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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 91/50

10:15 a.m., April 8, 1991

M. Camdessus, Chairman

Executive Directors

E. A. Evans

M. Fogelholm

B. Goos

J. E. Ismael

J.-P. Landau

A. Torres

A. Végh

Alternate Executive Directors

B. R. Fuleihan, Temporary

S. Gurumurthi, Temporary

G. C. Noonan

Wang J., Temporary

S. B. Creane, Temporary

M. E. Hansen, Temporary

J. Prader

V. Kural, Temporary

G. H. Spencer

C. Schioppa, Temporary

O. A. Himani, Temporary

W. Laux, Temporary

L. I. Jácome, Temporary

J.-L. Menda, Temporary

M. A. Ghavam, Temporary

L. J. Mwananshiku

P. Wright

D. Sparkes, Temporary

G. P. J. Hogeweg

K. Kpetigo, Temporary

K. Ichikawa, Temporary

K. Ishikura, Temporary

L. Van Houtven, Secretary and Counsellor

C. P. Clarke, Assistant

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Also Present

IBRD: M. Voljc, F. Changanaqui, Latin America and the Caribbean Regional Office. Asian Department: K. Saito, Deputy Director; J. R. Dodsworth, D. J. Goldsbrough, U. R. Gunjal, J. E. Zeas. Exchange and Trade Relations Department: E. Brau, Deputy Director; T. Leddy, Deputy Director; A. Basu, C. V. A. Collyns, R. A. Feldman, P. Mylonas. Research Department: R. C. Baban, P. R. Menon, P. Wickham. Treasurer's Department: G. Laske, Treasurer; W. J. Byrne, H. Flinch, C. A. Hatch. Western Hemisphere Department: J. Ferrán, Deputy Director; C. Cha, L. E. Escobar, J. A. Gons, C. M. Loser, S. J. Stephens, J. Thornton, K. Thugge, E. S. Williams. Advisors to Executive Directors: A. Gronn, Y.-H. Lee, A. Napky, A. M. Tanase. Assistants to Executive Directors: Chen M., S. K. Fayyad, C. J. Jarvis, P. Kapetanovic, G. Lindsay-Nanton, M. Mrakovcic, N. Sulaiman, Tin Win.

1. COSTA RICA - 1990 ARTICLE IV CONSULTATION; STAND-BY ARRANGEMENT AND EXTERNAL CONTINGENCY FINANCING UNDER COMPENSATORY AND CONTINGENCY FINANCING FACILITY (CCFF); AND PURCHASE TRANSACTION - CCFF - FLUCTUATIONS IN EXPORTS AND COST OF OIL IMPORTS

The Executive Directors considered the staff report for the 1990 Article IV consultation with Costa Rica, together with Costa Rica's requests for a 12-month stand-by arrangement in an amount equivalent to SDR 33.64 million, external contingency financing under the compensatory and contingency financing facility (CCFF) with maximum access up to the equivalent of SDR 21 million, and a purchase in an amount equivalent to SDR 33.64 million under the CCFF for compensation of an export shortfall and excess oil import costs (EBS/91/40, 3/14/91; Cor. 1, 4/5/91; and Sup. 1, 3/25/91). They also had before them a background paper on recent economic developments in Costa Rica and a letter of intent relating to Costa Rica's requests for the stand-by arrangement and CCFF purchase (SM/91/64, 3/27/91; and EBS/91/34, 3/6/91).

The staff representative from the Western Hemisphere Department said that preliminary data indicated that economic performance during the first quarter of 1991 had been in line with the program. The preliminary central bank accounts for end-March 1991 showed that the indicative targets for net international reserves and net domestic assets had been met, and central government finances had evolved as had been envisaged under the program.

Mr. Torres made the following statement:

On behalf of my Costa Rican authorities, I would like to convey their appreciation for the timely support always granted by the Fund and for the constructive manner in which the Article IV consultation discussions, as well as the negotiations on the economic program, took place. They feel that the staff documents reflect, in a well-balanced manner, the economic developments in Costa Rica during the past few years, and also the strategy envisaged by the Government for the next two years.

Since the early 1980s, Costa Rica has implemented economic measures, in the context of strong economic programs supported by the Fund, aimed at restructuring its economy, restoring economic growth, and reducing internal and external imbalances. During this period, growth of real GDP was maintained at levels of about 4.5-5 percent a year, inflation was reduced from its formerly high levels, the combined public sector deficit, as well as the external current account deficit, were reduced, and unemployment was brought down to acceptable levels.

Despite these achievements, the inflation rate in 1988 was still high, the ratio of the fiscal deficit to GDP was about

3.6 percent, and large foreign debt-service obligations were accrued, placing strong pressures on the balance of payments.

With the aim of curbing continuing inflationary pressures and finding a more permanent solution to their external debt problem, thus further reducing internal and external imbalances, the authorities designed an economic program for 1989 that was supported by a one-year stand-by arrangement approved by the Executive Board in May 1989. Under this program, real GDP grew by 5.6 percent and the rate of increase in consumer prices fell to 10 percent by the end of 1989. As 1989 was an election year, the implementation of the economic program faced several constraints: instead of declining to 2.8 percent of GDP, as originally envisaged in the program, the combined public sector deficit--including central bank losses--grew from 3.6 percent of GDP in 1988 to 5.5 percent of GDP in 1989, as expenditure grew at a higher than programmed rate. Also, the external current account deficit target was exceeded by 3.8 percent of GDP, as import growth was higher than projected. The capital account, however, evidenced a surplus, as private capital inflows rose and substantial debt relief from the Paris Club and from commercial banks--pending the completion of the debt-reduction package--was accomplished. In all, net international reserves increased by \$82 million instead of \$40 million, as envisaged in the program.

After long negotiations, an agreement with commercial banks on a financing package covering the purchase of about \$990 million of Costa Rica's debt and past interest was signed in November 1989. Under this agreement, the debt not purchased was exchanged for long-term bearer bonds. The package was completed in May 1990 with a payment of \$225 million, which was financed with external grants, loans, and official reserves.

During the first half of 1990, the economic situation continued to deteriorate and coffee prices continued to decline, thus substantially reducing revenues from exports taxes. On the other hand, new arbitration wage awards were conceded and interest payments were increased, resulting in a sharp increase in expenditure. Adjustment of petroleum prices, as well as public utility tariffs, continued to be postponed. Consequently, the combined public sector deficit continued to grow during this period.

As some of the external loans were used for the debt-reduction operation, foreign financing available for the budget was reduced and pressures were put on domestic financing. Also, the strong expansion in bank credit to the private sector and the declining growth of financial savings placed additional pressures on foreign reserves, causing net international reserves to decline by

\$390 million, of which \$140 million corresponded to debt-reduction operations with commercial banks.

Shortly after taking office in May 1990, the new Administration started working on a medium-term program to strengthen the economy. As a first step, in June 1990 the Government adopted a set of measures aimed at reducing the fiscal deficit and the pressures on the balance of payments. These measures included an increase to 10 percent of minimum import duties on raw materials and intermediate and capital goods; a widening of the spread between buying and selling rates for foreign exchange; an increase of 80 percent in the tax on banana exports; an increase in the price of basic grains sold by the state marketing agency (CNP) in a range of 17-22 percent; an increase in the price of petroleum products and public utility tariffs of 20-32 percent; a freeze on the creation of new central government posts; and expenditure cuts in the central government and decentralized agencies.

Further adjustments to petroleum prices were made during the remainder of 1990, as international oil prices were increased as a consequence of the problems in the Middle East. For these adjustments, the authorities introduced a new system that contemplates the automatic adjustment of petroleum product prices to account for cost fluctuations.

Short-term interest rates were increased by 9 percentage points since May 1990--and are now positive in real terms--and banks' legal reserve requirement was raised to 31 percent in August 1990. Since banks met the higher requirement by increasing the float with the Central Bank, the authorities froze bank credit to the private sector for the rest of the year and took measures to eliminate the float with commercial banks. The legal reserve requirement on sight deposits was temporarily reduced so as to avoid forcing the banks to call existing loans. Nonetheless, this legal requirement has been increased by 3 percentage points a month since October with a view to restoring the level prevailing in August. Moreover, the monthly rate of devaluation of the colón was raised from 0.60 to 2.75 per US\$1 during the period May-November 1990, and the spread between buying and selling rates was further increased.

As a result of the authorities' efforts during the second half of 1990, the overall fiscal deficit declined from about 7 percent of GDP in the first half of 1990 to about 3.5 percent of GDP in the second half, which was higher than programmed mainly because of the continued decline of international coffee prices and the wage increases granted in October 1990.

During 1990, real GDP grew at the slower pace of 3.5 percent, and the rate of increase of consumer prices rose to 27 percent, reflecting the recent price adjustments. The terms of trade continued to deteriorate--coffee export prices declined by 23 percent and petroleum import prices increased by 27 percent--and was strongly reflected in the estimated current account deficit of 11.4 percent of GDP. Payments related to the commercial bank debt-reduction operations, delays in disbursements from the World Bank, and reductions in private capital inflows, reversed the 1989 surplus in the capital account. In all, net international reserves declined during the year by \$514 million, including \$210 million of arrears for current international transactions, Paris Club creditors, non-Paris Club bilateral creditors, and the Central American Bank for Economic Integration.

For the period 1991-92, the authorities have designed a far-reaching economic program aimed at reducing inflation, strengthening the balance of payments, and setting the basis for sustained economic growth and external viability over the medium term. The program comprises actions toward a comprehensive fiscal reform, with a combined deficit of the public sector, including central bank losses, to be reduced from 5.1 percent of GDP in 1990 to 0.5 percent of GDP in 1991. In addition to the full effect of the measures implemented during 1990, the revenue performance will be complemented by the increase in the rate and coverage, from 10 to 13 percent, of the sales tax and the temporary import surcharge of 10 percent that was imposed in January 1991, which will remain in effect until August 1991. On the expenditure side, limits have been imposed on the increase in the central government wage bill, to be achieved by a cut of 2,300 working posts and limits on wage adjustments. Also, central government transfers in relation to GDP are to be substantially reduced. To control the public sector wage awards, the Government presented to the Supreme Court a constitutional challenge that has temporarily suspended the granting of new "laudos."

With the purpose of strengthening the financial position of the decentralized agencies and public enterprises, tariffs and charges will continue to be adjusted in order to reflect variations in operational costs. In this connection, the state-owned oil company (RECOPE) will continue to adjust petroleum product prices, and the state-owned public utility company (ICE) has been authorized to increase electricity rates--in addition to adjustments reflecting changes in the cost of petroleum--on a monthly basis for a period of one year.

Regarding monetary policy, a sharp decline in bank credit to the public sector--consistent with improvements in public finances--will permit an increase in bank credit to the private

sector. Credit policy will be implemented through open market operations and reserve requirements, and positive real interest rates will be maintained in an effort to encourage financial savings.

In order to improve external competitiveness while reducing the country's dependence on imports, the system of crawling peg adjustments will continue. Also, the program of fiscal incentives for exports has been modified, tying the subsidy level to the domestic value added.

The program provides for an increase in net international reserves of \$333 million, which includes a reduction in arrears of \$213 million through cash payments and rescheduling. The financing gap of the order of \$150 million is expected to be covered through debt relief from official creditors and loans currently being negotiated as cofinancing of the World Bank's third structural adjustment loan (SAL-III).

With regard to structural reform, the authorities are committed to continue with the reduction in the dispersion and maximum level of import tariffs. Also, the public sector reform program is to be initiated; the government-administered pension schemes are under revision, and the divestment program will be broadened.

