well as to traded merchandise. He supported the proposed decision.

Mr. Filosa said that he joined other Directors in supporting Mongolia's request for a stand-by arrangement. However, he was concerned about the proposed program to be supported by the stand-by arrangement, in particular with respect to its ability to bring about the necessary correction of the Mongolian economy.

Although the policies envisaged under the program represented a shift vis-à-vis the past, they were very much in line with previous cautious and ineffective reforms attempted in private economies, Mr. Filosa considered. He was not convinced that the program was fully consistent with the strategy adopted by the Fund in addressing the transformation of Eastern European economies into market-oriented economies. Mongolia was certainly weaker than some of the other Eastern European countries, and it had less exposure, both culturally and practically, to reform. However, the program to be supported by the stand-by arrangement would produce little change in the economy and in the ideological policy approach of the authorities. Unless the pace and quality of the reforms were substantially and quickly strengthened, it would be impossible to form a market economy within the three-year period that the authorities and the staff considered appropriate and feasible.

While he would support the inclusion of Mongolia among the countries eligible to use resources under the ESAF, the authorities should be urged to consider the more bold approaches needed to qualify for the use of ESAF resources, Mr. Filosa stated.

To avoid creating sharp conflicts between expectations and reality, the Mongolian authorities and the staff needed to agree on a more comprehensive reform program, Mr. Filosa concluded.

Mr. Fukui stated, with respect to the views expressed by Mr. Wright and Mr. Filosa on extending the list of low-income countries eligible to use resources under the ESAF, that his chair agreed that it would be appropriate to consider an enhanced structural adjustment arrangement in the case of Mongolia.

Mr. Prader said, with respect to the comments by Mr. Wright on coordination between the European and the Southeast Asia and Pacific Departments, that he was surprised that the staff did not have more information on the voucher system used in Mongolia, as there was a great deal of discussion concerning such systems throughout Eastern Europe. In addition, more coordination between those two departments was needed with respect to setting targets for inflation, as there was clearly a big difference between

the programs for Eastern European countries and for Mongolia in that respect. In that connection, he agreed with the concerns expressed by Mr. Filosa during the current discussion.

The Director of the Southeast Asia and Pacific Department said that the authorities' intention was to achieve positive interest rates in real terms, but they faced a number of constraints. First, although the price statistics had been compiled, they covered a period of only two months. Also, the current estimate of inflation for 1991 largely reflected a one-time adjustment of controlled prices and the underlying rate of inflation was estimated to be substantially lower. The authorities wanted to assess the real underlying rate of inflation, which would require some time.

Second, the banking system was relatively new, the Director continued. The central bank had been established in May 1991 and in September it had introduced for the first time a package of policies that included its own interest rate and its lending policies to commercial banks. While commercial banks were free to determine their own interest rates, they did so in light of the central bank's interest rate and the availability of credit from the central bank. In that respect, the interaction between the central bank and the commercial banks was still evolving, and it would require time to establish a firm relationship. Despite the fact that those two problems would take some time to address, the authorities hoped to achieve positive real interest rates as soon as possible.

The authorities considered that the implementation of price reforms would have to take place in a phased manner at least at the present stage, the Director noted. Experience thus far showed that merely announcing the deregulation of prices and allowing enterprises to determine prices freely was not enough. It was important, at the same time, to demonopolize the role of public enterprises and to develop private sector institutions. The establishment of a fully competitive environment would take time. More important, as Mongolia was facing a severe winter, the authorities did not consider it appropriate to deregulate or further adjust upward prices of some essential goods at the present stage. Nevertheless, during discussions with the authorities, the staff had argued that price deregulation should proceed as quickly as possible, and the staff intended to take up that matter for discussion again at the time of the first review under the standby arrangement.

In response to the question about the extent of monetary overhang, the Director indicated that, in the case of Mongolia, the staff did not consider it to be a significant problem.

As the staff report indicated, the continued negotiations on Mongolian debt, which was mostly to the U.S.S.R., involved two main issues, the Director stated. First, an agreement was yet to be reached on the level of outstanding debt, because the Mongolians considered that some of the debt should be classified as direct investment and, hence, should be excluded. Second, no agreement had yet been reached on the exchange rate that should

be used to convert Mongolia's debt, which was currently expressed in transferable rubles, into the currency in which the debt was to be repaid. Given the problems associated with determining the exchange rate to be used, it would be extremely difficult for the staff to estimate debt-service payments including debt to members of the CMEA.

