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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 90/65

3:00 p.m., April 25, 1990

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	A. Raza, Temporary
	C. Enoch
	G. C. Noonan
	Yang J., Temporary
T. C. Dawson	M. E. Hansen, Temporary
J. de Groote	J. Prader
E. T. El Kogali	
E. A. Evans	S.-W. Kwon
E. V. Feldman	P. O. Montórfano, Temporary
L. Filardo	M. A. Fernández Ordóñez
	R. Marino, Temporary
	N. Kyriazidis
	M. B. Chatah, Temporary
M. Fogelholm	A. Gronn, Temporary
	M. J. Mojarrad, Temporary
	B. Goos
	T. Sirivedhin
	L. M. Piantini
	J.-L. Menda, Temporary
	B. A. Sarr, Temporary
	B. S. Fuleihan, Temporary
G. A. Posthumus	
	N. Adachi, Temporary
	K. Ichikawa, Temporary

L. Van Houtven, Secretary and Counsellor
L. Collier, Assistant

Also Present
M. Vele, Secretary for Finance and Planning, Papua New Guinea; M. Taylor, Ambassador, Embassy of Papua New Guinea. IBRD: A. Bhattacharya, Asia Regional Office. Asian Department: K. Saito, Deputy Director; C. M. Browne, M. J. Fetherston, S. P. O. Itam, R. Kibria, J. Schulz, C.-H. Wong. Exchange and Trade Relations Department: A. Basu, S. Eken, G. R. Kincaid, J. M. Landell-Mills, R. L. Zandamela. External Relations Department: R. R. Bräuning. Legal Department: P. L. Francotte, A. O. Liuksila. Research Department: B. B. Aghevli, R. C. Baban, J. Martelino, E. C. Meldau-Womack, B. E. Rourke, P. Wickham. Treasurer's Department: G. Laske, Treasurer; D. Berthet, J. E. Blalock, W. L. Coats, Jr., S. J. Fennell, H. R. Lorie, A. J. Mathuran. Western Hemisphere Department: S. T. Beza, Counsellor and Director; J. Ferrán, Deputy Director; J. Berengaut, C. Cha, C. S. Lee, C. M. Loser, E. Sumar, E. C. Suss, E. S. Williams. Office of the Managing Director: E. A. Milne. Advisors to Executive Directors: F. E. R. Alfiler, M. Eran, A. R. Ismael, K.-H. Kleine, A. Napky, B. S. Newman, F. A. Quirós. Assistants to Executive Directors: T. S. Allouba, H. S. Binay, C. Björklund, A. Y. El Mahdi, A. Fanna, S. K. Fayyad, J. Gold, M. A. Hammoudi, M. Hepp, J. Heywood, L. I. Jácome, M. E. F. Jones, P. Kapetanovic, C. Y. Legg, G. Montiel, H.-J. Scheid, Wang J.

1. HONDURAS - OVERDUE FINANCIAL OBLIGATIONS - REVIEW FOLLOWING DECLARATION OF INELIGIBILITY

The Executive Directors considered a staff paper on the review of Honduras' overdue financial obligations following the declaration of the member's ineligibility to use the general resources of the Fund effective November 30, 1989 (EBS/90/79, 4/24/90).

Mrs. Filardo said that she wished, first, to reaffirm her chair's position on the need to solve the problem of arrears to the Fund in the most constructive manner; second, to inform Directors of the interest expressed by some countries in her constituency in supporting Honduras during the current difficult period; and third, to comment on the aspects of her recent experience that could have some relevance for future cases.

The Board's two-month postponement of the review, which she had requested, was a short period of time in which to solve the arrears problem of Honduras, Mrs. Filardo continued. Nevertheless, because Board procedures required the review, it had been necessary to proceed along those lines. While acting on a case-by-case basis, the Fund did not seem to take into proper consideration the complexity of each case. Members were given an extremely short time frame in which to undertake the difficult process of designing and implementing a strong adjustment program--in an unfavorable economic, social, and political environment--as well as obtaining the resources needed to clear their arrears and to finance the program.

Unfortunately, financial resources were not easily available to clear arrears to multilateral and bilateral organizations and to commercial banks, Mrs. Filardo commented. Potential bilateral donors were sometimes reluctant to participate, especially in current circumstances in which traditional donors, who had helped to support countries in the past, were experiencing strong financial constraints.

Usually, political unrest and changes in governments were not taken into account by the Fund, although such factors were important, Mrs. Filardo remarked. On the one hand, governments in office were less willing to cooperate because they believed that implementation of harsh policies would endanger the winning of an election. On the other hand, new governments were eager to cooperate, but usually the economic, social, and political situation was so difficult that more time was required to design and implement a program than the Fund would desire.

The concentration of arrears to the multilateral institutions, the fact that it was impossible for those institutions to reschedule or alleviate debt, and the institutions' desire to obtain a simultaneous solution to the arrears problem constituted additional constraints that implied further delays in reaching an appropriate solution, Mrs. Filardo observed. The Board would have to assess the issue more openly in the case of each member.

With respect to Honduras, in only two months the new Government had put in place one of the most comprehensive structural adjustment programs in the country's economic history, Mrs. Filardo said. Shortly, all components of the program would be in place, as indicated to Fund management and staff by the President of Honduras the previous week. The legislature had passed a comprehensive tax reform, and the Government was pursuing a privatization process for major state-owned companies--a key component of the program, given the large overall fiscal deficit during 1989. The authorities were also undertaking changes in the financial and trade systems and enhancement of monetary and exchange rate policies. The authorities had been advised by the multilateral institutions that their arrears should be cleared simultaneously, and the authorities were committed to doing so. Despite the country's limited reserves, the authorities, as a demonstration of goodwill, had cleared their arrears to the Fund in the SDR Department. However, it was clear that in the case of a simultaneous clearing of arrears, the Board would have to be patient, as it would take time to find potential donors both to support the program and provide bridge loans.

No new net money would be made available to Honduras because of its large arrears to multilateral and bilateral creditors and because it was not eligible to use the resources of the enhanced structural adjustment facility or from IDA-8, Mrs. Filardo explained. Thus, Honduras would be financing its program with adjustment measures and its own resources. The authorities were aware that they would have to establish a credible track record, and for that purpose they had implemented a major part of the program, and they were committed to implementing the full program promptly and to entering into a medium-term economic program with the Fund once that track record had been established.

With respect to the proposed decision, Mrs. Filardo suggested that paragraph 3 be moved to become paragraph 2 and be amended to read: "The Fund warmly welcomes the active cooperation of the Honduran authorities toward the elaboration and implementation of a comprehensive program of macroeconomic and structural adjustment. The Fund also welcomes the authorities' intention to pursue a comprehensive adjustment program with the Fund and urges the authorities to implement the additional measures needed to complement this program. The Fund continues to stand ready to respond to the authorities in supporting these efforts." The original second paragraph would remain as drafted except that the last part could read: "In this connection, the Fund notes that the strategy being pursued by the new Government is geared toward achieving full clearance of Honduras' arrears to all the multilateral institutions, which the authorities consider to be the strongest evidence of Honduras' determination to achieve a cooperative solution to the problem of its arrears."

Mr. Piantini remarked that since the previous Board discussion on Honduras (EBM/90/28, 2/28/90), the authorities had paid the Fund SDR 0.9 million, which was equivalent to one fifth of Honduras' liquid reserves at end-1989. Additionally, the authorities had put in place a far-reaching economic adjustment program aimed at fostering economic growth, increasing export competitiveness, and restoring external viability in the medium term. He regretted that the staff had minimized that effort in the draft decision.

As part of the economic program, important reforms were being implemented with respect to tariffs and the exchange system, Mr. Piantini said. Measures in the fiscal sector included new taxes, expenditure restraint, a public enterprise divestment program, and a substantial adjustment of petroleum prices. He was encouraged by the reforms, which were in the right direction and which would help Honduras deal with the severe external and internal imbalances. Fiscal and monetary measures should be implemented expeditiously to increase domestic saving, reduce inflation, and protect reserves.

Honduras was in urgent need of financial resources from the international financial community to support its economic program and to clear its external arrears, Mr. Piantini remarked. The country deserved broad and timely support; thus, he endorsed the proposed decision as amended by Mrs. Filardo.

Mr. Noonan observed that the first review of Honduras' overdue obligations since the declaration of Honduras' ineligibility to use the general resources of the Fund presented the opportunity to welcome not only the recent payment of SDR 0.9 million made by the authorities to the Fund, but also the formulation of an economic adjustment program for 1990 and the efforts under way to assist Honduras in clearing its arrears. Those were all indications of Honduras' interest in regularizing its relations with the Fund. It was difficult to know to what extent those indications were a response to the declaration of ineligibility or were the autonomous results of the new authorities' apparent desire to restore the international standing of Honduras. Either way, they were to be welcomed.

The payment of SDR 0.9 million might be the least significant of those indicators, Mr. Noonan continued. He had not been able to determine from the staff paper the new authorities' capacity to make immediate payments, but he would have hoped for more than that minimum sum. Indeed, normally a track record of regular payments would be required, as acknowledged by Mrs. Filardo, to establish the serious intent of the authorities to give the settlement of arrears a high priority.

The cooperation between the authorities and the Fund staff in formulating an economic adjustment program to deal with the dire economic situation in Honduras was a more reassuring indicator of progress in the right direction, Mr. Noonan remarked. Important elements of that program had already been implemented. However, he had some difficulty with the articulation of the program. The wisdom of some of the policy measures--for example, the taxing of exports--was not self-apparent. Other measures, such as those related to expenditure restraint, were less than specific. Perhaps the staff could elaborate somewhat more on the initiatives outlined.

The most significant element in the staff paper was the reference to efforts under way to assist Honduras in clearing its arrears to the international financial institutions by end-May, Mr. Noonan said. The staff had alluded to a series of meetings that had been held. He would appreciate some insight as to the progress of those discussions and the staff's views on whether those deliberations could be realistically expected to bear fruit in the near future. Subject to clarification of the points raised, he could support the draft decision or the revised version proposed by Mrs. Filardo.

Mr. Sarr commended the Honduran authorities, who, since the time of the previous Board discussion of Honduras' overdue financial obligations, had cooperated actively with the Fund and had implemented significant fiscal policy and structural reform measures in the framework of their comprehensive economic program for 1990. In spite of the critical reserve position reached at the beginning of the year, the new Government that had only recently taken office had resumed payments to the Fund and had committed itself to a strategy that sought a simultaneous settlement of Honduras' arrears to multilateral institutions.