In conclusion, the Costa Rican authorities are strongly committed to the economic program supported by the stand-by arrangement and the CCFF, and are ready to take any further measures that may become necessary for the achievement of the objectives of the program, if any adverse external development threatens the still fragile Costa Rican economy. They believe that their strong commitment to adjustment, combined with the support of the international financial community, are the anchors for a lasting solution to their economic situation.

Ms. Creane made the following statement:

Given Costa Rica's history of allowing its Fund-supported programs to go off track on two occasions, a further request for access to Fund resources calls for a strong and well-designed program with meaningful prior actions.

Therefore, we are pleased to see the request that is under consideration today. The measures taken and planned as part of this program are designed to address the major problems that derailed the last two programs, including lax fiscal policies and domestic financing of the resulting fiscal deficit. These new

measures include: the already enacted increase in the sales tax base and rate, with the remainder of the tax reform planned for later in 1991; cuts in public sector employment by 5 percent of the total, more than half of which has already been achieved; restraint in the public sector wage bill by limiting annual wage increases and challenging the "laudo" system of court-ordered wage increases; the increase in the minimum retirement age under social security by five years, with further pension system reforms planned; and the increases already taken and planned in prices of goods and services provided by public sector enterprises, which should have a major impact on the projected surplus of those enterprises in 1991.

Furthermore, the brunt of the impact of these measures should be felt early on in the program period, that is, in the first half of 1991. The cumulative effect is clearly one of aggressive fiscal tightening, with the overall public sector deficit projected to drop from 5.1 percent of GDP in 1990 to less than one half of 1 percentage point of GDP in 1991.

The other half of the challenge, though, is in avoiding a return to domestic bank financing of the remaining deficit. The dismantling of the "bicicleta" system of central bank financing is key to this end.

We also encourage the authorities to follow through on plans to enforce the programmed tight monetary policy through indirect tools, rather than a return to methods such as freezing credit to the private sector.

Through these steps, and those taken on assuming office last May, the new Administration has given every indication of its full commitment to reform. However, we have some concerns that a sizable amount of the adjustment in the first year is to be achieved through direct or temporary controls, such as the increase in revenue resulting from the import tariff surcharge. Additionally, more progress on privatization might have been built into the program.

The staff and the authorities are in agreement that the temporary measures enacted for short-term effect are clearly adequate for 1991, but they must be quickly buttressed by enactment of structural reforms, which would have a longer-term effect. Therefore, we strongly encourage the authorities not to ease their efforts following today's possible Board approval of their request for a Fund-supported program, and to supplement the important measures already taken with further structural reforms worked out with the World Bank. We would also recommend intensifying some of the measures already taken; for example,

deeper cuts in public employment, particularly in the public enterprise sector, would be warranted.

One area where we are not as sanguine as the staff is the current account prospects. The sharp improvement in the external balance for 1991 is as much related to a steep reduction in imports--particularly the 13 percent drop in import volume--as it is related to the projected improvement in exports or the terms of trade. The staff includes tight financial policies as one factor behind the decrease in imports, which seems appropriate and plausible. However, the other contributing causes are the residual--or temporary--and artificial constraints on import growth, including the import surcharge due to be removed in July 1991 and the import currency deposit requirement, which should be removed as soon as possible. This underscores the central importance of restrictive fiscal and monetary policies in the program.

We support the access requested under the CCFF, although it appears to us that somewhat arbitrary standards of cooperation with the Fund were imposed in this case, restricting Costa Rica's access compared with that of other members with weaker performance records or other problem relationships with the Fund.

In conclusion, the authorities have put forward an ambitious but necessary program that demonstrates their underlying fiscal responsibility. The program must be thoroughly implemented over the program period; in addition, a key test will be the depth and strength of the authorities' policy response to any unexpected external shocks. Nonetheless, we believe that this program can be the turning point in putting Costa Rica on solid ground for future healthy economic performance, and we support the proposed decisions.

Mr. Jácome made the following statement:

Since the last Article IV consultation, the Costa Rican economy has evolved from a period of expansionary financial policies to one of fiscal and monetary restraint. The relaxation of financial policies during the second half of 1989 and the first months of 1990 led to a widening of fiscal and external imbalances. However, in spite of this policy stance, the inflation rate improved, initially as a result of better crops and the postponement of price adjustments, and only started to accelerate again at the beginning of 1990.

Shortly after the new Government took office in May 1990, strong fiscal measures were adopted, aimed at reducing

macroeconomic disequilibria. These efforts were followed by the implementation of a comprehensive adjustment program for 1991, directed at consolidating the stabilization of the economy and paving the way for sustainable growth in the near future.

The Costa Rican authorities have correctly defined as the main objective of the present economic program a further reduction of the combined public sector deficit, from more than 5 percent of GDP in 1990 to 0.5 percent of GDP in 1991. It is planned to achieve this through both revenue and expenditure measures. Fiscal adjustment will facilitate monetary restraint and, at the same time, will permit the maintenance of bank credit flows to the private sector in line with the expected increase in nominal GDP.

In the external sector, the program envisages a sizable decrease in the current account deficit, from 11.4 percent of GDP to only 3.5 percent of GDP in 1991, to be attained with the help of a prudent wage policy and a small real depreciation. The reduction in the current account deficit appears ambitious, since it requires not only a large rise in net private sector saving over investment, but also an expansion of nontraditional exports by more than 14 percent and, in particular, a reduction in non-oil imports by more than 11 percent during the year.

The program expects annual inflation to be more than halved--to 12 percent--in 1991, and the rate of growth is expected to remain at 3.5 percent. While the latter target could probably be attained, we still have some doubts about the possibility of achieving the inflation target, given that the increase in prices accumulated in the first quarter of the year is already close to 7 percent, which might go beyond the effect of last year's sales tax and the imposition of the import surcharge. However, this figure should be seen in the context of the seasonal behavior of the price index in Costa Rica, and we wonder whether the staff has any information in this regard.

It is also important to stress the commitment of the Costa Rican authorities to continue implementing structural changes in order to improve resource allocation and, hence, economic efficiency. In this connection, it is worth mentioning the deepening of the tariff reform--initiated in 1986, with the aim of reducing maximum rates to 20 percent in 1992--and the ongoing privatization program, as well as the implementation of the public sector reform. The latter will certainly be reinforced with the programmed rationalization of public employment and the provision of a new law to determine the level of wages in this sector in line with overall fiscal objectives. The new financial reform aimed at increasing competition in the banking sector is also remarkable.

The Costa Rican financing agreement with its commercial creditors is one of the most advantageous agreements achieved so far in comparison with other countries' similar operations, in terms of both net debt reduction and net interest savings. However, in spite of this achievement, the medium-term outlook continues to be vulnerable to exogenous developments regarding changes in banana, coffee, and oil prices, as observed in the sensitivity analysis in the staff report. This reaffirms the importance of Costa Rica persevering in implementing sound macroeconomic policies to avoid the reappearance of external arrears, which at this time could also influence multilateral creditors.

In conclusion, we are of the view that, given the strong prior actions adopted by the Costa Rican authorities, and in light of the comprehensive economic program to be enforced in 1991, the Board should approve the requested stand-by arrangement and the compensatory financing. We support the proposed decisions.

Mr. Goos made the following statement:

At the outset, I would also like to welcome the fact that the new Administration has embarked on the far-reaching and, indeed, ambitious adjustment program, and that it has already implemented a number of encouraging policy measures. This policy reorientation is most commendable and timely when seen against the background of the unsatisfactory economic performance of the recent past. Costa Rica must now restart its adjustment effort from a position of financial imbalance that is significantly worse than at the outset of the previous program in 1989. Since then, Costa Rica has accumulated substantial amounts of external payments arrears. Even worse, the country appears to have missed the crucial opportunity to reap the potential benefit of the debt-reduction package achieved with commercial banks toward the end of last year. Overall, this experience demonstrates again that debt-reduction operations per se--that is, without the support of appropriate domestic policies--are rather useless. The authorities are, therefore, faced with the task of restoring confidence in Costa Rica's economic prospects, which, after the recent policy weaknesses, would appear especially challenging.

While the policy undertakings under the program seem to be consistent with this task, there are a number of issues indicating that the eventual success of the program is subject to particular risks. First, there is the risk of renewed policy slippages, as explicitly acknowledged by the staff. The possibilities of new difficulties in policy implementation might have been significantly reduced by the strong prior actions already taken,

but it is worrisome to note that renewed shortfalls in the implementation of planned expenditure cuts recurred in the second half of last year. Moreover, like Ms. Creane, I am concerned that quite a number of critical fiscal revenue measures are either only temporary or still awaiting parliamentary approval. The latter applies especially to the pending crucial legislation to change the practice of court-ordered wage awards, which, according to the background paper, produced cumulative real wage increases in the public sector of about 33 percent over the last two years.

I might add, however, that the information from the staff on recent policy implementation is quite encouraging. Moreover, the intention to compensate for any slippages by additional fiscal adjustment measures appears quite reassuring, but I wonder whether that intention is realistic in view of the very ambitious adjustment targets for both the fiscal and the external current account deficits. I would have thought that the realization of those targets, including the targeted increase in gross national savings by no less than 5 percent of GDP within only one year, would require the full use of all available policy instruments, thereby leaving little room for offsetting policy action in case of program deviations. This concern seems to be reinforced by the fact that the agreement on a Fund-supported program was reached only after unusually protracted discussions between the authorities and the staff, extending over a period of almost three quarters of a year, and notwithstanding the fact that both parties were assisted by a Fund resident representative. I would be surprised if this did not indicate that the authorities' implementation capacity will be stretched to the limit, and I would be grateful for the staff's comment on this issue.

The second risk concerns exchange rate policy. I am concerned that the crawling peg will unnecessarily complicate the task of domestic and external financial stabilization. In the first place, the policy of gradual depreciation might indicate to market participants that the authorities themselves are not sure about their ability to contain inflationary pressures. Furthermore, the accelerated rate of the crawl is most likely to increase inflationary expectations and the level of domestic interest rates, which are already considered to be too high.

In this context, I note that the significant depreciation of the real effective exchange rate by one third, which was achieved between 1985 and 1988, has been broadly maintained, and I wonder whether, from the viewpoint of external competitiveness, there is sufficient scope to absorb the impact of the intended reduction in import tariffs and fiscal export incentives at the existing exchange rate. At any rate, I would warn against the adoption of a too accommodating exchange rate policy in dealing with

inflationary and wage pressures. Such pressures should be tackled preferably through financial discipline and incentives to enterprises aimed at improving the efficiency of production.

Last, but not least, I should like to especially endorse the staff's call for the authorities to discharge Costa Rica's debt-service obligations to its external creditors, including the multilateral financial institutions, in a prompt manner. This will be absolutely essential, I believe, to mobilize the external financial assistance necessary to support Costa Rica's aspirations for sustainable development and growth. With these observations, I can support the staff appraisal and the proposed decisions.

Mr. Menda made the following statement:

Since the beginning of the 1980s, Costa Rica has maintained close relations with the Fund and has embarked upon a number of programs. During this period, many reforms have been implemented in close collaboration with the World Bank, with a view to liberalizing and opening up the economy. Economic growth, as a result, has been good: GDP grew at an annual rate of 4.5 percent during 1986-90. However, because of a more uneven course of financial policies, inflation averaged almost 20 percent during the same period, and the process of returning to external viability was more protracted than expected.

Therefore, we would like to welcome the prospects of a return to external viability by 1992-93. To this end, two elements are essential: first, Costa Rica has benefitted from a debt-reduction package, which has significantly alleviated its debt burden; second, last year, the new Administration took strong adjustment measures. The program before us, if fully implemented, should help restore internal and external equilibria.