Also with respect to the ongoing debt negotiations between the U.S.S.R. and Mongolia, one firm agreement had been reached, namely, that the outcome of the negotiations should not affect negatively Mongolia's future development, the Director noted. On the basis of that agreement, the staff assumed that the outcome of the negotiations would be satisfactory from the Mongolians' point of view.

With respect to production statistics, the data on output of individual products, for both agriculture and industry, were highly reliable and comprehensive, the Director of the Southeast Asia and Pacific Department said. However, there was a problem of aggregation, particularly with respect to calculating GDP according to standard national account methodology. Nevertheless, as Mongolia was receiving technical assistance from international organizations, including the United Nations and the Asian Development Bank, in the area of statistics, the staff expected that it would be possible to obtain satisfactory data on GDP and other related items soon.

Mr. Fogelholm noted that the level of access proposed under the stand-by arrangement, of 90 percent of quota, was fairly large for a first program. He wondered whether there was any specific reason for that, other than to cover financing gaps.

The Director of the Southeast Asia and Pacific Department said that, in determining the amount of proposed access under the stand-by arrangement, the staff had considered the amount needed to close the financing gap and the catalytic role of the Fund in generating international support. The staff had discussed its projections on the balance of payments and financing needs with the authorities. While the authorities had originally forecast a larger financing requirement, after a series of discussions, they had agreed with the projections contained in the staff report.

The staff representative from the Exchange and Trade Relations Department noted that, like Fund arrangements with other former members of the CMEA, the reform program in Mongolia involved a fundamental redirection of economic policies. Therefore, one reason for the high level of access proposed under the stand-by arrangement was the nature of the program to be implemented, which anticipated a fundamental reform of the economy. Table 8 of the staff report, on the balance of payments, showed a projected increase in net official reserves of \$36 million in 1992, while access to Fund resources under the program amounted to SDR 22.5 million, or roughly \$30 million. Thus, the amount of Fund access was expected to be less than the buildup of reserves, which was considered to be an important part of the program. It should also be noted that access to Fund resources would be phased under the program in light of not only the prior actions that had already been taken in Mongolia, but also the further actions to be taken in

the period ahead. Directors had mentioned the need for more action in several areas, as outlined in the staff report, prior to the midterm review.

In suggesting that exchange rates could stimulate exports, the staff had assumed that the rate of Tug 7 to the dollar was clearly overvalued, the staff representative noted. Over time, there would be a need to move that rate to a more competitive level. In terms of export diversification, which was a very important objective of the program, there would also be a need to change transport routes and to implement various structural reforms. Use of the exchange rate instrument should be seen as part of the overall program. Meanwhile, there was a need to try to estimate an appropriately competitive level for the exchange rate. Given the substantial changes in the economy, it was difficult to make long-term assessments, but that would certainly be a main focus of the midterm review of the program.

Table 21 of the staff, report on external debt, showed that the total size of debt to CMEA countries was very large, at about Rub 10.5 billion, the staff representative from the Exchange and Trade Relations Department commented. Debt-service payments were estimated to be about \$40 million a year. However, the estimates on debt-service payments were not exact, owing to the ongoing negotiations concerning how much of the debt should be repaid and the exchange rate to be used in converting the transferrable ruble into convertible currencies.

Mr. Wright noted that the staff report had taken up the issue of the mechanics of restraining the overall rate of monetary growth over the coming year. That approach was appropriate, given that the exchange rate clearly could not serve as a convincing nominal anchor in the program. Nevertheless, it was not clear what criteria would be used to allocate credit to harden the budget constraint on enterprises in the absence of proper interest rate signals or proper market signals about creditworthiness.

The Director of the Southeast Asia and Pacific Department said that over the next several months, the authorities intended to use a combination of direct and indirect methods with respect to the allocation of credit. The direct method would involve the credit allocation among the banks and the branches of the central bank that engaged in commercial operations. With respect to indirect methods, the authorities intended to employ three instruments: the central bank interest rate would be raised; central bank credit to commercial banks, which had been extended almost automatically during the first half of 1991, would be restrained; and reserve requirements would be introduced. The combination of those methods was expected to work toward containing the overall rate of monetary growth.

The criteria that would be used within the banking system for allocating credit among various enterprises would need to be developed primarily through negotiation over the coming months, the Director of the Southeast Asia and Pacific Department stated. The recent announcement that enterprises would no longer have automatic access to bank credit would strengthen the banks' position by enabling them to refuse requests for credit. It was

also hoped that interest rates would begin to play a greater role in the coming months by forcing the enterprises to consider the expense associated with the use of credit.