The continuous accumulation of arrears by Honduras had clearly damaged the economy, as evidenced by the further deterioration of the economic situation in 1989, Mr. Sarr commented. As the staff had pointed out, that trend could be traced in part to domestic causes, but the substantial decline in foreign loans and grants had also contributed. It was of paramount importance that Honduras resume normal financial relations with its creditors. In that regard, he hoped that bilateral creditors would show some understanding and would cooperate effectively and in a timely manner so that the efforts under way to arrange a financing package by end-May 1990 could lead to a normalization of Honduras' financial relations with creditors. He supported the draft decision, but he could go along with Mrs. Filardo's proposed amendments.

Mr. Feldman noted that the new authorities in Honduras had had intensive discussions with the staff since early 1990 and had formulated an economic adjustment program for 1990 to address the country's economic difficulties. He welcomed the important measures already implemented, as confirmed by Mrs. Filardo, and he encouraged the authorities to take the additional measures needed to achieve the objectives of sustained economic growth and balance of payments viability.

Honduras had recently made a payment of SDR 0.9 million to the Fund, which represented a significant proportion of the country's stock of liquid reserves, Mr. Feldman continued. He also noted the ongoing efforts of Honduras to complete financial arrangements in order to achieve the full clearance of Honduras' arrears to the multilateral institutions, particularly its arrears to the Fund, by end-May 1990.

In view of the actions already taken--the adoption of adjustment policies, the payment made, and the ongoing efforts toward full clearance of arrears by the end of May--he believed that the criteria for cooperation with the Fund had clearly been met, Mr. Feldman stated. The authorities were acting expeditiously, and they deserved the strong support of the international community. He supported the proposed decision, including the amendments suggested by Mrs. Filardo.

Mr. Enoch made the following statement:

Honduras' record of cooperation with the Fund over the years has been poor. After the country's endemic arrears were cleared with the help of a bridge loan in 1988, Honduras rapidly slipped back into arrears, and last year it was declared ineligible to use Fund resources. At the same time, economic performance deteriorated markedly, with high inflation, an increasing overvaluation of the exchange rate, and excessive fiscal deficits.

The swift and wide-ranging implementation of economic adjustment measures by the new Honduran authorities stands in welcome and marked contrast to this earlier performance. It indicates that Honduras has decided to join the growing number of countries in arrears that recognize that comprehensive economic adjustment is an essential prerequisite for restoring the country's relationships with the international financial community and creating conditions for sustainable economic growth. The measures introduced by the Honduran authorities--in particular, increasing revenue, reducing subsidies, and reforming the exchange rate--are crucial initial steps in dealing with Honduras' difficult situation. The authorities will need to remain resolute in carrying their program forward.

The progress in formulating and implementing their comprehensive program constitutes clear evidence that in this respect the authorities are moving toward cooperation with the Fund. It is therefore particularly disappointing that, since the postponement of this review, the authorities have made only a token payment to the Fund. Even this payment was insufficient to limit the further increase of arrears to the General Department and the Trust Fund, despite the view of the Board, reflected in the Managing Director's letter of March 7, 1990, that payments would constitute an important demonstration of cooperation.

Nonetheless, because of the decisive action by the authorities in implementing adjustment policies, I can support the proposal of the staff to make no mention of remedial measures in the draft decision. I am encouraged in taking this line by the imminence of the next review, which reflects the authorities' expectations of progress toward finding a way to clear their arrears in the near future, and by the staff's recognition that further progress is required if remedial measures are not to be considered later.

Regarding Mrs. Filardo's proposed amendments, I will wait until I have heard the comments of the staff on how they relate to decisions on other reviews of arrears.

The authorities are now seeking to put together bridge loans which would be repaid as Honduras embarks on a Fund-supported program. The prospects of early clearance of arrears clearly has attractions for the Fund. On the proposed timetable, Honduras would probably be the first of the 11 arrears cases to be restored to a full relationship with the Fund. With Guyana clearing its arrears at about the same time, this would be a strong signal of the success of the Fund's arrears strategy. The absence of any need to invoke the lengthy support group process in this case demonstrates the variety of approaches that may be enfolded within the arrears strategy.

However, the approach envisaged for Honduras does raise some concerns. In particular, it has been widely held that Fund disbursements to members with protracted arrears require not only the clearance of arrears, but also a demonstrable track record of cooperation. The establishment of such a track record would give some reassurance about the risks to Fund resources. Indeed, in several arrears cases, a fairly lengthy track record of cooperation has been established. Even in the case of Paraguay recently, where there had never been arrears but there was no track record of performance, the Board welcomed the authorities' intention to establish a track record before seeking Fund resources. So if Honduras is, as envisaged, to have a Fund-supported program soon, it clearly should be a particularly strong program to give reassurance about the security of Fund resources and to remove once and for all the risk of a re-emergence of arrears. The resolution with which the authorities have already introduced a number of important measures gives considerable assurance that they would be able and willing to agree to such a program and indeed, as would be necessary if problems were not to re-emerge, to carry it out meticulously.

Mr. Dawson recalled that in February, the Executive Board had postponed the review of Honduras' overdue obligations to provide additional time for the authorities and Fund staff to complete work on an economic program and to undertake arrangements to clear arrears to the Fund and other international financial institutions. The authorities had used that time well, and the number of protracted arrears cases was on the verge of being reduced.

As the staff paper noted, the new Honduran Government had moved quickly to begin placing its economic house in better order, Mr. Dawson said. Measures had already been introduced to reduce the budget deficit, tighten monetary policy, and rationalize the exchange and trade system. Additional measures were contemplated as part of an economic program being developed in cooperation with the Fund, the World Bank, and the Inter-American Development Bank. Clearly, Honduras was cooperating to deal with its economic problems.

The payment by Honduras had not been sufficient to prevent arrears to the Fund from increasing since the declaration of ineligibility, Mr. Dawson remarked. However, discussions were at an advanced stage on arrangements to clear simultaneously all Honduran arrears to the international financial institutions amounting to about $240 million. He expected that those arrangements would allow the arrears to be cleared in the very near future. In view of some Directors' attitudes about the need for support groups in all arrears cases, or the need for a certain protocol to be observed in forming such groups, he would point out that those arrangements were being made without the establishment of a support group. In those circumstances, he believed that Honduras had demonstrated clearly that it was cooperating with the Fund to deal with its problems and normalize its financial relations with the Fund. Therefore, he could support the proposed decision, including the amendments suggested by Mrs. Filardo.

Mr. Raza said that he generally agreed with the comments made by Mrs. Filardo regarding the short period of time given to countries in which to implement far-reaching adjustment programs, especially when availability of adequate resources was not ensured.

With respect to overdue financial obligations, the possible application of remedial measures depended upon the degree to which the country had demonstrated its willingness to cooperate actively with the Fund in finding a solution to its problem, Mr. Raza commented. The degree and extent of cooperation was indicated by its payments performance and adoption of appropriate macroeconomic policies. On both counts, the track record of Honduras in the past had been uneven. However, the new Government that had assumed office just a few months previously seemed earnest in tackling the problem. It was cooperating with the Fund and was committed to implementing a comprehensive and viable adjustment program. Most of the components were already in position, and as Mrs. Filardo had pointed out, the others would soon be in place. However, it was too early to judge whether the new Government would be in a position to effectively translate all its intentions into actions.

He appreciated the serious political, economic, and social problems facing the authorities, and he was convinced that taking harsh decisions at the present stage might cause difficulties for the new Government, Mr. Raza said. The Government should be given a little more time to implement the adjustment program and thus demonstrate its willingness to cooperate with the Fund. The authorities also needed the strong support of the international community. He therefore supported the proposed decision as amended by Mrs. Filardo.

Mr. Adachi noted that the economic situation of Honduras had deteriorated further in 1989. Domestic and external imbalances had resulted in a decline in economic performance as well as the accumulation of external arrears. He therefore welcomed the economic program for 1990 formulated by the authorities after close consultation with the staff. In particular, he commended the adoption of major elements of the program, and he encouraged the authorities to implement additional measures promptly. In that connection, he agreed with Mr. Enoch that the resolve of the legislature instilled confidence in Honduras' ability to pursue appropriate policy measures.

The recent repayment to the Fund was welcome, Mr. Adachi remarked. Nonetheless, he was not convinced that Honduras was unable to make further repayment, and he urged the authorities to make every effort to do so, even before completion of the financial arrangement to settle the arrears to the international financial institutions.

He supported the proposed decision, Mr. Adachi stated. While he could go along with the amendments proposed by Mrs. Filardo, he would like to hear the staff's comments on whether the additional measures that should be implemented by the authorities were essential to attain economic growth and balance of payments viability.

Mr. Goos said that he welcomed the authorities' decision to resume full cooperation with the Fund, as evidenced by the adjustment measures they had implemented thus far and the ongoing formulation of an adjustment program. But he shared the doubts of other speakers that the cooperation criterion relating to payments performance had been fully met, given that the last payment had been small and that arrears had been allowed to accumulate further. Nevertheless, he was pleased that there was a concrete expectation that the clearance of arrears would take place soon, and he urged the authorities to put in place the remaining steps needed to achieve that aim.

It had been pointed out by Mr. Enoch that an important factor with regard to the authorities' approach was the absence of a credible track record, especially when considering that Honduras had fallen repeatedly into arrears with the Fund, Mr. Goos remarked. The existence of a satisfactory track record had been emphasized in the arrears strategy, particularly with respect to preventive action. Mr. Enoch had indicated the appropriate way to proceed in the present case: a strong adjustment program, supplemented by convincing prior actions, was needed to demonstrate the willingness of the authorities to normalize their relations with the Fund and to ensure the security of any new resources that would be committed. He could go along with the thrust of the amendments proposed by Mrs. Filardo, but he would await the staff's assessment to ensure that the language was not inconsistent with previous comparable decisions.

Mr. Menda noted that almost two months previously, the Board had postponed the review of Honduras' overdue obligations to the Fund in order to give the new Government time to elaborate an economic adjustment program and to find the necessary financing to clear its arrears. Progress in those two areas had been somewhat slower than expected. Nevertheless, the information provided by Mrs. Filardo on the economic adjustment program adopted by the authorities was encouraging. He would appreciate further information from the staff on the measures taken by the authorities and on the status of negotiations between Honduras and the Fund on the elaboration of a program. He would also welcome comments on the track record that was required before an agreement with the Fund could be concluded; he shared Mr. Enoch's concern regarding the difference in treatment that could emerge between countries in that connection.