I will concentrate my remarks, first, on the main areas of the program and, second, on the use of Fund resources and medium-term prospects.

The program will rely heavily on the adjustment of the public sector accounts. The objective of reducing the public sector deficit from 5.1 percent of GDP to 0.5 percent of GDP in 1991 is a very ambitious one, which will need to be closely monitored, given the past experience of difficulties in implementation.

Revenue measures are expected to yield the equivalent of 2.4 percent of GDP. I note, however, that some of these measures are of a temporary nature, and I would like to encourage the authorities to introduce lasting measures. I understand that much

has already been done to reform the tax system. Could the staff elaborate on what else can be envisaged? In this context, the decline in public expenditure will play a crucial role in the reduction of the deficit. We especially welcome the implementation of the scheme to reduce public sector employment, which will have lasting consequences for the fiscal accounts. Critical to meeting the objectives, however, will be strict control of the wage bill, which has grown at a rapid pace in the past. Therefore, the suppression of the full indexation of wages is welcome, but the authorities will need to remain firm in this area. In case of slippages, they will have to react promptly and adopt offsetting measures. Lastly, the pursuit of the public sector reform program, with the support of the World Bank, including the reform of the government-administered pension schemes, will be of the utmost importance.

During the past few years, inflation has remained persistently high. Therefore, a tight monetary policy will be necessary in order to complement the fiscal adjustment. Much progress has already been achieved in deregulating interest rates, and credit controls have finally been eliminated. Furthermore, I understand that interest rates are very high in real terms. I note, however, that, in the past, interest rates have fluctuated widely and that the authorities have had some difficulty in controlling the expansion of credit; the authorities have on occasion been obliged to reinstate credit controls. Could the staff comment on the reasons behind those difficulties?

Turning to the external sector, I have two remarks. First, I note that, despite an active exchange rate policy, Costa Rica has continued to suffer substantial trade deficits, even after the substantial devaluation in real terms that occurred in 1986-87. The staff report is not, in my view, crystal clear on the recommendations in this area. I would especially point to the fact that past depreciations have had a direct impact on wage claims--in the public sector, in particular--and have contributed to the persistence of inflation.

Regarding the real effective exchange rate, the measure of that rate based on inflation differentials can be particularly misleading. Indeed, the background paper indicates that, although real wages have risen by 8 percent on average during the period 1986-90, private sector wages, which determine the competitiveness of the economy, have in fact declined by 1.5 percent a year. Therefore, if I am right, a real exchange rate index based on unit labor costs would show a more pronounced decline and, therefore, larger gains in competitiveness. I would be grateful for the staff's comments on the measurement of the real effective exchange rate.

Second, I would encourage the authorities to pursue the implementation of the trade reform and the phasing out of export subsidies. I understand that these reforms are being pursued in collaboration with the World Bank in the context of a new structural adjustment loan.

Turning now to the use of Fund resources and Costa Rica's medium-term prospects, I have no difficulty with the requests for external contingency financing and a purchase under the CCFF. I have only one remark regarding the whole package: this package is heavily front loaded, since 25 percent of quota, which represents the first credit tranche, and 40 percent of quota, the full amount of the drawing under the CCFF, will be purchased at one time. I can, however, go along with this request, since the authorities have already taken significant prior actions. Furthermore, the proposed adjustment appears strong and should lead to a return to external viability in 1992-93. The debt-reduction package with commercial banks concluded in May 1990 will contribute to this effort in an amount equivalent to \$600 million a year. However, medium-term prospects will depend heavily on the authorities' capacity to implement fully the program.

Finally, concerning Costa Rica's relations with official creditors, I would like to mention that my authorities are particularly concerned that Costa Rica eliminate its arrears and normalize its relations with creditors as soon as possible.

Mr. Hogeweg made the following statement:

When we discussed a program for Costa Rica almost two years ago (EBM/89/62, 5/23/89), we had just endorsed the guidelines on the Fund's involvement in the Brady Plan for the debt strategy. The stand-by arrangement we approved at that time had awaited those guidelines and was the first to be structured with those guidelines in mind. The main emphasis in that discussion was on financing assurances, since it was not certain when Costa Rica and its commercial bank creditors would reach agreement on a financing package or what that package would look like. However, the staff paper for that discussion contained interesting medium-term scenarios, with and without debt-reduction operations, which showed the importance of such operations in reaching viability in the medium term. That operation was based, however, on an earlier tentative agreement with the banks, which had to be renegotiated when the Brady Plan initiative opened up the prospect of official financial support to facilitate such operations.

In the event, agreement was reached with the banks, but lack of compliance with the performance criteria and, specifically,

large overruns in the fiscal area prevented the Fund and the World Bank from supporting the package, which nevertheless was implemented, because sufficient alternative finance was mobilized. In this fashion, Costa Rica demonstrates the theme, emphasized by many Directors during the debt strategy discussion last week, that debt-reduction operations will only truly assist the country to become, and remain, financially viable if domestic policies are strong. The medium-term projections in today's staff report show not only that viability is still within reach, but also that Costa Rica remains vulnerable to adverse external developments, as well as further domestic policy slippages. In this light, I fully support the structure of the new program, which is based on strong prior actions. I also believe that it is justified to place Costa Rica in the category that limits access to compensatory financing at this stage to 40 percent of quota. I join the staff in urging the authorities to improve their track record. I trust that the extreme front-loading of access, unavoidable in view of the relatively low access under the stand-by arrangement and the availability of the first credit tranche, will not adversely influence the authorities' commitment.

Fiscal policy is clearly the core of the program, and wage restraint is essential. In that connection, I was struck by the judgment of the authorities, which the staff endorses, that the crawling peg seems more conducive to appropriate wage developments than a step devaluation followed by stability. Circumstances differ and each case is unique, but at the very least it should be acknowledged that, as a system, the crawling peg represents resignation to an inflationary environment and does nothing to help hold inflation down. On the contrary, it defines a floor, in this case an accelerating floor, below which it is most unlikely that inflation will fall, and expectations will reflect that. Given the history of fiscal slippages, the practice--which has only been temporarily suspended--of court-ordered wage adjustments without regard to macroeconomic consequences, and the concern expressed by the authorities that the present positive real interest rate levels slow down economic activity, I can only hope that the basis for the program will prove strong enough to sustain the effort.

On a matter of detail, I note that central bank losses from earlier loan guarantees have diminished but have not yet been eliminated. I wonder whether this weakens the position of the Central Bank in any way. At this juncture, the Central Bank needs all the strength it can possibly gather. In addition, I note that export subsidies will be reduced in order to relieve the budget and force export industries to increase efficiency. In light of that, I did not understand the reference in the staff report to the effect that exchange rate adjustments will be geared to

compensating for the export subsidy reduction. I fully recognize the importance of export diversification, and I support the reduction in subsidies. I do not think, however, that the Fund should endorse real depreciations, brought about by nominal depreciations, in order to allow inefficient enterprises to compete internationally.

With these comments, I support the proposed decisions.

The staff representative from the Western Hemisphere Department remarked that the 1991 fiscal package contained several temporary measures. A number of reforms were being finalized, however, which were expected to replace the temporary measures and produce a lasting improvement in the fiscal position. On an annual basis, the revenue loss from the elimination of the 10 percent import surcharge and the rollback of the sales tax was estimated to be 1.2 percent of GDP. However, the modifications to the government-administered pension and social security schemes, as well as the reduction in export subsidies, could yield about 0.6 percent of GDP, which implied that the public sector reform program would need to produce a net reduction in expenditure of about 0.5 percent of GDP. The public sector reform program, which was expected to include an overhaul of the procedures for evaluating public expenditure, institutional restructuring to eliminate duplication and increase efficiency, and the transfer of a number of activities from the public sector to the private sector, would probably result in a further decrease in public sector employment. As many of the fiscal measures required the approval of the National Assembly, there would inevitably be delays in the adoption of the new measures. The authorities had therefore opted to focus on expenditure, as the necessary adjustments could be made in part through presidential decrees. Recent information from the authorities indicated that the employment reduction plan was on track and that the reduction in employment in 1991 would be larger than anticipated.

The tax package had focused on increasing the rate of sales tax and broadening the tax base to include electricity and petroleum, the staff representative continued. The measures that remained to be taken were related mainly to income taxes, such as the establishment of a progressive tax on pensions paid by the public sector, an increase in the level of presumptive income of professionals for tax purposes, and steps to improve tax collection. With respect to specific taxes, the authorities would focus their efforts on eliminating taxes on a number of commodities that produced only a small amount of tax revenue.

Credit restraint had been difficult to maintain in Costa Rica, mainly because of fiscal slippages, the staff representative considered, as the authorities had been unable in recent years to exercise fiscal discipline; indeed, domestic financing of the budget had averaged about 2 percent of GDP between 1988 and 1990. In addition, steps to control private sector credit

expansion through increases in the reserve requirements had been circumvented through the "bicicleta" mechanism, through which resources freed by clearing house delays were used to finance the purchase of government bonds on an overnight basis. As a result of those difficulties, the authorities had shifted to direct credit ceilings in September 1990, which had subsequently been eliminated toward the end of the year.

The Central Bank's losses had diminished in 1989-90, the staff representative went on, in large part because of the impact of the debt-reduction package and debt-equity swaps. Nevertheless, the staff agreed that the remaining losses weakened the position of the Central Bank, and the authorities were considering the use of transfers from the central government budget to cover some of them.

Inflation had persisted at an annual rate of about 20 percent over the past three years, the staff representative said, and had been caused mainly by the sizable increase in nominal wages, particularly in the public sector, and the accommodating monetary policy, as evidenced by the fact that domestic financing of the deficit had averaged about 2 percent of GDP in recent years. The authorities had placed considerable emphasis on maintaining the dynamism of the nontraditional export sector, and had sought to ensure external competitiveness by maintaining the value of the colón in real terms. Their strategy had been particularly successful during 1987-89, as nontraditional exports had increased by about 20 percent a year over that period.

The authorities fully recognized the importance of price stability and were determined to pursue that objective by dealing with the factors that they considered to have been responsible for the inflationary pressures, the staff representative stated. Important elements of the strategy for 1991 included termination of the system of wage indexation and further steps to eliminate the system of court-ordered arbitration awards, which, as indicated in the staff report, had been considered a major factor in the increase in public sector wages. Of equal importance, however, the program provided for a major fiscal adjustment, which would not only obviate the need for domestic financing but also provide for a reduction in public sector indebtedness equivalent to 2 percent of GDP. The combination of those measures was expected to achieve a significant reduction in inflation.

Taking into account the leveling off of traditional exports and the performance of nontraditional exports in 1990, the staff representative from the Western Hemisphere Department commented, the authorities felt that it was important to maintain export competitiveness, as it was an important pillar in strengthening the balance of payments. Therefore, they considered it necessary to allow some real depreciation of the currency in order to compensate for a number of developments in recent years, such as the deterioration in the terms of trade and the tariff reform, which had included a reduction in maximum tariffs from 70 percent to 40 percent, and to partially offset the planned reduction in export subsidies. The

authorities hoped that, once inflation was brought down, the size of the nominal depreciation could be reduced.

Mr. Menda noted that a much larger decline in the real exchange rate was evident when unit labor costs were taken into account, as real wages in the private sector had declined during the past few years.

The staff representative from the Western Hemisphere Department said that the public sector was the wage leader in Costa Rica, particularly for the export sector. As public sector wages had increased by more than was indicated by the movement in unit labor costs, the latter was not necessarily the most appropriate measure of export competitiveness for Costa Rica.