Mr. Evans thanked Directors for the interest they had expressed in the first Fund-supported program for Mongolia. He would convey their comments to the Mongolian authorities. He had no difficulty accepting the view that there was a greater need than envisaged in the program to concentrate on fiscal and monetary control.

In response to questions raised about the voucher system implemented in Mongolia, it should be noted that the Mongolians were very trusting, Mr. Evans said. They had adopted that particular voucher system because they had been advised to do so by some eminent U.S. economists. A similar response would explain some other measures recently taken in Mongolia, such as the doubling of wages, prices, and savings deposits.

One difficulty with respect to the case of Mongolia was that the authorities were still learning about the management of a market-oriented economy, Mr. Evans considered. Therefore, it was possible that they had implemented part of the measures recommended, but not all of the elements that would be needed to make the plan successful. For that reason, Fund advice was very important to the success of Mongolia's economic program, and he hoped that a senior resident representative could be assigned to Mongolia as soon as possible.

He had no difficulty agreeing with Mr. Filosa and other Directors that Mongolia would need a much bolder program to qualify for an enhanced structural adjustment arrangement, Mr. Evans continued. He was sure the Managing Director would convey that message to the authorities during his forthcoming visit to Mongolia after the 1991 Annual Meetings.

The program initially recommended by the staff was much bolder than that currently under consideration, Mr. Evans recalled. At the time of the discussions between the authorities and the staff on the reform program, the Mongolian authorities had expressed concerns about an overly rapid adjustment, because they wanted to maintain public support for the program. Since that time, however, and in light of developments in the U.S.S.R., public opinion in Mongolia had changed somewhat. Therefore, the prospects for a program that would warrant support by the ESAF were likely to be better at the time of the first review under the stand-by arrangement.

The Acting Chairman made the following summing up:

Executive Directors commended the authorities on their progress in implementing the commitment to shift from a centrally planned economy to a market-based economy, notwithstanding the inexperience with market mechanisms in Mongolia and the severity of the external shocks that Mongolia has faced in the recent past--including the impact of changes in trade with, and the loss of assistance from, the U.S.S.R. Directors cautioned, however,

that meeting the objectives contained in the Government's economic strategy for the next three years would require further large and sustained efforts to implement the stabilization policies and structural reforms needed under the new conditions facing Mongolia.

In view of the rapid surge in inflation in 1991, Directors agreed that priority must be given to stabilizing the economy and urged that reforms designed to strengthen and improve policy tools in the institutions responsible for implementing economic policy be carried out promptly. At the same time, they encouraged the authorities to accelerate other structural reforms, particularly the liberalization of prices and the elimination of mandatory state orders, to mitigate domestic shortages and strengthen and diversify exports. Such reforms, together with ongoing programs to increase substantially the scope for private sector economic activity, were also essential for improving the efficiency of resource allocation while establishing the basis for sustained economic growth and an expansion of employment.

Directors emphasized the need to achieve firmer control over monetary and credit growth, especially to the public sector, which would now have to operate under a hard budget constraint, in order to restrain inflation. In this connection, Directors welcomed the introduction of new instruments of indirect monetary control, while recognizing that some administrative controls over credit may be required in the short run until the array of indirect instruments can be broadened and their effectiveness improved. While noting the September increase in the central bank's interest rate on advances to commercial banks, Directors urged the authorities to act quickly to bring key deposit and lending rates to levels that would be positive in real terms. They urged that attention be given to the problem of nonperforming loans in the context of the effort to reform the banking sector, and they encouraged the authorities to continue steps to strengthen the functioning of the central bank, including control over the ability of the branches to create credit.

Directors observed that success in achieving credit restraint will depend crucially on budgetary developments, and they stressed the urgent need to further constrain the budget deficit. In line with the authorities' strategy to reduce the share of the public sector in the economy, fiscal restraint should be focused on the expenditure side, especially subsidies and noninfrastructure investment. In this connection, Directors stressed that current budgetary procedures for controlling expenditures needed to be strengthened; at the same time, there was an urgent need to bolster the potential for budget revenues through broadening the tax base, including the prompt introduction of a sales tax, and the strengthening of tax administration.

Directors noted the authorities' program for privatizing a large portion of public sector assets and commended them for establishing much of the legal and regulatory framework that is required for the operation of private sector activities in Mongolia. Directors also observed that privatized enterprises and newly emerging activities required an uncontrolled operating environment in order to generate a satisfactory supply response. Emphasis should continue to be given to encouraging private sector activity and to steps that would remove the impediments and, in fact, stimulate the development of competitive markets and reduce the scope for monopolistic pricing.