The fact that the authorities were actively seeking ways to clear their arrears to the multilateral institutions was commendable, Mr. Menda continued. However, he would appreciate more information on current negotiations, and in particular on the bridge loan announced by Mrs. Filardo two months previously. Finally, given the authorities' efforts, he could support the text of the draft decision, including the date of May 31 for the next review. He would, however, appreciate some comments from the staff on the amendments proposed by Mrs. Filardo.

Mr. Posthumus said that he agreed with the staff report; the Honduran authorities' efforts to clear their arrears as soon as possible should be supported. He was not fully convinced by Mr. Enoch's arguments with respect to assessing Honduras' track record at the current stage; such an early appraisal could make it more difficult for countries to clear their arrears in a short period. Rather, an assessment should be made when the Board discussed the program. At the present meeting, according to the Board's usual practice, Directors could appropriately point to the need for a strong program. He supported the draft decision, including Mrs. Filardo's amendments. He would, however, appreciate information on why the Honduran case called for simultaneous clearance of arrears to the Fund and the World Bank when consideration might have been given to clearing the much smaller arrears to the Fund first.

Mr. Feldman said that he concurred with Mr. Posthumus's comments on assessing the member's track record. As to Mr. Enoch's reference to Paraguay establishing a track record, that situation had arisen because the authorities had been unsure of the quality of their data and they had wished to avail themselves of a tentative period of indicative targets. He was concerned that Mr. Enoch was suggesting that countries could not be given the benefit of the doubt but would have to establish a record under a Fund-monitored program before a Fund-supported program could be adopted.

Mr. Enoch explained that the Board had endorsed the decision of the Paraguayan authorities to refrain from using Fund resources until a track record--lacking, for whatever reason, at the time of the discussion--gave further assurance that a Fund-supported program would be carried through successfully. On a more general point, he did not dispute the fact that it was envisaged that Honduras would undertake a Fund-supported program when its arrears were cleared. But programs could be of varying strengths, and it would be helpful to the Honduran authorities to have a strong program for a number of reasons, including to give reassurance to the Board that Honduras was not an endemic arrears case and to profit from the opportunity provided at the outset of a new administration. His comments on a track record at the present meeting were intended to give guidance to the member in formulating an appropriate adjustment program in the near future.

Mr. Dawson said that he agreed with Mr. Enoch on the need for a strong program. The case could be made that the program had already started: the Government, which had taken office recently, had immediately begun its implementation. By the time a Fund arrangement would be discussed by the Board, Directors would have a track record of the Government's prior actions.

Mrs. Filardo remarked that Mr. Enoch was correct in stating that, in view of past experience, Honduras would have to establish a credible record. Directors' comments would be conveyed to her authorities to guide them in choosing the appropriate measures envisaged by the Board, and in that connection she asked Mr. Enoch to offer explicit suggestions as to what measures would constitute a stronger program. Nevertheless, Mr. Dawson's comments on the new Government's timely implementation of the major portion of the program were noteworthy. Moreover, in a meeting the previous week, the President of Honduras and the President of the Central Bank had committed themselves to completing the program during April 1990.

Mr. Enoch stated that, on the member's track record, he did not wish to minimize the performance of the authorities since they had taken office, and he commended their various policy actions. However, the country's payments record constituted another aspect of cooperation, and he joined other Directors who had expressed concern on that issue.

The staff was in a position to determine the specific measures that should be expected of the authorities, Mr. Enoch remarked. He recalled, for example, the strong program implemented by Venezuela the previous year, which had been highly commended by the Board. The support accorded Venezuela by the Board at the outset had continued through subsequent difficulties--including those beyond the control of the authorities--as the program had progressed.

Mr. Goos observed that, in connection with the present discussion--but not related specifically to the case of Honduras--one general issue remained unsettled. When considering the strengthened arrears strategy, the Board had concluded that countries with protracted arrears to the Fund would normally be expected to establish a satisfactory track record under a Fund-monitored program extending up to three years. At the present meeting, it had been pointed out that Honduras had already started a program and that the one to two months of program implementation would satisfy the requirement regarding a track record. That situation raised questions about the objectives sought under a Fund-monitored program and also about the length of the track record and whether it was a mere function of the member's ability to mobilize funds to clear the arrears within a period shorter than three years.

Mrs. Filardo pointed out that one aspect of the present case was exceptional: the small amount of resources needed to clear Honduras' arrears. Thus a support group or the rights approach would not be necessary.

Mr. Evans said that, like previous speakers, he welcomed recent developments in Honduras. He could support the decision as proposed by the staff because of its consistency with previous Board decisions, and he saw no need to alter the text. However, there seemed to be some sympathy from Directors for the amendments proposed by Mrs. Filardo, and he would wait to hear the staff's comments, particularly concerning the use of "active cooperation" in the first line of paragraph 2, as revised. He did not think that the phrase, as defined by the Board in similar cases, should be included there.

Mr. Kyriazidis remarked that as the discussion on February 28, 1990 had resulted in Honduras developing a program that had been put in place, he could agree with the staff conclusion. But at the same time, he concurred with Mr. Enoch's remarks concerning the strength of the program and the track record. He was not entirely enthusiastic about the progress in reducing arrears; as other Directors had pointed out, only a small payment had been made over the past few months, and arrears in the General Resources Account had accumulated further. It was disturbing that those issues had not been emphasized in the language of the decision. The staff report stated that: "It is rather suggested that a further review be held not later than the end of May 1990, in order to afford the authorities a further opportunity to underscore Honduras' desire to cooperate fully with the Fund in dealing with the problem of its overdue financial obligations by making payments to the Fund and by making arrangements to settle Honduras' overdue obligations, as well as by continuing to implement the package of policy measures. If Honduras has not demonstrated fully its commitment to cooperate with the Fund by the time of the next review, the Executive Board would need to come to a view on the application of remedial measures at that time."

That paragraph should be reflected concretely in the language of paragraph 4 of the draft decision, Mr. Kyriazidis commented. The text should specify to the extent possible the actions expected of the Honduran authorities by the Board at the time of the next review.

Mrs. Filardo remarked that as the case of Honduras' arrears would likely be the first to be solved, it would not be prudent to refer to any negative aspects in the decision.

Mr. Prader stated that the country's efforts should be supported, especially when there was hope that Honduras might constitute the first case of successful elimination of arrears to the Fund. The economic adjustment program was quite strong, even though it included some inconsistent elements, such as tax and export policy. He had only one major problem, namely, the procedural aspects of the amended decision as submitted by Mrs. Filardo. By accepting the revision, a precedent could be set whereby in future cases, amended decisions could be submitted by Executive Directors for endorsement by the Board. The decision proposed by the staff seemed complete, and it was fair to the country. However, if the majority of Directors could endorse the decision as amended by Mrs. Filardo, he would join the consensus, although with some concern for the consequences for future Board discussions.

Mr. Fogelholm said that recent developments in Honduras were welcome and the new Government's economic policymaking was particularly encouraging. Nevertheless, although not necessarily the fault of the present Government, Honduras' payments record with the Fund was not particularly good, and Honduras had, during the previous year, discriminated against the Fund. He joined Mr. Posthumus in wondering whether it might not have been possible to have sequential clearance of arrears, rather than simultaneous clearance as proposed. Sequential clearance would have been particularly beneficial in the present case, where arrears to the Fund could have been cleared first, because in most cases in future the reverse would be the norm.

He tended to agree with those speakers who had stated that in arrears cases where financing could be found, it might not be necessary to resort to the debt strategy as implemented in other cases, but simply to clear the arrears and formulate a program, Mr. Fogelholm remarked. However, the Government should show, if not a track record under a Fund-monitored program as such, at least a clear commitment to its new course along with prior actions. Finally, on the draft decision, he could go along with the revision proposed by Mrs. Filardo, with perhaps some editorial changes.

The staff representative from the Western Hemisphere Department stated that the centerpiece of the authorities' program was the reduction in the fiscal deficit from about 9 percent of GDP in 1989 to 6.9 percent of GDP in 1990, implying a reduction in public sector recourse to domestic financing from about 4 percent of GDP in 1989 to about 0.5 percent of GDP in 1990. The fiscal adjustment was expected to be achieved largely through the implementation of a comprehensive tax package, yielding about 4 percent of GDP, that included increases in the sales tax, petroleum taxes, and the export tax. The last measure was temporary, and the schedule for its elimination starting January 1991 was built into the program. The authorities had considered that they needed time to formulate more optimal measures, and in addition, there was a case for tapping the windfall gains of the export sector.

Other major elements of the program included the virtual unification of the exchange system and the pursuit of a more flexible exchange rate policy, as well as an import tariff reform that was part of a structural adjustment program being discussed with the World Bank, the staff representative continued. The tariff reform program involved a reduction in existing tariffs as of March 3 from a range of 0-130 percent to 2-40 percent. The program also included structural measures in the areas of tax reform, divestment, and financial sector reform as well as a social safety net of about 0.9 percent of GDP.

Most of the prior actions of the program had been implemented as from early March, the staff representative reported. The authorities had informed the staff that they would shortly be putting in place a number of credit measures.

The staff had participated in discussions with the World Bank, the Inter-American Development Bank, the U.S. Agency for International Development, and the Japanese Overseas Economic Cooperation Fund, and progress had been made in putting together a financing package to support the program and to clear the arrears, the staff representative from the Western Hemisphere Department reported. The bridging scenarios involved possible loans from the U.S. Treasury as well as from the central banks of Venezuela, Mexico, and Spain, but the staff had not received firm undertakings, particularly from the latter group. As to Honduras' capacity to make payments, the country's foreign reserves remained at a critical level, and the latest information indicated that, as of April 18, liquid unencumbered reserves amounted to less than $5 million.

The staff representative from the Treasurer's Department remarked that, with respect to the amendments to the decision proposed by Mrs. Filardo, the first sentence in paragraph 2 had been used previously for Viet Nam. The rest of the paragraph followed the traditional format, except for the reference to the additional measures needed to complement the program. The first part of Mrs. Filardo's draft paragraph 3 almost duplicated the language of paragraph 2 in the draft decision, but the last sentence, which implied that the Fund supported the authorities' strategy, had not appeared in past decisions.

Regarding paragraph 4, no reference to the possibility of remedial action at the time of the next review had been included by the staff because of the progress achieved by the authorities thus far toward the timely clearance of arrears and because the review was the first following the declaration of ineligibility, the staff representative concluded.