Mr. Jácome asked whether the staff could quantify the seasonal behavior of prices in Costa Rica, which would be helpful in assessing developments in the price index. In Colombia, for example, about 40 percent of the annual inflation was concentrated in the first quarter of the year.

The staff representative from the Western Hemisphere Department replied that the large price increases in January and February 1991 reflected the 10 percent import surcharge and the increase--from 10 percent to 13 percent--in the sales tax, which, for the first time, had been applied to petroleum sales. It should be noted, however, that after accounting for those changes, monthly inflation had declined to 1 percent in March 1991, which was a positive sign. If tight financial policies were maintained, the inflation rate was expected to approach the projected rate of 12 percent for the year as a whole.

Mr. Laux said that he wondered why it had taken so long to reach an agreement with the authorities on the program.

The staff representative from the Western Hemisphere Department responded that, although many factors had contributed to the length of the negotiations, the main factor had been the difficulties in getting the tax package approved by the National Assembly and building a consensus on wage policy. The negotiations had begun in June 1990, and, following the recommendations of the technical assistance mission that had traveled to Costa Rica, tax reform had been identified as an important element of the program; indeed, the staff had insisted on implementation of tax reform as a prior action. Under Costa Rica's congressional system, the tax reform package had to be presented to a special session of the National Assembly. The package had been submitted to the National Assembly at the start of its August session, but had been approved only at the following session, which had begun in December. With regard to wage policy, since 1987, the authorities had adopted some form of wage indexation, and, given the movement of prices, the relevant formula had indicated a wage increase of about 18 percent for 1991, which would not have been feasible in the context of the program that the authorities had been considering. Therefore, it had

been necessary to try to convince the unions of the need to abandon the existing system of wage indexation; those efforts had proven to be extremely difficult, and, ultimately, the change had to be imposed unilaterally.

Mr. Laux remarked that he had not intended to be critical of the length of the negotiations; he was interested only in the cause of the delay.

Mr. Hogeweg recalled that the staff report indicated that the reduction in export subsidies would force the export sector to increase efficiency, but exchange rate policy was intended to compensate for the reduction in export subsidies. He wondered how the two statements could be reconciled.

The staff representative from the Western Hemisphere Department noted that many industries in the export sector in Costa Rica depended heavily on export subsidies. Fiscal subsidies were projected to increase from about one half of 1 percent of GDP in 1989 to about 2 percent of GDP in 1991. The authorities had considered that removing all the subsidies at one time would have had a negative impact on some industries and the export performance of the nontraditional export sector. It was hoped that, by simultaneously improving competitiveness and reducing subsidies, the nontraditional export sector would receive the necessary support. Clearly, the nontraditional export sector had to become more competitive and would require improvements in productivity. As those improvements would take time, it was felt that the depreciation of the exchange rate could facilitate the improvement in competitiveness in the short term.

Mr. Wright said that the program was strong, contained significant prior actions, and, as other speakers had pointed out, would be of great benefit to Costa Rica if it was sustained. The debt-reduction agreement had conferred several benefits on Costa Rica, but had been concluded without Fund or World Bank resources. Some aspects of the agreement were, in his view, questionable, such as the high price that was used for the debt buy-back and the fact that, while the agreement contained recapture clauses, there was no allowance for downside contingencies. Although those features of the debt agreement were largely of academic interest, they did have a bearing on the program that was currently under consideration. The program for Costa Rica, including the purchase under the CCFF, was intended to compensate partially for the drain on reserves resulting from the debt-reduction agreement, which had been very costly in cash-flow terms. In that sense, the Fund could be seen as providing retrospective finance to support an agreement with commercial banks in which it had not been involved. As other speakers had pointed out, Costa Rica had failed to reap the full benefits of the debt-reduction agreement, as it had not pursued a complementary Fund-supported program. The situation was clearly unsatisfactory, and such a route should not be recommended for other countries considering debt reduction.

With respect to the program itself, Mr. Wright went on, it was important that the authorities hold the line on public sector expenditure.

Any additional expenditure resulting from wage increases should be fully offset by additional reductions in public sector employment. The lifting of the freeze on bank credit and the authorities' commitment to maintain market-determined interest rates were welcome, but it was important to stick with those policies. The authorities should move more rapidly on financial sector liberalization, which seemed to have stalled recently. The crawling peg policy was dangerous, in that it validated inflation and made it harder to contain inflationary expectations, and he associated himself with those speakers who had commented on that policy. The authorities should be encouraged to honor their commitment to phase out the current multiple currency practice and, therefore, to meet their obligations under Article VIII as soon as possible. The process of phasing out the system of export incentives appeared too gradual; the subsidy on new contracts was being phased out slowly, and the adjustments to the subsidy on existing contracts were rather modest. Moreover, those adjustment were offset by lengthened maturities.

The further moves toward privatization were welcome, Mr. Wright stated, and he wondered whether the authorities intended to link privatization to the program of debt-equity swaps under the commercial bank debt-reduction agreement. There was also a need to reduce the cost associated with pensions, but the authorities' proposal should achieve the necessary reduction. It was worth noting that Costa Rica, which had been for many years a leader in Central America in the provision of social services, had been forced to raise the minimum retirement age and cut back on the provision of health and education services. While those measures were probably necessary and appropriate, he hoped that Cost Rica would be able to restore some of those services when its economic position improved.

He had a number of concerns about the various calculations for the CCFF purchase, Mr. Wright said. The partial shutdown of the domestic oil refinery during the shortfall year seemed to have contributed to the oil excess by shifting the composition of oil imports toward higher-value refined products. It was not clear to him whether the shutdown of the refinery was beyond the authorities' control. The shortfall in merchandise exports reflected partly the collapse of the International Coffee Agreement (ICA). In view of the fact that no new pricing agreement had yet been reached under the ICA, did the staff know the extent to which the shortfall would be fully reversed? In addition, it was uncertain to him whether all the factors contributing to the decline in meat exports--for example, marketing difficulties and the need to rebuild herds--were truly exogenous. However, Costa Rica's access had been scaled down under the provisions of paragraph 49(d) of the decision on the establishment of the CCFF, which was an entirely appropriate interpretation of that decision, and the reduced access would offset the problems that he had mentioned in connection with the CCFF calculations. Finally, he supported the proposed decisions.

Mr. Ghavam made the following statement:

As Mr. Torres's opening statement indicates, today's discussion on Costa Rica's 1990 Article IV consultation and its requests for Fund support is taking place at an important juncture for the country's economy. Since we are in broad agreement with the staff's appraisal and recommendations, we will confine ourselves to a few brief comments on the authorities' program.

The targeted decline in the public sector deficit of 4.6 percent of GDP in 1991 is quite ambitious and calls for strong discipline in expenditure and revenue. On the revenue side, while we are encouraged by the envisaged measures to augment tax revenue, further improvements in tax administration and collection will be necessary for the effective implementation of these measures.

Regarding expenditure, as noted by some speakers, there have been large increases in current expenditures, particularly wages, during past years. In coping with this problem, the authorities' program correctly envisages, inter alia, lowering public sector employment. To enable the private sector to absorb the additional labor, as well as to further increase its share in the economy, an appropriate adjustment in the growth of credit to the private sector relative to the public sector is crucial and must be pursued vigorously.

The authorities' serious concern about the finances of public enterprises is demonstrated by the targeted increase in that sector's overall surplus to 1.9 percent of GDP in 1991. However, the disparity between wage increase targets in the central government sector and public enterprises may produce pressure for wage increases within the enterprises. Could the staff comment on this issue?

Turning to the external sector, the authorities' exchange rate policy, combined with trade liberalization and incentive mechanisms for exports, has resulted in an expansion of the export base. Moreover, the measures undertaken so far, and those envisaged for the future on import tariff reductions, have resulted in a substantial opening up of the economy. Having said this, it seems reasonable to expect that the country's trade partners in the industrial world will increase further Costa Rica's access to their markets by reducing trade barriers.

Concerning the medium-term outlook for the balance of payments and the country's capacity to repay the Fund, two issues are important to note. First, the country's vulnerability to fluctuations in coffee and banana prices, as well as domestic

climatic conditions, will remain matters of concern. However, given the prospects regarding reactivation of the International Coffee Agreement (ICA), it is hoped that Costa Rica, along with other ICA member countries, will attach great importance to the effective operation of the price stabilization mechanism of the Agreement. Second, the prospects for the international assistance needed to fill the financing gap are now more promising, following the recently concluded debt-relief package. The further enhancement of this package, incorporating a stronger element of debt reduction, should be considered seriously by the country's creditors. In this respect, vigilant avoidance of any slippages in the authorities' program should facilitate new negotiations with the creditors.

In conclusion, we support the proposed decisions.

Mr. Ichikawa made the following statement:

The debt-reduction operation that took place last May was a major step toward medium-term viability for Costa Rica. However, the fact that no purchases were made under the previous stand-by arrangement and the delay in the negotiations for the proposed program resulted in the re-emergence of substantial external arrears in 1990. While the short-term deterioration was disappointing, I believe that the staff's careful assessment and patient negotiation have led to a more reliable program than would otherwise be the case; the program before us appropriately addresses the weaknesses in Costa Rica's fiscal policy. I welcome the adoption of a number of strong prior actions.

Nevertheless, there remains much to be done in the structural area in order to achieve sustainable growth over the medium term--I emphasize "sustainable," as monetary inflation has been the dominant and persistent problem underlying Costa Rica's domestic and external imbalances.

First, the suspension of full indexation of public sector wages is welcome. However, a mere postponement of a wage increase only adds difficulty to the conduct of fiscal policy in subsequent years. The real challenge is to break the indexation of public wages in a more lasting manner. This is also important in order to send the right signal to the private sector, in which an implicit wage indexation is prevalent. In addition, the 18 percent increase in the wage bill seems to be excessive, in light of the substantial wage increases in previous years. If this increase includes retirement benefits related to an additional reduction in public employment, could the staff comment

on the extent to which it contributes to the increase in the wage bill?

Second, pension transfers from the central government budget have been growing rapidly in recent years. The cut in transfer expenditure is welcome. However, a more efficient pension system has to be established in a timely manner; a delay in that reform would lead to additional budgetary pressure on the central government over the medium term.

Third, I was surprised to learn that one third of the consumer price index basket was still subject to government control. While the 43 percent increase in those controlled prices represents lagged adjustment, there is a risk that, as long as there remains such a large number of items subject to official price controls, adjustment will be delayed again in the future. I would urge the authorities to review their pricing policy.

Fourth, on the exchange rate policy, the vicious circle of lax financial policy, high inflation, and step devaluation was the dominant recent development in Costa Rica's external sector. In light of the uncertainties in the external sector, I can endorse the retention of the flexible exchange regime, but only with some reluctance. Given that inflation is projected to be about 12 percent, exchange rate stability cannot be expected without a strong incomes policy. I urge the authorities to pursue disinflation policies in a determined manner and to adhere to the targeted reduction in the monthly rate of depreciation.

I have some concerns about the financing assurances for the program. While the disbursement of SAL-III seems to be of key importance to the achievement of the viability of the balance of payments, the second tranche of SAL-II has not yet been disbursed, owing to the failure to meet the World Bank's conditionality. There is a risk that the conclusion of SAL-III may be delayed substantially, in light of this development. I would appreciate the staff's comment on this matter.

In conclusion, while I welcome the series of prior actions, many of them are temporary measures, and the critical phase of institutional and policy reforms has yet to be seen. In this regard, in my view, considerable vulnerability will remain in the program unless structural reforms are deepened. While I can go along with the proposed decisions, including that on the compensatory and contingency financing, strong additional measures should be taken in the areas of fiscal and incomes policies in the event that contingent resources are released.