Directors supported the authorities' policy of restraining civil service wages, while refraining from exerting control over private wages other than the minimum wage. To reinforce efforts to dampen wage increases, particularly in light of the very large wage increases that were generated in the first half of 1991 and had contributed to the underlying very high rate of inflation, the Government should focus on accelerating the privatization of public enterprises.

Directors strongly supported the authorities' objective of diversifying trade as a means of obtaining new technology and boosting exports and strengthening the current account. The elimination of administrative restrictions on trade, in particular the system of mandatory state orders, was considered essential for achieving this objective. Directors also noted that recourse to barter agreements, while understandable under current circumstances, was likely to perpetuate resource distortions and, if continued, could impede trade diversification over the medium term. To increase the chances of a positive supply response, they urged that the allocative role of the exchange rate be strengthened as soon as possible by using the official rate for valuing all transactions and for domestic procurement and pricing purposes.

Directors observed that Mongolia had made a successful start in obtaining substantial donor support and that such support would remain necessary on a significant scale and must be provided on a timely basis, given the magnitude of the reforms that lay ahead and the external financing requirements. It was therefore critical that efforts be intensified to strengthen the prospects for exports and domestic savings and to create the environment for inflows of foreign investment.

With respect to external debt, Directors noted the large size of Mongolia's debt to the U.S.S.R. The negotiations concerning the servicing of this debt would have an important impact on Mongolia's balance of payments prospects, and debt relief would have to be a product of these negotiations.

In sum, Directors recognized the important steps that had been taken by the authorities to move toward stability and to implement structural reforms. Difficult challenges remained ahead, however, including the effects of the changes that were taking place within the U.S.S.R.; in that context, Directors cautioned that, given the rate of price increases in the U.S.S.R., these developments would no doubt have a significant impact on Mongolia in the period ahead and would likely require a further response by the authorities in formulating their domestic policies.

Drawing on the experience of other centrally planned economies in Central and Eastern Europe in managing transition to market economies, Directors encouraged the authorities to pursue an even bolder approach to their economic reforms and stabilization efforts. This would include not only setting more ambitious targets--for example, with respect to inflation--but also accelerating the structural reforms that would permit a diversification of the economy and enable the economy to reduce its degree of dependence on one market.

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

The Executive Directors then took the following decisions:

Decision Concluding Article XIV Consultation

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

2. Mongolia maintains restrictions on the making of payments and transfers for current international transactions in the form of restrictive features in bilateral payments arrangements maintained with three Fund members, restrictions on invisible payments and transfers not related to merchandise trade, and the foreign exchange allocation system, and multiple currency practices arising from the multiplicity of exchange rates under the commercial, the officially recognized and the auction exchange markets, which are maintained under Article XIV. The Fund encourages Mongolia to further liberalize these measures, including the restrictive features of bilateral payments arrangements with Fund members.

Decision No. 9841-(91/139), adopted
October 4, 1991

Stand-By Arrangement

1. The Government of Mongolia has requested a 12-month stand-by arrangement in an amount equivalent to SDR 22.50 million.

2. The Fund approves the stand-by arrangement set forth in EBS/91/156, Supplement 1.

Decision No. 9842-(91/139), adopted
October 4, 1991

3. BRAZIL - 1991 ARTICLE IV CONSULTATION

The Executive Directors, meeting in restricted session, considered the staff report for the 1991 Article IV consultation with Brazil (EBS/91/158, 9/16/91). They also had before them a background paper on recent economic developments in Brazil (SM/91/201, 9/30/91).

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/91/138 (10/2/91) and EBM/91/139 (10/4/91):

4. ANNUAL MEETINGS - CHARGES FOR SPECIAL GUESTS AND VISITORS

The Executive Board approves the recommendation to defer consideration of charging fees for special guests and visitors at annual meetings as set forth in EBD/91/236, Supplement 1 (9/30/91).

Adopted October 2, 1991

5. STAFF MEMBER - LEAVE WITHOUT PAY

The Executive Board approves the proposal set forth in EBAP/91/240 (9/27/91) concerning an extension of leave without pay for a staff member.

Adopted October 3, 1991

6. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 91/13 through 91/16 are approved.

7. EXECUTIVE BOARD TRAVEL

Travel by an Advisor to Executive Director as set forth in EBAP/91/228, Supplement 1 (10/2/91) is approved.

APPROVED: April 10, 1992

JOSEPH W. LANG, JR.
Acting Secretary