Mr. Kyriazidis stated that the decision should reflect the view that the additional time provided to the authorities would afford a further opportunity for Honduras to underscore its desire to cooperate fully with the Fund by making arrangements to settle its overdue obligations and by continuing to implement the package of policy measures. As a matter of principle, the decisions on overdue financial obligations should, in general, include a concrete reference in the final paragraph to the criteria on which the Board would base its review and conclusions.

Mr. Dawson commented that, following the staff's clarifications with regard to Mrs. Filardo's proposed amendments to the decision, he was concerned that Mr. Kyriazidis's suggestion might constitute a significant departure from past decisions.

The staff representative from the Legal Department noted that there had been some minor variations in the language of previous, similar decisions. Recently, the decision on Panama had referred not only to settling arrears but also to meeting maturing obligations to the Fund. In other cases, the paragraph had stated that in the light of developments, the possibility of remedial action against the member would be considered at the time of the next review; such wording, of course, was not applicable in the present case.

The Acting Chairman observed that the final paragraph of the proposed decision had been drafted following discussions on possible developments by the end of May. If the arrears were cleared by that time, a program could be presented to the Board shortly thereafter as the basis for a bridge loan. In the case of a reversal in economic policies and the absence of collaboration, remedial measures might have to be considered. Those possibilities were difficult to capture concisely in the wording of the paragraph.

Earlier, following consultations with the Honduran authorities, the World Bank, and the Inter-American Development Bank (IDB), it had been decided that, in light of the efforts being made to put together a bridge loan, the financial obligations to the Fund, the World Bank, and the IDB could be cleared simultaneously, the Acting Chairman explained. While that would be the best way to place the member back on track, the matter would be kept under review, and if the bridge loan did not materialize, an alternative would have to be considered--possibly the sequential clearing of arrears. The decision as to whether the clearance of arrears should be simultaneous or sequential was made in light of the circumstances in each case.

Mr. Posthumus observed that he did not question the judgment on the clearance of arrears, but in light of Mrs. Filardo's comments, he wondered whether it might not prove to be more difficult to obtain bridge financing for the arrears owed to all three multilateral agencies than for the somewhat lower amount owed to the Fund. It might be useful, if there was no problem in principle on the part of the World Bank and the IDB, for the Fund to move ahead in the case of Honduras.

The Acting Chairman said that the prospects for putting together bridge financing adequate for the simultaneous clearance of arrears were good. If, at the end of May, it was not possible to put together the entire amount, an alternative strategy, perhaps a sequential clearing of arrears, could be considered.

Mrs. Filardo pointed out that the new Government of Honduras had put so much effort, under difficult circumstances, into designing the program, implementing the economic measures, and trying to obtain the necessary resources that it deserved the support of the Board. While she had thought that perhaps another member of her constituency could provide the funds to clear the arrears to the Fund first, a simultaneous clearance of arrears had been considered the best approach following meetings with the authorities and potential donors and an evaluation of different avenues.

Honduras needed a strong program because of the country's large arrears to multilateral and bilateral agencies and to commercial banks, Mrs. Filardo continued. The authorities would have to make a great effort to establish a credible track record so as to obtain significant support from those institutions. As Directors were aware, traditional bilateral creditors--Mexico and Venezuela--were experiencing financing constraints, although they were committed to helping Fund members to clear arrears. Progress had been made in approaching the authorities of Japan, Mexico, Spain, Venezuela, and the United States; all called for equal treatment and for burden sharing. It was also necessary to take into consideration Honduras' arrears to bilateral creditors and the plans to obtain a package to clear those arrears.

Many Directors had mentioned that Honduras had made only a token payment, but it was important to consider the payment from the point of view of the member, Mrs. Filardo remarked. From that perspective, the payment was significant as it amounted to about 20 percent of Honduras' liquid assets.

She had suggested the amendment to the second paragraph of the proposed decision because the authorities were cooperating and because that wording had been used in other cases, such as that of Viet Nam, Mrs. Filardo stated. The amendment to the third paragraph had been included to recognize the authorities' commitment to a simultaneous clearance of arrears to all the multilateral institutions. The authorities would endeavor to obtain bridge financing and to implement the additional measures necessary to complement the program.

Mr. Evans said that, while he could appreciate Mrs. Filardo's objective, he considered that the reference to "active cooperation" in the first sentence of paragraph 2 of Mrs. Filardo's amended decision was not appropriate, and he suggested deleting the word "active" so as to retain the sense of the sentence. The staff had indicated that the proposed reformulation had been used for Viet Nam, but in that case the member had been cooperating actively with a track record of nine months--a different situation from that of Honduras. Therefore Viet Nam's decision should not be used as a precedent.

Mr. Fogelholm suggested that to avoid repetitiveness, the staff's draft should be retained, with the insertion of a reference to the Fund welcoming the authorities' intention to pursue a comprehensive adjustment program with the Fund and urging the authorities to implement the additional measures needed to complement the program.

Mrs. Filardo explained that she had wanted to indicate that the authorities had designed a program and that while most measures thereunder had been implemented, the Fund urged the authorities to implement the additional measures needed to complement the program; moreover, the Fund would be ready to support Honduras upon implementation of the program and clearance of arrears.

Mr. Enoch observed that amendments along the lines suggested by Mr. Fogelholm gave a stronger and more balanced message of support to the Honduran authorities. He proposed starting with paragraph 3 of the staff's draft decision--which welcomed measures already taken--as amended by Mr. Fogelholm, and avoiding any reference to "active cooperation," a term that could prove difficult to define.

Mr. Menda said that he supported Mr. Fogelholm's proposal.

The staff representative from the Legal Department commented, with respect to paragraph 2 of the draft decision--paragraph 3 as proposed by Mrs. Filardo--that the text drafted by the staff was more precise because it included a time reference for the completion of financial arrangements to settle Honduras' overdue financial obligations to the Fund.

Mr. Kyriazidis added that the staff's formulation also avoided having the Fund appear to approve the strategy being followed by the Honduran authorities.

Mr. Dawson commented that care should be taken not to send a message that Directors seemed to favor a strategy of sequential--rather than simultaneous--clearance whereby arrears to the Fund would be taken care of and not those, for example, to the World Bank. The decision should acknowledge that the effort being undertaken by Honduras was comprehensive, as it involved clearance of arrears to all the multilateral institutions.

The Acting Chairman noted that, based on earlier statements, the majority supported paragraph 3 as proposed by Mrs. Filardo.

The Executive Board then took the following decision:

1. The Fund has reviewed further the matter of Honduras' continuing failure to fulfill its financial obligations to the Fund in the light of the facts and developments described in EBS/90/79 (4/24/90).

2. The Fund welcomes the economic measures implemented recently by Honduras and the authorities' intention to pursue a comprehensive adjustment program with the Fund, and thus urges the

authorities to implement the additional measures needed to complement this program. The Fund continues to stand ready to respond to the authorities in support of these efforts.

3. The Fund acknowledges the payment made recently by Honduras. However, the Fund deeply regrets the continuing failure of Honduras to fulfill its financial obligations to the Fund, which is placing a financial burden upon other members and reducing Fund resources needed to help others. The Fund urges Honduras to make full and prompt settlement of the overdue financial obligations to the Fund, and stresses that settlement of these arrears should be given the highest priority. In this connection, the Fund notes that the strategy being pursued by the new Government is geared toward achieving full clearance of Honduras' arrears to all the multilateral institutions, which the authorities consider to be the strongest evidence of Honduras' determination to achieve a cooperative solution to the problem of its arrears.

4. The Fund will review the matter of Honduras' overdue financial obligations to the Fund again not later than May 31, 1990, in light of the actions taken by Honduras in the meantime in settling its arrears to the Fund and in implementing a comprehensive adjustment program.

Decision No. 9417-(90/65), adopted
April 25, 1990

2. PAPUA NEW GUINEA - STAND-BY ARRANGEMENT, AND PURCHASE TRANSACTION - COMPENSATORY AND CONTINGENCY FINANCING FACILITY - FLUCTUATIONS IN EXPORTS

The Executive Directors considered a staff report on Papua New Guinea's request for a 14-month stand-by arrangement in an amount equivalent to SDR 26.36 million and a purchase in an amount equivalent to SDR 42.835 million under the compensatory and contingency financing facility (EBS/90/61, 3/30/90; Cor. 1, 4/18/90; and Sup. 1, 4/24/90).

Mr. Evans made the following statement:

The Papua New Guinea economy has been well managed since the country gained independence in 1975, as reflected in part by the fact that Papua New Guinea has not previously drawn on Fund resources. With the onset of unexpected difficulties in mid-1989, the authorities acted swiftly to limit the damage, and those prior actions have now been supplemented by much more significant measures planned--and already largely implemented--for 1990 in support of the request for the stand-by arrangement. The authorities, however, do not intend to draw on the stand-by arrangement unless absolutely necessary. All of this bodes well for the program and provides the firmest possible assurance that the Fund's resources will be safeguarded.

As the report indicates, the growth momentum that had built up in 1987-88, generated by the combination of prudent domestic financial policies and favorable world market prices for mineral exports, was stalled by the closure of Bougainville Copper Limited in May 1989, following civil disturbances by militant landowners in the region. Until its closure, the Bouganville mine had accounted for about 10 percent of GDP, 35 percent of exports, and 15 percent of government revenue. Combined with the 16 percent deterioration in the external terms of trade brought about by depressed prices for Papua New Guinea's major export commodities, a sharp slowdown in economic activity ensued, involving a loss in potential exports of about SDR 300 million and increasing unemployment.

The authorities moved quickly in 1989 to implement a comprehensive program, which included expenditure cuts and tighter monetary policy. These measures helped to prevent a more serious deterioration of Papua New Guinea's financial position. At the beginning of 1990, the Papua New Guinea authorities decided that macroeconomic and structural policies would have to be formulated on the assumption that the Bougainville mine would be closed indefinitely. On that basis, the authorities have resolved to continue tight monetary and fiscal policies and, noting the dual nature of the economy highlighted by the mine closure, to embark on a medium-term structural adjustment strategy aimed at diversifying the economy and ensuring that it remains competitive in world markets.

Reflecting these considerations, my Papua New Guinea authorities have formulated for 1990 a comprehensive economic program which combines prudent monetary and fiscal policies aimed at containing the damage wrought by the Bougainville mine closure, with structural reform measures geared toward a broader-based and competitive market economy. The macroeconomic and structural measures that the authorities are undertaking are well elaborated in the staff report and the authorities' Memorandum of Economic and Financial Policies; I will highlight only what the authorities regard as the key elements of their program.