With these comments, I support the proposed decisions.

Mr. Kural made the following statement:

Since the middle of May 1990, the Government of Costa Rica has been pursuing two economic objectives. The first, supported by incomes policies, is to reduce the fiscal deficit. The second, supported by a structural adjustment program, is to ease pressures on the balance of payments. The emphasis given to these two issues reflects the main problems facing the Costa Rican authorities.

However, the efforts made toward achievement of these objectives have met with little success up to now. Although the consolidated public sector deficit declined from the first half to the second half of 1990, failure to take timely corrective measures resulted in a net loss of international reserves and an increase in external arrears during the first half of the year. During the second half of 1990, however, the pace of the loss of Costa Rica's reserves slowed down, in spite of the reduction of export earnings and capital inflows caused by uncertain world economic conditions. Nonetheless, the lack of external financing has forced the Government to rely more heavily on domestic bond financing, creating upward pressure on domestic interest rates. The rise in domestic interest rates, combined with price adjustments and a sharp expansion of net bank credit to the public sector, had caused a 27 percent rise in consumer prices by the end of 1990.

In light of these factors and of the inflation and balance of payments objectives of the 1991 program, the importance of refinancing arrangements becomes clear. From 1986 to 1990, Costa Rica's balance of payments deficits were financed by debt relief and the accumulation of arrears. Costa Rica's debt-service burden, measured by existing commitments and projected debt, has begun to decline as a result of the reduction in debt service achieved by increased reliance on concessional external resources and the effects of 1990's rapid export growth.

Even though Costa Rica's short-term prospects improved slightly in 1990 with respect to foreign exchange flows, through a combination of refinancing and debt-service reduction, the country's medium-term external debt profile will continue to require prudent debt management. This outlook underscores the importance of the structural adjustment policies currently being pursued in Costa Rica, which include public sector reforms, a restrained wage policy, tight credit, defense of the present

exchange rate, and a significant improvement in export performance over the medium term.

We support the proposed decisions.

Mr. Spencer said that he wondered whether it was realistic to assume that the terms of trade would improve by between 1.5 percent and 2.5 percent a year over a six-year period, and whether coffee prices would increase by between 9 percent and 12 percent a year over the same period, following a number of years in which the coffee market had been depressed. The sharp drop in import volumes, which other speakers had noted, was obviously an important factor contributing to the projected steep decline in the current account deficit. Given that the maximum tariff had already been reduced from 70 percent to 40 percent, with the intention of reducing it further to 20 percent by 1992, he was concerned that import penetration would in fact increase as the economy was opened further to international trade. He was therefore unsure whether the projected decline in imports to 27.5 percent of GDP was realistic, following a period in which they had already increased from 30 percent to 35 percent as a result of the continuing import liberalization. Presumably, the real depreciation of the exchange rate would be an offsetting factor, but a fairly large depreciation would be required in order to generate such a drop in import volumes, and it did not appear that the authorities were considering a real depreciation of that size.

Mr. Wang made the following statement:

I am impressed with the prompt policy response of the new Administration, which entered office in May 1990. The results of the corrective measures have been positive, as catalogued in the staff report and Mr. Torres's informative statement. Moreover, the economic program for 1991 is strong and ambitious. If the conditions, both internal and external, are met and the program is kept on track, then it is reasonable to expect Costa Rica to restore external viability in the medium term, or even sooner. In my opinion, the program deserves the full support of the Fund. Therefore, at the very outset, I wish to express my endorsement of the proposed decisions. Having said that, I have a few comments on certain aspects of the program.

The emphasis on fiscal measures is appropriate, since the expansionary fiscal policy has been responsible for almost all the imbalances that plagued the Costa Rican economy in 1990 and, for that matter, the past several years as well. Rising inflation, loss of international reserves, declining external competitiveness, and the excessive external debt cannot be checked or reversed without a major overhaul of the fiscal position. Two concerns came immediately to our attention in this area.

One concern is that the measures to boost revenue have some downside risks, owing to the inherent volatility of prices in the nonfinancial public sector, such as those for coffee. Should the price of coffee deteriorate, the envisaged shift of the public sector from a deficit of 3.1 percent of GDP to a small surplus may not materialize. In addition, some of the tax measures, such as the 10 percent import surcharge, are only temporary and cannot be expected to generate revenues permanently. More lasting solutions must be found by improving the tax system and tax administration.

The second concern relates to the expenditure side of the budget, specifically, the wage increases of the employees of the central administration. The full indexation of wage increases plus the downward stickiness of wages, even under circumstances in which actual prices fell short of expectations, has contributed in no small measure to the public fiscal deficit and, therefore, must be abolished. In this connection, the measures taken by the authorities to counter the "laudo" system seem to be sufficient for the time being. To better control wage increases in the future, however, the arbitration award practice should be eradicated altogether. Reduction in public sector employment will be necessary if excessive wage increases transpire during the program period.

On monetary policy, I understand the justification given for the potential increase in bank credit to the private sector during 1991, but would caution against any excessive increase. Furthermore, if the envisaged fiscal outcome should fail to materialize, the total expansion of credit to the private sector will have to be cut back as a compensatory measure, no matter how undesirable this may be, as the desirability of promoting private sector activity has to be carefully weighed against the undesirability of rising inflation. The outcome should further drive home the absolute necessity of carrying out the fiscal actions mapped out in the program.

Interest rates should continue to be market determined for the sake of maintaining efficiency in resource allocation, as well as of avoiding distortions.

Turning to the external front, while endorsing the exchange rate policy and supporting the endeavors to restructure the external debt, I wish to point out the tremendous risks associated with the projections for exports in 1991. The 12 percent growth in the U.S. dollar value of exports is not entirely impossible, but is rather precarious. With respect to traditional exports, of the two major commodities, coffee and bananas, the price of the former is rather volatile and the productivity in the production of the latter is heavily dependent on weather conditions. The

authorities will be in a better position to weather external disturbances if there is a second line of defense against any unexpected developments in international coffee prices. The staff is right to state that the authorities must be prepared to take additional measures as needed to ensure that the program remains on track. Could the staff specify what additional measures the authorities should be prepared to take?

Mr. Noonan considered that the adjustment program for 1991-92 was a step in the right direction, particularly the commendable aim of reducing the combined deficit of the public sector from 5.1 percent of GDP in 1990 to no more than 0.5 percent of GDP in 1991. He was concerned, however, that revenue would bear a substantially greater share of the burden of adjustment than public expenditure. That approach, which implied more compression of the private sector than the public sector, was not conducive to optimum or sustainable economic growth. Notwithstanding the comments of the staff representative, it did not appear that there would be a noticeable change in future years in the relative emphasis placed on revenue and expenditure. He concurred with the staff that both the elimination of the system of court-ordered wage awards and greater wage restraint in the public sector were essential to ensure the success of the program. However, if those changes were to be satisfactorily realized without a period, perhaps prolonged, of industrial unrest in the public sector, a new system for determining pay in the public sector should be negotiated without delay.

The U.S. dollar value of nontraditional exports was expected to increase by about 15 percent in 1991, following a year of stagnant export growth and an earlier period in which exports grew by about 20 percent a year, Mr. Noonan observed. The background paper indicated that the poor performance of nontraditional exports in 1990 had stemmed from marketing difficulties. He wondered what sort of marketing difficulties had been encountered and how they would be addressed in 1991. Finally, given the prior actions taken by the authorities, he supported the proposed decisions.

Mr. Fogelholm made the following statement:

I am in broad agreement with the staff appraisal. In light of the fact that the last two Fund programs have gone off track, it is essential that, this time around, the authorities stay the course and make the necessary real economic adjustments to regain the confidence of the international community.

On the question of the length of the program negotiations, let me say that I am in full agreement with the staff's approach in this case. Agreement between the authorities and the Fund should not be made prematurely. Also, when staying the course has been the major problem, the staff's main emphasis in program design should be to ensure that a critical mass of prior actions has been

implemented. That should, indeed, be the general rule, and I believe that the Costa Rican program largely meets that requirement, despite the fair amount of temporary revenue-enhancing measures.

Fiscal tightening is at the core of the adjustment efforts. Measures taken last year by the new Government to reverse the growth in the budget deficit, and other actions implemented this year prior to the request for the Fund program, are encouraging signs of the authorities' determination to adjust the economy. However, the many temporary revenue-increasing measures give rise to some concern and make it imperative that the authorities expeditiously formulate and effect lasting deficit-reduction measures on the expenditure side of the budget, in order to provide a robust basis for attaining medium-term viability in the external accounts. In this connection, maintaining tight control over the wage bill is crucial.

It is, indeed, pleasing to note that medium-term viability can be achieved as soon as 1992-93, provided that planned economic policies are firmly implemented. The staff's sensitivity analysis shows, nonetheless, that the authorities will have to stand ready to undertake additional policy measures, should adverse external developments so warrant.

The financial relief provided by the debt-reduction package agreed upon last year is significant. In this context, I fully concur with Mr. Goos's view that debt reduction alone cannot do the trick, but needs to be accompanied by stringent financial policies. Moreover, as the debt-reduction operation has already been implemented, this implies that no major additional relief can be expected from the outside, and, consequently, from now on the country's fortunes are in the hands of the authorities and their ability to adjust the economy and put it on a sound footing.

Let me add just one word on the exchange rate policy. Until the strengthened financial policies have driven inflation down substantially, it seems inevitable that further exchange rate changes will be necessary. However, under the present system--a crawling peg--expectations of continuous depreciations can easily become too deeply ingrained, thereby complicating the anti-inflationary efforts. Consideration could, therefore, be given to adopting a "cleaner," flexible, that is, market-determined, exchange rate policy, which could well lead to a fairly stable flexible exchange rate if the expected stringent financial policies are pursued. Then this flexible exchange rate policy could constitute a first step toward a stable, nominal exchange rate, conducive to price stability.

To conclude, I can support the proposed decisions, particularly because of the prior actions taken, but also in the expectation that the authorities will undertake lasting adjustment.

Ms. Creane remarked that she was not particularly enthusiastic about an exchange rate system based on a crawling peg, but she was reassured by the staff's extensive consideration of Costa Rica's situation, and, like the staff, she endorsed the authorities' policy. Nevertheless, she would have preferred a more flexible, less structured approach to exchange rate policy, particularly as the authorities were already pursuing tight financial policies, and both wage increases and domestic bank financing of the budget deficit would be addressed in the program.

The staff representative from the Western Hemisphere Department said that revenue had borne a greater share of the burden of adjustment, but the authorities intended to replace many of the temporary revenue measures with expenditure reforms. Over the longer term, expenditure would bear a larger share of the adjustment burden.

The anticipated performance of nontraditional exports in 1991 represented a significant improvement compared with 1990, the staff representative considered, although it should be recalled that nontraditional exports had grown at an average annual rate of about 25 percent in 1987-89. The difficulties in that sector in 1990 had stemmed from many factors, including capacity constraints. Those constraints should be eased as a result of the ongoing reform of the public sector, which would release labor for employment in the private sector. In any event, the authorities remained committed to maintaining export competitiveness.

The export price projections in the program were derived largely from the world economic outlook paper, the staff representative continued. As Mr. Spencer and others had commented, coffee export prices were slightly lower than anticipated; on the other hand, oil import prices were also lower than anticipated, and the medium-term projections would be revised throughout the program period on the basis of updated WEO projections. The projected reduction in imports in 1991 was a critical element of the program; the authorities felt that a reduction in non-oil imports of about 11.5 percent was achievable, given the basic stance of financial policies and the temporary measures that had been taken to dampen import demand, specifically, the 10 percent import surcharge and the 50 percent domestic currency deposit requirement. It was vital, however, that financial policies remained tight in order to reduce the demand for imports.