On the fiscal front, the authorities are now aiming for near balance in the overall budget, or an improvement of about 1 percentage point of GDP over 1989. To this end, expenditure cuts amounting to K 73.8 million over the original expenditure program were approved by the Cabinet in early April 1990. This cut is higher than the K 70 million agreed with the Fund staff. Cuts have been made in practically all expenditure categories except debt-service payments. Specific measures include a freeze on filling vacancies and creating new positions in the civil service; sharply reduced appropriations for travel allowances, official functions, and other goods and services; and a decision to start an extensive retrenchment scheme. The authorities have created a Ministerial Committee chaired by the Prime Minister to monitor fiscal developments closely and to ensure that the programmed expenditure cuts are implemented.

The fiscal tightening is expected to contribute significantly to the necessary reduction in liquidity without unduly curtailing credits to the private sector where activity in the nonmining areas is expected to drive GDP growth. The decline in liquidity in 1990 is also expected to generate a rise in interest rates, which in turn should help mobilize domestic savings and reduce the potential for capital outflows. On the exchange rate, my authorities, in response to the deterioration in the terms of trade and the significant effective appreciation of the currency, devalued the kina by 10 percent on January 9, 1990 and instituted a policy of severe wage restraint. They are of the view that competitiveness should be attained primarily by containing domestic cost pressures through sound macroeconomic and incomes policies rather than frequent resort to exchange rate devaluations.

In this regard, they have adopted a policy of containing the government wage bill and are aiming for a reduction in real wages over the medium term. They have abandoned the practice of fully indexing wages to increases in the consumer price index, have agreed with the Public Employees Association (PEA) to limit nominal wage increases to 4 1/2 percent annually for the next three years--an agreement was reached with the PEA that will result in a 5 percent real wage decline in 1990--and are encouraging the private sector to practice the same restraints. As stated in the staff report, the real wage reduction policy, combined with a policy of retrenchment in civil service employment, is estimated to reduce the real wage bill of the Government by 12 percent over the three-year period ending in 1992.

In summary, my Papua New Guinea authorities, in a quick and decisive manner, have implemented macroeconomic and structural measures to contain the effects of the unfortunate closure of the Bougainville mine, which, if not addressed in a timely manner, could have severe consequences for the economy over the long term. For 1990, they are committed to continuing their reform efforts as they anticipate a further deterioration in the terms of trade and assume that the mine will remain closed for the rest of the year.

For their economic and financial program, my authorities are, for the first time, approaching the Fund for financial support.

Because timely Fund support is essential to catalyze donor responses, this request merits the Board's endorsement. In their letter to the Managing Director (Annex I to the staff report), the authorities have indicated that a drawdown under the stand-by arrangement will be made only if Papua New Guinea's foreign reserves decline below the indicative target for reserves set out in the Fund-supported program. The authorities expect that approval of the program will generate adequate donor financing, which will obviate the need for a drawing. Nevertheless, they remain committed to satisfying all performance criteria under the program.

The authorities, however, see the need for drawing compensatory financing under the compensatory and contingency financing facility in view of the severe shortfall in both mineral and nonmineral exports calculated by the staff for the year ending June 1990. The calculated shortfalls are SDR 76 million for mineral exports and SDR 20 million for nonmineral exports. For these, the authorities are requesting compensatory financing of SDR 42.8 million. The staff report is clear concerning the satisfaction by Papua New Guinea of all the requirements for a purchase under the compensatory and contingency financing facility. The program in support of which the stand-by arrangement and the compensatory financing of export fluctuations are being requested is a sound one--in many respects, exemplary--and merits Board approval.

Mr. Enoch made the following statement:

At the time of the Board's previous discussion on Papua New Guinea in October 1988 (EBM/88/154), this chair congratulated the authorities on their steady pursuit of sound financial policies over the preceding few years. Indeed, we joined other Directors in welcoming the new Government's assurance that no major shifts in economic policy were planned. At that time it seemed that Papua New Guinea could look forward to a sustained period of rising prosperity based on the balanced exploitation of the country's abundant natural resources.

Eighteen months later, the country's prospects have been somewhat clouded by the impact of a major supply-side shock--the closure of the Bougainville mine. Although, as the staff's medium-term projections demonstrate, Papua New Guinea's economic prospects remain good, it is clear that in the short run the authorities face a significant stabilization problem.

The financial program put together by the authorities seems well directed. On the fiscal side, the key challenge is to eliminate the need for any bank financing of the deficit. The authorities intend to achieve this objective through a balanced package of revenue-raising measures and expenditure cuts, although the additional adjustment envisaged under the program is entirely accounted for by the proposed cuts in spending. In reviewing these cuts, the staff gives prominence to the streamlining of the civil service. This is indeed welcome, although Appendix Table II implies that reductions in the civil service wage bill account for only 1 percent of the total expenditure package. I would be grateful for some indication from the staff of where the main burden of adjustment will fall. For example, does the large fall in net lending reflect smaller transfers to the public enterprise sector?

The key to maintaining investor confidence and to keeping downward pressure on inflation lies in the projected tightening of monetary policy. The major contractionary impact on liquidity will come from the fiscal squeeze and from the expected deterioration in the balance of payments. However, the authorities are also expecting a further rise in interest rates. I would welcome clarification from the staff of whether this projection is consistent with the programmed expansion in credit to the private sector. I would also appreciate further information on whether the Bank of Papua New Guinea has sufficient instruments at its disposal to influence the level of short-term interest rates. For example, have the authorities introduced debt sales to the nonbank sector?

The recent economic downturn has brought into focus a number of more deep-seated structural weaknesses that have held back activity in the nonmining sector in recent years. It is clear that the authorities have now begun to address some of these issues, most directly by focusing on measures to improve competitiveness.

More specifically, the recent devaluation of the kina should provide a helpful boost to private sector activity in the tradable goods sector, particularly given the authorities' courageous decision to sever the link between wage increases and changes in the cost of living. A period of wage restraint, backed by tight financial policy, should create the right conditions for a resumption of growth in the nonmining sector and a reduction in unemployment. However, these measures will need to be accompanied by further trade liberalization and by a deregulation of the approval system for direct foreign investment. In addition, the authorities should press ahead with their proposed rationalization of the agricultural stabilization funds to ensure that public sector resources are put to their most productive use.

Given the temporary nature of Papua New Guinea's current problems, the good prospects for a sustained recovery, and the authorities' fine record of economic management, I have no difficulty in supporting the use of Fund resources in this case. I do, however, have a number of questions about the nature of the proposed financing. The request under the compensatory and contingency financing facility does not relate to a projected shortfall in any particular category of export earnings but to export earnings in aggregate. On this basis, there is no doubt that the authorities have a strong case for a compensatory purchase. I have, however, two specific questions for the staff. First, while the closure of the Bougainville mine has disrupted exports, has there not been a corresponding fall in intermediate imports and a similar rise in the net services balance? Given that Papua New Guinea's mineral sector is characterized by the staff as an "enclave," it seems unlikely that a fall in production would not lead to an offsetting reduction in imports and in profits remitted abroad. Second, I would be grateful for some clarification of whether the gold price assumption the staff has used for 1990 reflects the recent fall in world gold prices.

Under paragraph 12(c) of the Decision on the Compensatory and Contingency Financing Facility, if a member's balance of payments position is satisfactory "apart from the effects of the export shortfall" being compensated, access of up to 83 percent of the member's quota can be agreed. My understanding is that if the trend in exports had not been interrupted, Papua New Guinea's external position would have been relatively comfortable. Indeed, the staff notes that before the disturbances started last year, the overall balance of payments in 1989 was expected "to remain in virtual equilibrium."

In these circumstances, I would be interested to hear why the staff is proposing to combine access under the facility with a conventional stand-by arrangement. If Papua New Guinea's external position would have been comfortable in the absence of the exogenous shortfall in exports, a single 83 percent of quota drawing under the facility might have been more appropriate. My question is reinforced by two considerations. First, the front-loaded nature of the proposed access would in any case not appear to give the Fund a great deal of additional leverage over the authorities' policies in the remaining 12 months of the program. And second, as Mr. Evans has explained, his authorities intend to draw on the proposed stand-by arrangement only if the level of gross reserves targeted under the program is not realized.

I can support the proposed decisions, and also the proposal to put Papua New Guinea back on the regular annual consultation cycle.

Mrs. Sirivedhin said that she was in broad agreement with the thrust of the staff appraisal. She endorsed the request for a 14-month stand-by arrangement and commended the authorities for their intention to draw on the arrangement only if absolutely necessary. She also endorsed the authorities' request for purchases under the compensatory element of the compensatory and contingency financing facility, as all the requirements had been met. The support from the Fund, together with the World Bank's structural adjustment loan and the Asian Development Bank's program loan, would substantially enhance the implementation of the authorities' adjustment program.

It was worth recalling that Papua New Guinea's recent economic hardship had not been precipitated by bad economic policies or policy slippages, Mrs. Sirivedhin continued. It had been brought about by two exogenous factors--namely, the closure of the Bougainville mine, which had contributed a substantial portion of Papua New Guinea's GDP, exports, and government revenue; and a sharp decline in prices of almost all of the country's major export commodities. As a result, the economy had deteriorated sharply in 1989 instead of improving steadily as expected.

Under the circumstances, she welcomed the authorities' decision to embark on a vigorous program aimed at containing the detrimental impact of the exogenous developments while promoting the growth of the nonmining sector, Mrs. Sirivedhin stated. With regard to the former, she agreed with the authorities that the program for the current year called for strong fiscal and monetary measures, especially in light of the indefinite closure of the Bougainville mine. Since revenues from a number of the newly introduced tax measures were expected to cover only partially the loss of corporate tax receipts owing to the closure of the mine, the targeted decline in the overall budget deficit could be achieved only through a substantial cut in expenditures. In that context, she welcomed the additional measures adopted by the authorities at the beginning of the year to further streamline budgetary outlays.

A substantial decline in the budgetary deficit would be crucial in effecting the targeted contraction in total liquidity in 1990, thereby contributing to the attainment of the authorities' inflation and external targets, Mrs. Sirivedhin remarked. In addition, the decline was expected to provide greater scope for credit expansion to the private sector. That trend, together with the expected improvement in domestic savings and credit allocation, should contribute to the enhancement of the nonmining private sector over the medium term.

The authorities had initiated a number of important measures to strengthen the external competitiveness of the economy, including wage restraint and a flexible exchange rate policy, Mrs. Sirivedhin noted. She also welcomed their commitment and efforts to further improve public resource management. In concluding, she commended the role and assistance of the World Bank and the Asian Development Bank in facilitating Papua New Guinea's efforts in the implementation of structural adjustment.

Mr. Menda made the following statement:

After two years of favorable economic performance in 1987-88, Papua New Guinea has suffered dramatic changes with the closure of the Bougainville mine, which represented 10 percent of GDP and 35 percent of exports, and a severe and sudden deterioration in the external terms of trade. The prompt reaction of the authorities and their ability to manage the economy under difficult circumstances are impressive. Indeed, the restrictive financial policies promptly set in place have avoided a more severe deterioration and could serve as an example for those countries faced with similar shocks.

I have little difficulty with the program as it stands, but I do have some difficulty with the use of Fund resources and the proposed phasing. On the program, I am in broad agreement with the staff report. The twofold objective, consisting of short-term stabilization and structural adjustment measures, is well suited to the present situation. The fiscal measures, aimed at raising revenue and curtailing expenditure, are broadly satisfactory, but I have two questions. First, there seems to be a heavier reliance on import duties than on additional internal sources of revenues; I wonder whether this does not contradict the medium-term objective of opening and diversifying the economy. I would appreciate some comments from the staff on this issue. Second, I would like to know the exact burden of producer price subsidies on the budget.

On monetary policy, I agree that prompt elimination of the financing of the budget deficit by the banking system is appropriate and that it will leave more room for the financing of private sector activity. As regards exchange rate policy, I would recommend, after the recent devaluation, that the authorities adopt a more stable approach. Indeed, the nominal anchor provided by a stable exchange rate should help them control the evolution of wages and attract the needed foreign investment to diversify the economy; but I am reassured by Mr. Evans's statement on this issue.

As to structural policies, the emphasis placed on promoting the nonmining private sector and improving public resource management is appropriate. In the task of improving the competitiveness of the economy, the departure from full indexation of wages will certainly be of the utmost importance, as will the progressive phasing out of heavy producer price subsidies. However, on the latter, I wonder whether a bolder approach was not possible; given the importance of trade liberalization in the diversification process, I would appreciate more information from the staff on the steps envisaged in this area. I welcome the measures adopted to limit the social impact of the adjustment program.

With respect to the use of Fund resources, first, I believe that the package is too heavily front-loaded. As concerns the compensatory financing request, I have no difficulty with this front-loading, especially as adequate policies are in place, supported by an agreement in the upper credit tranches. However, I wonder why a similar pattern has been followed for the stand-by arrangement, which considerably weakens the conditionality of the whole package. I would appreciate some comments from the staff on this issue.

Second, on the request for compensatory financing, I was somewhat surprised to learn that the closure of the Bougainville mine was considered beyond the authorities' control, and that therefore the Fund agreed to finance a "political risk." The staff reports that similar decisions had been taken in the past and I would appreciate learning the relevant cases.

That being said, I have no major problem with the technical aspects of the request. It is, however, surprising to note in Annex VII of the staff report that the major element of the shortfall is in gold exports and not major commodity exports. Nevertheless, I believe that the authorities deserve the support of the Fund and, in particular, that they pass the test of cooperation. I support the proposed decisions.

Mr. de Groote said that he supported Papua New Guinea's requests. The dual nature of the Papua New Guinea economy was obvious, as it was sharply split between a modern mining and manufacturing sector and a traditional sector encompassing a fascinating culture and a rich environment. Somehow, the country had been hit harder than others by the downturn of the terms of trade because it had no opportunity to accumulate appropriate reserves to resist those shocks. The dual aspect of the economy was especially apparent when considering that the country's per capita income was extremely low and that traditionally about 55 percent of consumption resulted from imports. That basic characteristic of the economy had to be kept in mind in elaborating with the authorities a reasonable program that was viable in the medium term and that could lead to a reduction of the dichotomy between the modern sector and the traditional sector.

The contingency nature of the program resulted from the fact that, faced with the closing of the Bougainville mine, the country had had to resort to immediate stopgap measures, Mr. de Groote commented. Admittedly, some measures with important medium-term effects had also been adopted, such as the deindexation of wages and salaries and the gradual correction of agricultural prices. But on the whole, the program was only the first step in the process of continuous collaboration with the Fund, and further improvements could be made, for example, with regard to the fiscal system, the parastatals, and the functioning of the monetary system.

On the fiscal system, it was, although understandable, somewhat disappointing that, instead of an overhaul of the tax and revenue system, the measures had taken the form of withholding taxes and fees, as well as excise duty increases, Mr. de Groote remarked. It was well known that withholding taxes had a distortionary effect on supply and prices, and it would be appropriate in future to consider other methods for increasing public revenue that would be more compatible with the further development of private enterprise.

On parastatals, public tariffs, and privatization, the Government intended to follow the program set out in the Memorandum on Economic and Financial Policies for 1990, Mr. de Groote noted. He was surprised, however, that more importance was not accorded in the program to further steps in the evolution of the economy toward privatization and a more effective role for public enterprises. The staff had not provided much information about the soundness of public enterprises or about the possibility of implementing an action plan.

He also had some difficulty understanding the institutional framework for monetary and credit policy, and perhaps on the occasion of further negotiations with the authorities, the system could be improved, Mr. de Groote remarked. For instance, the treasury bill rate was substantially higher than the discount rate; and banks had a reserve requirement, but their low rediscount rate facility amounted to a subsidy that offset part of the burden resulting from the deposit obligation. The system seemed somewhat cumbersome, and undoubtedly other ways could be found to control liquidity and to provide the banks with appropriate profit margins.

As to the medium-term projections, it was difficult to reconcile the expected 3 percent increase in import volume with a 4 percent projected increase in income, Mr. de Groote stated. In a country where 55 percent of consumption was based on imports, it was not clear how, with such a limited increase in import volume, such a substantial increase in income could be attained; one explanation was if consumption fell drastically and most imports were directed toward investment.

He wondered why a stand-by arrangement, and not an extended arrangement, had been requested, or whether the stand-by arrangement could be transformed over time into an extended arrangement, Mr. de Groote said. The changes needed in Papua New Guinea were structural, and the country was obviously moving in that direction. The program before the Board would require additional improvements, most of them structural and institutional. Perhaps it would be wise to consider the necessity, if adjustment continued, to transform the arrangement into an extended arrangement.

He was surprised that the World Bank had postponed the possibility of an environmental loan for Papua New Guinea, which had the protection of the environment inscribed as one of its main objectives in its constitution, Mr. de Groote noted. Especially at the present juncture of world political opinion, the case for such a program seemed ideal.

Mr. Noonan said that he agreed with Mr. Evans that the Papua New Guinea program was sound and, in many respects, exemplary. It was noteworthy that many of the policy measures underlying the adjustment effort, including the devaluation of the currency and fiscal retrenchment, were already in place. Moreover, he was particularly impressed by the authorities' efforts to reduce real wages to improve the competitiveness of the economy, instead of relying on further devaluations of the currency. While he could agree with Mr. de Groote that diversification of the economy was required, financial support for that purpose could more appropriately be provided by the World Bank.

As stated by Mr. Evans, the authorities were requesting the stand-by arrangement essentially for two reasons: first, for precautionary purposes, and second, to catalyze donor support, Mr. Noonan continued. It appeared that both aims could be met adequately without the stand-by arrangement. With regard to the first, such precautionary balances were available to the authorities, if required, in the form of a drawing on the first credit tranche. As to the second objective, the World Bank, through the consultative group process, should be able to catalyze donor support. It was not clear that a stand-by arrangement had an appropriate role to play in the process.

Like Mr. Enoch, he had some queries arising from the enclave nature of the mining industry in Papua New Guinea, Mr. Noonan said. About two thirds of the country's exports were generated by the mining industry. He asked the staff to estimate the proportion of imports associated with that industry, both directly and indirectly, and also to estimate the debt-service capacity of Papua New Guinea net of remuneration of private foreign capital. The moderate level of Fund payments falling due in the medium term did not appear to give rise to immediate concern. Nonetheless, a clearer picture of Papua New Guinea's capacity to repay debt would need to take account of the net resources that were actually available to the authorities. The contribution of the mining industry to government revenue was only about 7 percent of GDP, from both direct and indirect taxes, including the associated income tax revenues. Despite those queries regarding the request, his reservations were not such that he would raise any objection to the proposed decisions.

Ms. Yang observed that Papua New Guinea's economy had been hard hit by both internal and external shocks in 1989. The indefinite closing of a major mine and a continued deterioration of the terms of trade in the external sector had led to a sharp reduction in the level of economic activity and a worsening of the current account position. The authorities had moved decisively to tighten the fiscal and monetary stance in response to the adverse effects of the shocks on the economy. Progress has been made in reducing both the budget deficit and inflation.

The budget deficit had been limited to 1 percent of GDP, which had contributed to a moderate expansion in domestic credit and a slowing down of inflation, Ms. Yang noted. At the same time, the authorities had devalued the kina and instituted a policy of severe wage restraint. That action had helped to improve Papua New Guinea's competitiveness while containing inflationary pressures induced by devaluation, and she welcomed those efforts by the authorities.

As mentioned by the staff, the adverse effects of the shocks on the economy had underscored the need to diversify the economic base and accelerate growth in the nonmining sector, which called for comprehensive structural reforms, Ms. Yang said. The economy could be revitalized through sustained structural adjustment efforts supported by cautious fiscal and monetary policies. She supported the proposed decisions.

Mrs. Hansen commended the authorities of Papua New Guinea for their record of sound economic management. In 1987-88, prudent domestic policies had provided the basis for relative financial stability and helped to strengthen the external position. Subsequently, following the closing of the Bougainville mine and the decline in world prices of a number of Papua New Guinea's commodity exports, the authorities had moved decisively to tighten fiscal and monetary policies so as to limit the deterioration in the domestic and external accounts.

She supported the authorities' requests for a stand-by arrangement and compensatory financing under the compensatory and contingency financing facility, particularly given Papua New Guinea's strong policy record, Mrs. Hansen stated. However, with regard to the phasing of disbursements, it was unusual that a country applying for resources totaling 105 percent of quota would be eligible to draw as much as 91 percent of quota in the first drawing. She realized that there were special circumstances involved in the case of Papua New Guinea, namely, that a large part of the requested stand-by arrangement consisted of its first credit tranche, and that Papua New Guinea qualified under the compensatory and contingency financing facility decision for an immediate purchase of 65 percent of quota. However, her authorities had been concerned about the tendency of large up-front disbursements under the facility to distort normal phasing. The phasing in the present case amply illustrated the point.