Pension payments had not been included in the wage bill for 1991, the staff representative went on. While the programmed increase in the wage bill of 12 percent was somewhat larger than the staff would have preferred, it included a 5 percent built-in increase that could not have been avoided,

and would still result in a sharp contraction in real terms. There had been difficulties in the past in maintaining wage restraint in the public enterprises. The wage policy for 1991, however, which had been imposed unilaterally by the Government, affected both the central government and the public enterprise sector. The elimination of the "laudo" system would also reduce the pressure for wage increases in public enterprises.

The divestment policy was, indeed, related to the debt-equity scheme, as Mr. Wright had suggested, the staff representative from the Western Hemisphere Department said. The debt-reduction package provided for a five-year \$100 million debt-equity conversion program, with minimum operations of \$20 million a year. The public sector reform program included the transfer to the private sector of activities that had previously been handled by the public sector and the overhaul of the pension schemes, which had had a significant fiscal impact over the past few years. The reform of the pension schemes would be discussed in the context of the third structural adjustment loan from the World Bank.

The staff representative from the Research Department noted that the total volume of oil and oil products produced by the domestic refinery in the shortfall year had been almost exactly the same as in the preshortfall year. Actual oil import costs during the shortfall year had been \$192 million; if the import mix had been similar to that of 1989, the cost would have been \$185 million, amounting to a difference of about \$0.90 per barrel. On the basis of actual 1990 costs, the oil import excess was SDR 28 million, or 33 percent of quota. If the product mix had not changed in 1990, the excess would have been about SDR 24 million, a difference equivalent to 4.7 percent of quota. If the refinery had maintained operations during 1990 at normal levels, there would have been some savings in Costa Rica's total oil import bill. Therefore, it could be argued that, if it had been possible, it would have been in Costa Rica's interest to have maintained operations during 1990. Thus, the oil import excess, including the effect of the change in the product mix, could reasonably be considered to be attributable largely to circumstances beyond the control of the member.

The projected increase in coffee export prices was relatively modest in the two postshortfall years, the staff representative from the Research Department continued. The decline in prices following the breakdown of the ICA negotiations was considered beyond the control of the member. Costa Rica's quota in the ICA was relatively small--about 2 percent of the world trade in coffee--and the shortfall was not dependent on the renewal of the ICA and a rapid recovery in prices. Meat exports had been declining, because of intensive competition in export markets and the marketing difficulties that Costa Rica had faced owing to health restrictions. The herd buildup in 1990 was not expected to continue in the postshortfall year.

Mr. Fogelholm asked whether the staff agreed with Ms. Creane's view about the need for a more flexible exchange rate policy. As the authorities

were attempting to maintain fairly tight financial policies, a more flexible rate might stabilize the exchange rate rapidly, which could be seen as a first step toward a fixed exchange rate. With the crawling peg system, however, that process would be more difficult, as the system had to be administered by the authorities.

Mr. Wright said that it appeared that the export sector faced, among other problems, a capacity constraint. That sector was expected to receive a supply-side benefit in the form of an increase in the pool of available labor as a result of retrenchment in the public enterprise sector. He was therefore even more skeptical about the appropriateness of the crawling peg system, which tended to exacerbate the pressure on wages.

The staff representative from the Western Hemisphere Department remarked that the authorities considered that their exchange rate policy had been successful. The strength of the crawling peg system, which was instituted in 1987, was that it was accepted by investors and the business community and it had succeeded in producing an increase in nontraditional exports. The system had also largely avoided a rapid acceleration of private sector wages. In 1988, the authorities had implemented a step devaluation of about 6 percent, which had unleashed a wave of wage demands that had made economic management difficult. Taking that experience into account, the authorities felt that a step devaluation should be avoided in 1991 and the existing policy should be continued. It should be noted that, when the authorities were considering their exchange rate strategy, they were in the middle of wage negotiations with the trade unions. The authorities felt that if they had effected a step devaluation or any other change to the system, they would not have been able to restrain wage increases and, in particular, abandon the system of wage indexation, which they had replaced unilaterally with a 5 percent wage increase in 1991.

Mr. Ichikawa said that it was not clear to him whether the planned increase in the wage bill was to be 15 percent, as the staff representative had indicated, or some larger figure; the staff report indicated that the central government wage bill was not to exceed 18 percent in 1991.

The staff representative from the Western Hemisphere Department replied that the central government wage bill would increase by 18 percent, while public sector wages as a whole would increase by only 15 percent.

The staff representative from the World Bank said that the staff of the World Bank had been working with the Costa Rican authorities since May 1990 and had followed their program very closely. If the Executive Board of the Fund decided to approve the proposed stand-by arrangement, the Bank would be in a much stronger position to consider release of the second tranche of SAL-II, which could be disbursed within the next two months. It was hoped that, following a program monitoring period of three to six months, the final tranche of SAL-II could be disbursed. It was also hoped that SAL-III

could be appraised in December 1991 in order to submit the loan request to the Executive Directors of the World Bank before the end of the year.

Mr. Torres noted that the authorities' program was ambitious and had been preceded by the full implementation of strong prior actions, which was a strong signal of their commitment to adjustment. It should be emphasized, however, that the authorities' commitment to certain policies extended far beyond the program period, and that the adoption of certain temporary measures was intended to provide the necessary time to design and implement the required structural reforms to address permanently the significant distortions in the public sector, the labor market, and the external sector. Nevertheless, the concerns that had been raised by Directors would assist the authorities in underscoring the need to continue on the path they had chosen.

The Chairman made the following summing up:

Executive Directors were in general agreement with the thrust of the staff report for the 1990 Article IV consultation with Costa Rica. They noted the adjustment measures implemented by the authorities in the second half of 1990, and were encouraged by the adoption in 1991 of a comprehensive economic program with significant prior actions geared to lowering inflation and strengthening the balance of payments. Directors, however, recalled that since 1988 two consecutive programs supported by the Fund had gone off track because of policy slippages, which had led to growing inflationary and balance of payments pressures; they urged the authorities to act determinedly to implement their current program, and were encouraged by indications that performance to date was broadly in line with the program.

Fiscal policy, in particular, was very ambitious, and rightly so. Directors commended the authorities for the measures they had undertaken immediately on assuming office and for the more recent measures, including increases in taxation and public utility tariffs, cutbacks in public sector employment, measures of wage restraint, and curbs in government transfers, which are expected to reduce the overall public sector deficit from 5 percent of GDP last year to 0.5 percent in 1991.

Directors observed that some of the fiscal measures were temporary, and attached importance to the Government's intention to introduce structural reforms so as to ensure a lasting solution to the fiscal problem. In particular, Directors urged the authorities to start the public sector reform program without delay and to proceed quickly with the overhaul of the government-administered pension schemes. They also emphasized the importance of reducing wage indexation and developing a framework that would

assure the implementation of a wage policy consistent with the economy's capacity.

Directors viewed the restrained monetary stance incorporated in the program as essential for reducing inflation, and welcomed the authorities' decision to eliminate quantitative credit controls and to rely on open market operations as a means of controlling credit expansion. It was observed that the current high level of interest rates was mainly the result of the acceleration of inflation and the sharp increase in the public sector financing requirement in 1990, and that these rates could be expected to decline as inflation subsided and the fiscal deficit was reduced.

There was general agreement that the vigorous pursuit of the tight financial policies was also essential for the strengthening of the balance of payments and the external liberalization of the economy. Directors noted the view of the authorities that exchange rate policy, suitably backed by financial policies, had an important role to play in achieving an adequate degree of export competitiveness in the face of the deterioration of the terms of trade and in the light of the reductions being made in import tariffs and export subsidies. Directors also took note of the authorities' judgment that they could pursue their exchange rate strategy most effectively within the framework of the present system of mini-devaluations. Several speakers endorsed Costa Rica's exchange rate policy. Some other Directors, however, noted that the authorities in effect were targeting the real exchange rate, and they felt that such a policy could complicate the task of achieving the objective of lowering inflation. They encouraged the authorities to keep exchange rate policy under review and to ensure that the use of the various policy instruments is mutually reinforcing so as to achieve all the main objectives of the program.

Directors observed that Costa Rica's debt-reduction agreement with the commercial banks could be expected to make a contribution to the attainment of medium-term balance of payments viability. However, Costa Rica's past history of policy slippages and programs that had gone off track clearly illustrated that achievement of this goal required continued implementation of sound adjustment and structural policies. In that context, several speakers emphasized the continuing vulnerability of Costa Rica's external position, and the importance of the commitment of the authorities to exert particular vigilance in the implementation of their program.

It is expected that the next Article IV consultation with Costa Rica 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 Costa Rica's exchange measures subject to Article VIII, Sections 2(a) and 3, in the light of the 1990 Article IV consultation with Costa Rica conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. Costa Rica maintains restrictions on payments and transfers for current international transactions as evidenced by external payments arrears by public enterprises to official creditors and undue delays in the approval of applications for foreign exchange purchases for certain current payments, and engages in multiple currency practices for certain current payments as described in EBS/91/40. The Fund notes the temporary nature of the multiple currency practices and the authorities' program to reduce and eventually eliminate the above restrictions, and grants approval of the retention by Costa Rica of the restrictions on the making of payments and transfers for current international transactions and of the multiple currency practices until a review under the stand-by arrangement on July 15, 1991, whichever is earlier.

Decision No. 9698-(91/50), adopted
April 8, 1991

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

1. The Government of Costa Rica has requested:

(a) a stand-by arrangement in an amount equivalent to SDR 33.64 million for the 12-month period beginning April 8, 1991, and

(b) a decision that, should adverse external contingencies occur during the period of the stand-by arrangement, the Fund will provide, in association with the arrangement, external contingency financing under Section III of the Decision on the Compensatory and Contingency Financing Facility (Decision No. 8955-(88/126), adopted August 23, 1988, as amended), up to a maximum amount equivalent to SDR 21 million.

2. (a) The Fund approves the stand-by arrangement set forth in EBS/91/40, Supplement 3.

(b) The Fund decides that:

(i) should adverse external contingencies occur during the period of the arrangement, the Fund will provide, in association with the arrangement, external contingency financing under Section III of the Decision on the Compensatory and Contingency Financing Facility (Decision No. 8955-(88/126), adopted August 23, 1988, as amended) up to a maximum amount equivalent to SDR 21 million, in accordance with the factors set out in the attachment to EBS/91/34, and

(ii) should favorable external contingencies occur during the period of the arrangement, adjustments of up to SDR 21 million will be made by the Fund at that time under paragraph 27 of Decision No. 8955-(88/126), adopted August 23, 1988, as amended, in accordance with the factors set out in the same attachment.

3. Should the Government of Costa Rica notify the Fund after the date of this decision that it no longer wishes to avail itself of the benefit under paragraph 2(b)(i) above in association with the stand-by arrangement, the provisions of paragraph 27 of Decision No. 8955-(88/126), adopted August 23, 1988, as amended, shall continue to apply for the remainder of the baseline period.

Decision No. 9699-(91/50), adopted
April 8, 1991

Purchase Transaction - Compensatory and Contingency Financing
Facility - Fluctuations in Exports and Cost of Oil Imports

1. The Fund has received a request by the Government of Costa Rica for a purchase equivalent to SDR 33.64 million for the compensation of an excess in the cost of oil imports and a shortfall in export earnings 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 finds that Costa Rica is eligible for a purchase under Section V of Decision No. 8955-(88/126), adopted August 23, 1988, as amended, for an excess in oil import costs and a shortfall in export earnings, and approves the purchase in accordance with the request.