In that connection, she wished to reiterate her chair's view that all compensatory financing purchases should, in principle, be phased, Mrs. Hansen continued. Her authorities had, however, expressed some willingness to consider front-loading in cases where the country had a good track record and had presented a fully articulated program that met upper credit tranche conditionality. Indeed, under those criteria

Papua New Guinea appeared to be a strong candidate for front-loading, but her authorities did not agree that front-loading should be the norm.

Regarding the economic program, despite Papua New Guinea's good record, the country faced serious economic problems, among which were its heavy dependence on the mining sector, which seemed destined to increase in the medium term, and the massive environmental damage caused by current mining and logging practices, Mrs. Hansen remarked. In that connection, she underlined the importance of both the authorities' efforts to create conditions that would stimulate activity in the nonmining private sector, and the steps they were taking to improve the control and monitoring of the environmental impact of exploiting the country's natural resources.

Mr. Goos praised the authorities' exemplary economic management, including in particular their prompt policy adjustments in response to the changing economic conditions in the recent past. That responsiveness could be expected to pay off at present, in that it would facilitate the task of coping with the adverse consequences of the mine closure and the sharp decline in agricultural export prices. He was also glad to note from the proposed arrangement that the authorities appeared to be resolved to adopt further adjustment measures to stabilize the macroeconomic situation and also to tackle the existing structural problems.

In that regard, he endorsed the program's objective of diversifying the economy and accelerating growth in the nonmining sector, Mr. Goos said. However, like Mr. Menda, he had some difficulty reconciling that objective with important program assumptions and projections, in particular with the substantial amount of investment that was being planned in the mining sector and with the forecast continued increase in export shares for mining products in the years ahead. Moreover, he was not clear to what extent the envisaged investment in the mining sector was feasible. Possibly, the same developments that had caused the closure of the Bougainville mine might also hamper new investment activities. That concern suggested that environmental concerns needed to be more appropriately taken into account in the design of the new mining projects; at the same time, it also served to highlight the need for a timely and comprehensive correction of the existing cost-price distortions affecting nontraditional investment. He assumed that such investment could make a more integrated contribution to overall economic activity than that derived from the mining sector, with correspondingly stronger spillover effects for employment. Mr. de Groote had referred to that point, and to the importance of overcoming the dichotomy of the economy. In that vein, he welcomed in particular the envisaged phasing out of the price support for agricultural products.

As to the medium-term prospects, it appeared that the adjustment strategy critically hinged on the assumed increase of the national savings ratio to the remarkable level of 36 percent of GDP by the middle of the decade, Mr. Goos noted. At first glance, that savings effort appeared to be exceptionally ambitious if not somewhat unrealistic. He would therefore welcome some explanation by the staff of the underlying assumptions. Nevertheless, he was satisfied that the program constituted an impressive effort of adjustment, and he welcomed in particular the authorities' intention, as mentioned by Mr. Evans, to achieve stabilization primarily by containing domestic costs and price pressures rather than resorting to frequent exchange rate devaluations.

He noted from the report that the Fund was providing long-term technical assistance to Papua New Guinea, Mr. Goos remarked. He wondered whether the Fund, as a monetary institution, should engage in such long-term activities, especially in light of the existing budgetary constraints and the heavy demands on the manpower resources of the departments that provided technical assistance. Staff comment on that point would be helpful. Finally, he supported the staff appraisal and the proposed decisions.

Mr. Raza commented that the staff report and Mr. Evans's statement described clearly the unexpected and severe problems faced by Papua New Guinea since mid-1989. The problems had arisen as a result of the closure of the Bougainville copper mine and the sharp decline in the unit value of the country's major export commodities--two factors largely beyond the control of the authorities. However, to the credit of the authorities, they had moved quickly and had taken strong countervailing measures on both the fiscal and monetary fronts. The promptness with which actions had been taken--many of which had been painful, with adverse social consequences--as well as the authorities' resolve to initiate further strong measures should the situation so demand, clearly demonstrated their earnestness. That they were not assuming any beneficial effects from the possible reopening of the Bougainville copper mine spoke well of their pragmatism.

While he agreed with and fully supported most of the policy measures already initiated or planned, he was not entirely clear about the advisability of phasing out the price support program for agricultural commodities within two years, Mr. Raza remarked. He could agree with the scheme in principle, but to expect the authorities to be able to strengthen the extension and research services sufficiently to enable producers to reduce their operating costs, raise productivity, and become competitive in the highly speculative world market within a short period of two years seemed too optimistic. He would therefore counsel caution. However, he fully agreed with the need to provide support for the program through government-guaranteed loans, rather than through subsidies, and to help put public resources to better use.

On the medium-term outlook, it was difficult to accept some of the staff's projections, Mr. Raza said. To expect the national savings rate to double to 25 percent of GDP and the investment rate to rise by almost 50 percent to over 33 percent during a short period of three years seemed overoptimistic. Similarly, the staff's explanation notwithstanding, it was difficult to accept that the current account deficit would narrow from about 25 percent of GDP in 1991 and 1992 to only about 4 percent in 1993. The sharp ups and downs in both the volume and value of exports and imports during the following five years, as indicated in the staff report, also seemed inexplicable, and the staff implied a sharp upturn in unit values of the country's major export commodities in 1993. The staff might wish to throw some light on the assumptions behind those projections.

Those comments notwithstanding, he agreed with the staff and Mr. Evans that policies and measures being pursued or envisaged by the authorities would help Papua New Guinea's economy to move to a higher and sustainable growth path, Mr. Raza stated. He was also convinced that the sharp export shortfall was due to factors beyond the control of the authorities. He therefore supported the authorities' request for both the stand-by arrangement and compensatory financing of export fluctuations.

Mr. Ichikawa made the following statement:

The closure of the Bougainville mine and the unfavorable developments in world commodity prices last year were a major setback to Papua New Guinea's economic growth. Over the years, the strong growth of the mining sector had more than offset the stagnant situation in the agriculture sector, leading to steady and stable economic development. Nevertheless, the adverse developments in the economy following the closure of the mine highlight the structural weakness of the dual economy, where few linkages have been developed between the modern and traditional sectors. Therefore, I endorse the authorities' intention to diversify the economy over the medium term, while addressing the short-term economic imbalances. These two objectives are mutually complementary; in particular, short-term stabilization at this critical juncture should build a firm basis for viable growth over the medium term. The authorities need to provide an appropriate macroeconomic environment by addressing fully the internal and external imbalances in order to enhance the efficiency of the ambitious investments in the mining sector planned in subsequent years.

With regard to program design, we welcome the adoption of fiscal and monetary retrenchment measures aimed at preserving the competitiveness of the economy. It is encouraging to learn that a considerable reduction in the fiscal deficit would result in a turnaround of the Government's net borrowing position vis-à-vis the banking system. This, together with a tight stance on monetary expansion, will promote the efficient allocation of credit to the private productive sector. While inflation is expected to rise this year, mainly reflecting the income effects of devaluation, this tight monetary stance can contain price pressures during a short transitional period.

Structural policies are of key importance in the adjustment process. Wage restraint in the public sector, including a limit on indexation, would send the right signal to the private sector. However, in the agricultural sector, which absorbs a large segment of the population, the main vehicle of incomes policy should be an appropriate pricing policy for agricultural commodities. We welcome the phasing of producer prices, which is imperative to streamline the operation of the commodity stabilization funds in the context of overall fiscal adjustment. At the same time, however, the authorities are encouraged to accelerate the introduction of a phasing approach to producer prices for commodities other than cocoa.

As to external policies, we support the devaluation in January as a complementary measure to the adjustment policies mentioned earlier. In particular, the weakening of the indexation of wages will allow exchange rate policy to actively support incomes policy. However, some uncertainty remains with regard to economic diversification. While development of the nonmining sector is emphasized in the program--and I believe that the reduction in import tariffs for agricultural inputs will enhance the efficiency of the agricultural sector--the predominance of the mineral mining sector in exports and income earnings is projected to continue over the medium term. I would appreciate the staff's elaborating on how gains in development of the mining sector can be integrated into the overall development of the economy and how sectoral integration could be improved in the context of structural adjustment.

On the request for access to compensatory financing, I support the proposed decision in view of the satisfactory adjustment efforts envisaged under the program. With broadly conservative assumptions, the staff projects a rapid recovery of growth and exports after the shortfall year, demonstrating the temporary nature of the shortfall. The program seems adequate to cope with the short-term imbalances and will provide a firm basis for viable growth in the medium term. In this context, the use of compensatory financing is an important element of the program. At the same time, however, the authorities should monitor closely developments in the export sector and should be prepared to take additional measures, if necessary. I support the proposed decisions.

Mr. Marino joined other speakers in commending the authorities of Papua New Guinea for their rapid implementation of a comprehensive adjustment program to address the deterioration in the terms of trade and the disruptions associated with the closure of the Bougainville mine. The actions already undertaken, along with the support of the financial community, should help to mitigate the costs in terms of economic activity and unemployment.

The economy of Papua New Guinea had been well managed since gaining independence in 1975, as pointed out by Mr. Evans, Mr. Marino continued. The current economic program apparently continued that tradition and also incorporated measures to alleviate some of the structural problems of the economy. In particular, the program aimed at diversifying the economy and ensuring that it remained competitive in world markets by decreasing labor market rigidities, liberalizing the external sector, and trying to break infrastructural bottlenecks. The rationalization of the tariff structure, the streamlining of the approval system for foreign investment, and the efforts toward privatization should help to promote the flow of resources into the nontraditional sector. The move toward a more balanced situation between the mining and the nonmining sectors should reduce Papua New Guinea's vulnerability to disruptions of the type it was currently facing.

He concurred with the staff that the export shortfall was attributable to factors largely beyond the control of the authorities, Mr. Marino stated. However, he encouraged the authorities to work intensively to find a solution to the problem of the Bougainville mine. Because of Papua New Guinea's excellent record of cooperation with the Fund, the well-designed adjustment program, and the temporary character of the balance of payments problems, he could support the proposed decisions.