Decision No. 9700-(91/50), adopted
April 8, 1991

2. LAO PEOPLE'S DEMOCRATIC REPUBLIC - STRUCTURAL ADJUSTMENT FACILITY -
SECOND ANNUAL ARRANGEMENT

The Executive Directors considered a staff paper on the request by the Lao People's Democratic Republic for a second annual arrangement under the structural adjustment facility (SAF) in an amount equivalent to SDR 8.79 million (EBS/91/32, 3/4/91; and Sup. 1, 3/21/91). They also had before them a policy framework paper for the Lao People's Democratic Republic for 1991-93 (EBD/91/58, 3/4/91).

The Managing Director made the following statement:

There follows for the information of Executive Directors the text of a memorandum that I have received from the President of the World Bank to serve as the basis for my statement on the matter to the Board. This text summarizes the main points covered by the Committee of the Whole of the Executive Directors of the Bank and IDA in their meeting on March 21, 1991:

The Executive Directors of the Bank and IDA discussed, in a meeting of the Committee of the Whole, the second-year policy framework paper for the Lao People's Democratic Republic for 1991-93. Speakers complemented the Government of the Lao People's Democratic Republic for its continued commitment to a strong and ambitious reform program to lay the foundation for sustained development. They indicated their appreciation of the difficulties of this undertaking and wished the Lao authorities continued success in their endeavors. Staff noted that the growth strategy described in the document relies on a strong increase in investment, combined with the removal of structural obstacles to the efficient allocation of resources. Financial and fiscal policies are designed to mobilize additional resources to support such a strategy. Speakers stressed the importance of measures, such as tax reforms and expenditure control, as well as an appropriate public investment program, to achieve this objective. Speakers also emphasized the need to adapt the pace of reforms to the implementation capacity of the government and welcomed Bank technical assistance to strengthen economic institutions.

Concerns were raised about avoiding high price inflation through prudent monetary and credit measures. The importance of giving priority to social sector developments, and the need for complementary basic infrastructure investments was noted. The importance of continuing the policy of conserving forestry resources was also stressed.

A number of interventions stressed the need for mobilizing resources for the Lao People's Democratic Republic, and IDA was urged to continue its support for the commendable efforts of the

Lao authorities to both reform their economy and deal with pressing social and environmental issues.

Mr. Ismael made the following statement:

As reported earlier, the Lao People's Democratic Republic adopted a medium-term structural program in mid-1989. At the time of the 1990 Article IV consultation with the Lao People's Democratic Republic on November 28, 1990 (EBM/90/167), the Executive Board commended the authorities on the progress made in introducing market-oriented reforms during the first annual arrangement under the structural adjustment facility. At that time, I also informed the Board of the upcoming Fund mission in early December, which had the objective to assist the authorities in finalizing a second year arrangement under the SAF for possible Board consideration in February 1991.

I now have the pleasure to inform the Board that the Government of the Lao People's Democratic Republic has submitted a request for the second annual arrangement under the SAF. My authorities would be grateful if this request could be approved, thereby making available the equivalent of SDR 8.79 million (or 30 percent of quota) in support of the proposed program.

The thrust of the medium-term--1991-93--growth strategy is directed toward removal of the remaining institutional and policy weaknesses, continuation of the restructuring of the economy along market lines, and adjustment to adverse external shocks, particularly the higher price of imported oil and the changes in trade and aid relationships with the Soviet Union. Within this framework, the 1991 program is designed to maintain a growth rate of about 5 percent, reduce the inflation rate to 14 percent, and strengthen the balance of payments and international reserves.

To this end, monetary and fiscal policies are being tightened to protect the competitiveness of the economy while minimizing downward pressures on the exchange rate. A pragmatic strategy will be pursued, taking into consideration any necessary adjustment to address fundamental external disequilibria. The development of an interbank market is being considered as an option, in order that a more market-based exchange rate management can be pursued.

To reduce the budget deficit, expenditure priorities will be reordered to emphasize investment, and new revenue measures will be adopted. In addition, growth in current spending will be curbed, while capital spending will be increased. Moreover, my authorities recognize the fundamental importance of improved tax

collection and budgetary control, and are determined to introduce strengthened measures in these areas.

In order to restrain liquidity growth, indirect monetary policy instruments are being developed. As an initial move in creating a system of open market operations, the issuance of central bank securities in the first half of 1991 is being contemplated. However, direct instruments cannot be totally abandoned during the transitional phase. Budgetary constraints of the public enterprise sector will be stiffened and its efficiency improved.

In conclusion, I join my Lao authorities in expressing deep appreciation to the staff for its assistance in the preparation of the policy framework paper for 1991-93, and for its excellent report.

Mr. Menda made the following statement:

Only a few months ago, when we discussed the Article IV consultation report, this chair welcomed the considerable progress made by the Lao People's Democratic Republic in moving from a centrally planned economy to a market-based economy. This is especially remarkable since the country faces not only the traditional difficulties of centrally planned economies, but also those of a very low-income country. I will not comment in detail on this issue. Suffice it to say that the first arrangement under the SAF has been successful in deepening structural reforms and creating the necessary institutional framework. The state's retrenchment from economic activity is a reality, and public sector reform is well advanced. It is worth noting that this process has been accompanied by a resumption of GDP growth of about 5 percent.

However, macroeconomic stabilization has proved more difficult to achieve and will certainly be a priority in the period ahead. The staff rightly insists that, in order to implement these policies, it is of crucial importance to improve the administrative capacity, given the present weaknesses, owing mostly to the scarcity of skilled personnel.

That being said, we fully support the request for a second-year arrangement under the SAF, and we share the views expressed in the staff's excellent report. I will therefore limit myself to a few brief remarks.

First, raising the level of domestic savings will be of the utmost importance in regaining control over macroeconomic

developments and allowing a higher level of public and private investment. A strengthening of the budgetary position is therefore warranted. The difficulties experienced in raising revenues underscores the priority to be given to the pursuit of the reform of the tax system. Difficulties faced by the country have been compounded by weak administrative capabilities. Therefore, I agree with the staff recommendations that simplification of the tax system, introduction of excise taxes, and improvement in revenue collection should be the priorities. Although the objective for 1991--increasing revenues from 11 percent of GDP to 12.5 percent of GDP--appears ambitious, it does not appear that the planned increase of 3 percent of GDP for the period 1990-93 is particularly ambitious.

On the expenditure side, limiting current expenditure in relation to GDP while, at the same time, taking into account the necessity to retain qualified civil servants will be a top priority. To this end, particular attention will need to be given to limiting total civil service employment.

To conclude on this issue, the objective of eliminating the current budget deficit will be crucial and will leave room for the much-needed public investment program, which will be financed through concessional assistance in order to avoid recourse to commercial bank financing.

A tight stance of monetary and credit policies will be necessary in order to keep inflationary pressures under control. The maintenance of real interest rates is certainly essential to this process, and we welcome the authorities' intention to rely more on indirect instruments. It is clear, however, that credit controls may still have to be relied on during this difficult period of transition, particularly to impose financial discipline on public enterprises.

The process of separating the commercial banking and central banking functions of the former State Bank will be an important step in reforming the financial system. Fostering the independence of the Central Bank would also be a welcome measure. Could the staff tell us what degree of autonomy is provided for in the central banking law adopted last year?

The broad range of structural reforms are very well described in the report, and I will not comment in detail. Let me only stress the importance of the public enterprise reform and the pursuit and stepping up of the Government's divestiture policy. A more systematic approach in this area, in collaboration with the World Bank and the Asian Development Bank (AsDB), will be welcome.

Lastly, I have two remarks on external policies. First, I fully agree with the authorities that a more stable exchange rate is particularly important in the period of transition to a market economy. In addition to the traditional arguments developed by this chair in favor of a stable exchange rate, I would like to refer to an intervention by Peter Kenen during a recent seminar on convertibility in Eastern Europe. He considered that a fixed exchange rate allows the structure of international prices to be reflected fully in the domestic market, and thus provides a clear and direct reference for the internal market. Therefore, it is essential to improve the allocation of resources and eliminate distortions.

Second, I believe that trade reform is an essential element in the process of structural reforms. Much has already been done in this area, and I would like to encourage the authorities to phase out the remaining restrictions.

Mr. Ishikura made the following statement:

As the staff rightly elaborates, the Lao authorities have implemented a number of structural policy measures under the first-year arrangement under the SAF. We commend their efforts to develop a more market-oriented economy in the face of the deep-rooted rigidities and distortions. We welcome the authorities' strong commitment to pursue the structural adjustments, particularly with the support of the Fund, the World Bank, and the AsDB. In 1990, the economy sustained real GDP growth of 5.3 percent. Inflation, although still high, has decelerated significantly from 68.1 percent in 1989 to 22 percent in 1990.

Nevertheless, there remain many fragilities and uncertainties, which threaten the successful implementation of the current arrangement under the SAF.

First, on the fiscal front, the authorities have envisaged several new revenue and expenditure measures. In order to strengthen the revenue base, it is proposed to widen the tax base through the expansion of excise duties and the introduction of a minimum corporate tax. The measures on the expenditure side are aimed at restraining current expenditure and ensuring resources for productive investment. While we endorse the thrust of the authorities' fiscal targets and measures, a source of concern is the insufficient centralization and institutional weakness of the fiscal system. As the program envisages, the centralization and reinforcement of budgetary control procedures should be pursued without delay through the establishment of a central Treasury.

Special attention should be paid to provincial government spending, particularly on outlays on wages and salaries, in view of the fact that provincial governments presently employ over four fifths of the country's civil servants.

On the monetary front, the authorities intend to keep a tight stance. At the same time, they are planning to develop indirect policy instruments and to shift the emphasis from direct measures to indirect measures. This policy seems to be moving in the right direction. Under the current circumstances, however, it is crucial to reduce further the inflation in the monetary system, which is not necessarily efficient. Therefore, as the staff has recommended, the authorities should not hesitate at this stage to use direct instruments, including limits on currency issue and credit ceilings.

Another source of concern is the weakness in the statistical base, which prevents the precise review of program implementation and causes delays in adopting corrective measures. In order to supplement the weak database, close monitoring on all fronts is imperative. Furthermore, the planned provision of Fund technical assistance is desirable. I would encourage the staff to continue to provide technical assistance to improve statistics, as well as the fiscal and monetary systems.

My final comment relates to the balance of payments prospects, as there is much uncertainty about the future. The authorities envision two main adverse factors in their medium-term projections, namely, higher oil prices and the decline of external assistance from the U.S.S.R. Among these factors, oil prices are likely to be more favorable than envisaged, in view of recent movements in oil prices. On the other hand, I am inclined to think that the projections for export growth are somewhat optimistic. I am concerned about the impairment of external competitiveness in the event of prolonged high inflation. At the same time, the import level will be higher as a result of trade liberalization and increased investment in plant and machinery. Taking these factors into account, I wonder whether actual developments in the external front in the coming years will be different from those in the projection. Moreover, there seems to be a risk that a sizable financial gap will emerge in the event of insufficient implementation of necessary measures envisaged in the program.

In conclusion, despite the progress so far under the program, the vulnerability of the economy and the uncertainty in the external position underscore the need for further implementation of structural measures. We hope that the

authorities will persevere with the program and that their efforts will lead to fruitful results.

With these remarks, I support the proposed decision.

Mr. Laux remarked that the staff report was an outstanding example of brevity and conciseness without compromising quality. He noted that it had taken the staff 4 months to agree with the authorities on the program, and he wondered whether that unusually long period indicated that there had been difficulties in agreeing on specific issues.

The authorities' efforts at fiscal adjustment and, in particular, the objective of reversing the worrisome weakening in budgetary savings in 1990 were welcome, Mr. Laux said. Further progress in that area, as envisaged under the medium-term projections, was clearly desirable so as to reduce the country's dependence on external financial assistance. To that end, it would be of paramount importance to contain current fiscal expenditure and strengthen government revenue. The authorities should avail themselves of the technical assistance offered by the Fund and other institutions in that area. In the absence of an efficient administration, the mere transfer of responsibility for tax collection to the central authorities would be unlikely to help solve the budget problem. In that context, he would be grateful for some clarification of why the large overruns in current fiscal outlays in 1990--70 percent, instead of the programmed 6 percent--was not reflected in the corresponding ratio of current expenditure to GDP. Moreover, could the staff explain the absence of tangible progress in reducing the large overall fiscal deficit--including grants--in the coming years?

The lack of progress in that area, which was accompanied by an expected increase in the external current account deficit of about 80 percent by 1993, was worrisome in view of the steep increase in official medium- and long-term debt in convertible currencies, which was projected to almost double between 1991 and 1993, Mr. Laux commented. An additional concern was the extent to which the assumed availability of external credit, as reflected in the significant strengthening of the external capital account, was feasible and realistic. In any event, the authorities would be well advised to strengthen their efforts at fiscal consolidation wherever possible. Such a policy stance would also help to achieve the welcome program objective of protecting external competitiveness, in the first instance, by tight demand-management policies and, to a lesser extent, through recourse to currency depreciation. Finally, he supported the proposed decision.

Ms. Hansen made the following statement:

We commend the authorities for their continuing efforts to restructure the Lao economy and move it away from a centrally planned model to one that is based on market principles. Clearly, this holds the most promise for achieving rapid and sustainable growth and a viable balance of payments position. The authorities have already taken a number of important steps to strengthen financial policies and have begun some far-reaching structural reforms, and we hope that these efforts will be intensified during the second annual arrangement under the SAF.

Nevertheless, much remains to be done to establish a sound macroeconomic framework and transform the economy into a dynamic market system.

We agree with the staff that primary emphasis should be placed on strengthening financial policies. The staff documents describe in some detail the many weaknesses that need to be addressed on the fiscal side. Though fiscal performance improved last year compared with 1989, revenues still fell short of program expectations and lagged well behind current expenditure. Moreover, the mix of expenditure appears to have been less than satisfactory, in view of the overruns in wages and salaries, the cuts in needed materials and supplies, and the sharp reduction in capital expenditure.

We support the measures to be introduced in 1991 to remedy these problems. In particular, we view the steps to improve administration and develop institutions, through the establishment of a Treasury function and the redefinition of provincial responsibilities, as being especially critical to the overall fiscal effort. Unless the institutional framework for administering fiscal policy is put in place right away, it may prove difficult to meet the 1993 current budgetary target. In addition, given the obvious institutional weaknesses, measures to simplify taxes and facilitate their administration will also be important. We also welcome the authorities' intention to improve the mix of expenditure so that the materials and supplies needed for effective maintenance and operations are available, and so that the investment in infrastructure needed to support the private sector can be undertaken.

We also hope the divestiture plan for public sector enterprises will be completed shortly, which will not only improve the Government's financial position but also advance the structural transformation of the economy. As we have seen in the programs of several other formerly centrally planned economies, privatization and liquidation of state enterprises can be a

lengthy process. Yet the success of the overall adjustment effort depends on increasing domestic competition and improving the allocation of resources, not to mention strengthening government finances.

Monetary and credit policies appear appropriately restrictive. We do hope, however, that within the overall limited increase in domestic credit, a large share of the planned increase in credit will be used by the private sector. We welcome the authorities' intentions to keep interest rates at positive real levels. However, we hope that, increasingly, an appropriate interest rate structure will emerge from use of indirect monetary policy instruments, rather than from administrative directives to banks. Clearly, monetary policy is another area where it will be important to develop greater institutional capacity.

On the external side, exchange rate policy seems quite appropriate under the circumstances. The emphasis is clearly on strong policies, but there is also recognition that a number of factors, such as possible external shocks, trade liberalization, and other domestic institutional changes, may require some exchange rate adjustment to maintain competitiveness. We agree with the staff, however, that the re-emergence of a significant gap between the official and parallel exchange rates should suggest in the first instance a need to strengthen domestic policies. We also join the staff in urging the authorities to continue trade liberalization by removing remaining quantitative import restrictions.

In conclusion, the Lao authorities clearly have a very long way to go toward economic stabilization and structural reform. Nevertheless, they have made a good start in recent years and performed well under the first annual arrangement under the SAF. We hope they will continue and intensify their efforts under the second year of the program.

Mr. Sparkes said that he joined other speakers in commending the Lao authorities for their substantial progress in moving toward a market-oriented economy in recent years. The extremely low per capita income of the Lao People's Democratic Republic and its vulnerability to external developments did not appear to have been a serious impediment to the adoption of far-reaching reforms, despite the fact that some of those measures had had substantial short-term costs. Presumably, the predominately agricultural nature of the economy had made the authorities' task easier than that confronting the authorities of the industrialized economies of Eastern Europe, which were attempting a similar transformation. That should reassure Mr. Dai, who, at the seminar on Eastern Europe (SEM/91/4, 3/13/91), had wondered whether the transition to a market economy

necessarily involved a sharp fall in output. Nevertheless, the transformation to a market economy was not without significant risks, and the authorities were clearly aware that price and trade liberalization must be supported by appropriately tight financial policies.

He had no hesitation in supporting the program, which was admirably focused on the main policy and institutional issues on which the authorities needed to concentrate their limited administrative resources, Mr. Sparkes commented. His only concern was that, while the program as a whole was clearly articulated, there were no quantitative or structural benchmarks in the key area of fiscal adjustment. Finally, it was unclear to him whether the authorities' divestment plans extended to the financial sector. Given the very limited experience of commercial banking practice in a market environment, there could be considerable benefits to the country from greater foreign participation in the financial sector. He would be grateful if the staff could comment on those issues.

The staff representative from the Asian Department noted that the economy was in transition and, until very recently, had not had a fully functioning tax system. Revenue had been mobilized primarily through the transfer of state enterprise profits, which had been generated through a system--subsequently abolished--of administered prices. Therefore, there was a need to put in place an appropriate tax system for a market-oriented economy. In a country like the Lao People's Democratic Republic, where there was only limited administrative expertise and a large part of fiscal operations were carried out by provincial governments, tax system changes would take time to implement. Taking into account the need for a realistic pace of reform, particularly with respect to strengthening revenue and expenditure administration at the provincial level, the revenue targets were fairly ambitious, even though they did not appear particularly high in comparison with those in other countries. The speed with which the fiscal deficit--including grants--declined over the medium term would depend on the level of external financing. Virtually all of the deficit would be financed externally on highly concessional terms and would be used to support an expanded investment program that had been agreed with the World Bank and the Asian Development Bank. If external financing was not available, the medium-term public investment program would have to be amended accordingly.

The new central bank law provided a considerable degree of autonomy for the Central Bank in the sense that it had the full range of direct and indirect instruments to control monetary policy, such as reserve requirements, open market operations, and control over foreign exchange, the staff representative remarked. It was less certain how much autonomy the Central Bank would have in practice to resist financing demands from the Government.

There had been some progress in privatization in the financial area, the staff representative continued. A new private sector bank, which was a joint venture with foreign participation, had been allowed to enter into

commercial banking. There were no plans at present, however, to sell off existing state-owned banks.

The crisis in the Middle East was the main reason for the delay in concluding the negotiations for the program, the staff representative commented. An earlier program had been subjected to a number of revisions, as the crisis had erupted while those negotiations were being concluded.

While there were no quantitative or structural fiscal benchmarks in the program, there were some other fiscal benchmarks, such as the targets for bank financing of the fiscal deficit, the staff representative from the Asian Department said. Given that much of the external financing was on highly concessional terms, and that the investment program would be tailored to the level of external financing, the level of bank financing of the fiscal deficit was the key measure of fiscal adjustment. If the authorities received additional concessional financing, the associated increase in productive investment would not be a problem.

Mr. Sparkes remarked that the staff's comments had met some of his concerns, but he was also concerned about the mobilization of revenue. There had been government revenue targets in the recent programs for both Benin and Mali, and he wondered whether a similar benchmark would be appropriate for the program for the Lao People's Democratic Republic.

The staff representative from the Asian Department said that he agreed that it might have been useful to have included a benchmark for government revenue in the program. The program already contained revenue to GDP targets, but they had not been formulated as explicit benchmarks.

The staff representative from the Exchange and Trade Relations Department noted that the Lao People's Democratic Republic was in the process of implementing a substantial change in the tax system, and estimating revenue mobilization would be extremely difficult. The use of benchmarks under those circumstances--which neither Benin nor Mali had faced--could result in large deviations on both sides of the benchmark. The primary function of a benchmark was to signal the need for prompt action in response to financial developments, and that function would be adequately performed in a timely manner by the resident representative in the Lao People's Democratic Republic, who would follow financial developments closely.

In response to a question from the Chairman, the staff representative from the Exchange and Trade Relations Department said that the staff would give careful consideration to the inclusion of a benchmark for government revenue in the third annual arrangement under the SAF for the Lao People's Democratic Republic.

The staff representative from the Asian Department stated that such a benchmark would be useful in the third-year arrangement. It was worth

noting, however, that since all the revenue measures under the program were already in place, including the new excise taxes and the streamlining of the turnover tax, a considerable degree of fiscal adjustment had already been achieved. The key issue, of course, was the strengthening of tax administration; if that process was not successful, there might be a need for some other benchmark.

Mr. Ismael commented that the authorities believed that the current medium-term strategy was the appropriate way to embark on a sustainable growth path and to achieve further market-oriented reforms. Adequate financial and technical support from the international community was crucial for the strategy's success. Therefore, his authorities viewed the ongoing collaboration with the Fund and the World Bank as an important supportive element of their adjustment program. Finally, the support of the United States for the authorities' second-year program under the SAF was welcome, and he looked forward to similar support in the near future for a solution to the problem of Viet Nam's overdue financial obligations to the Fund.

The Executive Board then took the following decision:

1. The Government of the Lao People's Democratic Republic has requested the second annual arrangement under the structural adjustment facility.
2. The Fund has appraised the progress of the Lao People's Democratic Republic in implementing the policies and reaching the objectives of the program supported by the first annual arrangement, and notes the updated policy framework paper (EBD/91/58).
3. The Fund approves the arrangement set forth in EBS/91/32, Supplement 2.

Decision No. 9701-(91/50), adopted
April 8, 1991

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/91/49 (4/5/91) and EBM/91/50 (4/8/91).

3. TONGA - ACCEPTANCE OF OBLIGATIONS OF ARTICLE VIII,
SECTIONS 2, 3, AND 4

The Fund notes with satisfaction that, with effect from March 22, 1991, Tonga has accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Articles of Agreement. (EBD/91/96, 4/1/91).

Decision No. 9702-(91/50), adopted
April 5, 1991

4. ACCESS TO FUND ARCHIVES

The Executive Board approves the proposal relating to the use of material in the Fund archives as set forth in EBD/91/98 (4/2/91).

Adopted April 5, 1991

APPROVED: November 15, 1991

LEO VAN HOUTVEN
Secretary