Mr. Fuleihan made the following statement:

In the recent past, the economic performance of Papua New Guinea has been noteworthy; the external position has strengthened while public finances have improved. However, with the closure of the Bougainville mine and the deterioration in the external terms of trade, severe economic dislocations loom on the horizon. Consequently, credible stabilization measures, coupled with effective structural reforms, are imperative. It is encouraging to note from Mr. Evans's statement that the authorities are adopting such policies.

The economy's high vulnerability to adverse exogenous developments in the mining sector highlights the need to diversify the economic base and to invigorate the growth of the nonmineral sector. The 1990 program addresses appropriately this objective and delicately balances the need to stabilize the economy with the need to promote nonmining private sector growth.

On the fiscal front, the planned increase in revenue measures, including a broadening of the tax base and an increase in consumption taxes, allows for a reduction in import duties on essential inputs for the nonmining sector. Moreover, the proposed expenditure cuts avoid unwarranted reductions in allocations to social services and priority projects. In this context, it is reassuring that the authorities plan to improve public resource management and strengthen expenditure control and monitoring mechanisms.

Moreover, quality public expenditures on infrastructure and enhanced labor training should reduce production costs and improve the economy's growth potential.

It is obvious that a central feature of the economic program is the two-pronged approach to improving competitiveness based on exchange rate and wage policies. The authorities' attempts to introduce severe wage restraint will not only lead to improved competitiveness and reduced absorption but they also underscore the authorities' strong commitment to adjustment. In addition, the envisaged exchange rate devaluation would correct relative prices in favor of the trade sector, further improve competitiveness, and reduce domestic absorption.

Although I support the proposed devaluation, I am somewhat troubled by the indication in the staff report that the intention is to implement an exchange rate policy responsive to the need to maintain competitiveness, through the use of a real effective exchange rate peg. Because imports constitute 55 percent of the official consumer price index, such an effective exchange rate policy could impose an inflationary bias on the economy. This could be particularly true if private sector expectations perceive some traces of automaticity in this policy. Therefore, due regard should be given to the potential benefits of a policy that promotes the exchange rate as a nominal anchor. In this context, I endorse the authorities' view that competitiveness should be attained primarily by containing domestic cost pressures through sound macroeconomic and incomes policies rather than through frequent resort to exchange rate devaluations.

I welcome the limit imposed by the authorities on public sector contracting or guaranteeing of additional nonconcessional loans, which should help to avoid excessive debt-service pressures. Furthermore, the rationalization of the tariff structure and the streamlining of foreign investment regulations should enhance the economy's growth potential.

Regarding the authorities' request to draw on the compensatory element of the compensatory and contingency financing facility, it is clear that a balance of payments need exists. In addition, Papua New Guinea obviously meets the test of cooperation, given its excellent record of cooperation with the Fund and its implementation of a Fund-supported adjustment program. Consequently, in light of indications that this shortfall is temporary, and given the prompt repurchase expectation, I can approve such a request. Notwithstanding the severe economic dislocations confronting the economy, the medium-term outlook remains favorable if the authorities faithfully implement the adjustment program. Therefore, I support the proposed decisions.

Mr. Gronn observed that the economy of Papua New Guinea had been exposed to severe shocks by the indefinite closing of the Bougainville mine--which represented 10 percent of GDP and 35 percent of exports--and by a substantial deterioration in the terms of trade. Those events had exposed structural problems and highlighted the need to diversify the economy. However, the Government was implementing commendable economic policies, with expenditure cuts, higher interest rates, reductions in real wages, and structural reform.

He was in broad agreement with the staff appraisal and would only emphasize a few points, Mr. Gronn continued. First, he was struck by the fact that unusually sharp swings were expected in the external accounts. Even though domestic savings were high and remained relatively stable, the medium-term scenario predicted abrupt changes in national savings, the initial downturn owing mainly to early repatriation of profits. In addition, investments in the mining sector would be substantial in the next couple of years and would be followed by a strong mineral export performance in subsequent years. In a few years, such favorable developments would--according to the staff's estimates--result in a substantial surplus in the current account. The projected scenarios were extraordinary.

The staff noted in its report that the balance of payments projections were sensitive to assumptions about prices and the development of new mines, Mr. Gronn said. In that context, he asked the staff to describe the difficulties it foresaw for Papua New Guinea in making new mines operative, particularly with regard to environmental considerations and repercussions from the Bougainville disturbances.

The authorities had embarked on an ambitious wage policy, partly to reduce real levels and partly to strengthen the fiscal budget, Mr. Gronn remarked. That policy would contribute to improved competitiveness and would help to diversify the economy. Moreover, the authorities' emphasis on tight wage and macroeconomic policies to preserve competitiveness after the recent devaluation was welcome, and it would set a stable framework for the exchange rate and help to keep the inflation rate low.

In view of the authorities' sound policy responses to the shocks in the economy, he could support the request for a stand-by arrangement, Mr. Gronn stated. With regard to the drawing on the compensatory element of the compensatory and contingency financing facility, the staff considered that the request met all the requirements. It might be argued that the increase in reserves resulting from a purchase under the compensatory and contingency financing facility could potentially preserve or improve the confidence in the mining companies that was necessary for the development of mining projects, which was another vital element in the process of attaining a favorable medium-term performance. Therefore, he could support the request for compensatory financing; however, doing so did not reduce the need to strengthen the nonmining sector of the economy. He endorsed the draft decisions and the proposal to put Papua New Guinea back on the standard 12-month consultation cycle.

Mr. Montórfano noted that Papua New Guinea's economic situation had changed after the indefinite closure in May 1989 of the Bougainville mine--which had represented 10 percent of GDP, 35 percent of export earnings, 15 percent of government revenues, and an important source of employment. At the same time, the market for Papua New Guinea's principal export commodities, particularly coffee, cocoa, copra, and palm oil, had been affected by lower world market prices; that trend represented a loss in exports with a consequent reduction of foreign currency earnings and a negative effect on the balance of payments.

The Government's objectives of improving the infrastructure in the medium term and raising employment and the standard of living, as a result of a sustained structural adjustment effort, could constitute a satisfactory solution to the problem facing the Government, namely, the need for a new orientation of the economy, Mr. Montórfano observed. The stabilization of the economy in the short term to limit its deterioration and maintain investors' confidence and the implementation of structural measures to guide the economy in the direction of diversified growth in the medium term would need international cooperation. Taking into account both the record of cooperation of the country with the Fund and the adjustment program for which Papua New Guinea had requested a stand-by arrangement and compensatory financing, he supported the proposed decisions.

Mr. Chatah said that he concurred with Mr. Enoch's remarks regarding the compensatory purchase. Although the compensatory financing facility had undergone a lot of change, one aspect had remained, for good reason: in a case where balance of payments difficulties appeared not to extend beyond the export shortfall, the staff had to convince the Board that the difficulty did extend beyond the shortfall and that access of less than 83 percent was justified. He had not found such justification in the present case. Obviously, structural and other measures would help to boost growth and employment and to diversify the export base, but he was not sure that that constituted a criterion. The real test was whether the balance of payments difficulties extended beyond the export shortfall. He would appreciate the staff's response.

Mr. de Groote commented that, along the same lines, he would like to have guidance from the staff on Mrs. Hansen's suggestion regarding the phasing of drawings under the compensatory and contingency financing facility. It had been his understanding that the objective of the facility was to compensate for the loss of export earnings in the shortfall year that was reversible in the immediately subsequent years. He did not understand how a phasing mechanism that was not envisaged in the decision could be implemented. Perhaps Mrs. Hansen was referring not to phasing or front-loading, but rather to the possibility of a country with a shortfall requesting only part of its possible access to the facility because another shortfall could arise subsequently. However, the staff and the authorities had argued that in the present case the situation was reversible.

Mr. Kyriazidis said that he supported both decisions. However, like Mr. de Groote, Mr. Enoch, Mr. Chatah, and Mr. Noonan, he would appreciate an explanation of the rationale behind the specific financing packages that were being proposed. Apparently, the compensatory financing, as discussed by the staff, pertained to the provision allowing a drawing of 65 percent of quota in light of the member's performance.

Mrs. Hansen explained that her authorities' concern about the phasing of disbursements arose because a request for compensatory financing combined with a stand-by arrangement could result in a large disbursement under the compensatory financing facility that could swamp the normal tranching of the stand-by arrangement with which it was associated. The case of Papua New Guinea stood somewhat apart because the member was a good performer, and the concern might be less about sending the wrong signal to the country. But in another case, where a country was not performing well and a combination of a stand-by arrangement and compensatory financing, with the overwhelming bulk of resources provided up front, was approved, it was possible to argue that the country's incentive to continue performing well was weakened when it was obvious that subsequent drawings under the stand-by arrangement would be considerably smaller.

The staff representative from the Asian Department remarked that, in the authorities' view, with which the staff agreed, a stand-by arrangement was important in the current circumstances. The export shortfall was temporary, but there was also a structural imbalance in the country that would take some time to correct, and the member needed the Fund's support in designing a program for that purpose. The Fund-supported program would also play an important catalytic role. In fact, the authorities expected that after the Board's approval they would be able to mobilize larger financial resources during the forthcoming Consultative Group meeting in May.

The revenues generated from the mining sector should be utilized to strengthen public infrastructure, particularly the rural infrastructure, in Papua New Guinea, the staff representative said. For example, producers' access to inputs, services, and markets should be improved, and research and extension services in the agricultural sector should be supported. Moreover, revenues were needed to accelerate human resource development, especially training. Resources from the mining sector could also be utilized to strengthen public sector institutional capacities and to prepare and implement projects that would accelerate the growth of the nonmining sector.

The inflation rate during 1990, expected to be about 4 percentage points higher than in 1989, and the growth of credit to the private sector of 11.3 percent in 1990, compared with 9.6 percent in 1989, did not imply that credit conditions would be more relaxed during the program period, the staff representative noted. Actually, the staff considered the programmed expansion tight enough to be consistent with a possible increase in interest rates.

On fiscal policy, the cut in net lending reflected a deferment of a project of the Electricity Commission, the staff representative stated. As to the wage bill, the retrenchment might take some time to implement and the bill could show a slight increase during the program period. The major cuts in administrative expenditures would amount to about 20 percent, while expenditures under the public investment program would be 2 percent higher than the 1989 level in real terms.

Several Directors had commented on the behavior of imports in the medium-term projection, the staff representative recalled. Imports in Papua New Guinea largely reflected the stages of development of the mines. At the initial construction stage, import and services payments had been large; upon completion, imports had tended to decrease. Similarly, investment followed the same pattern. The staff had used the incremental capital output ratio to derive investment. Once the growth rate was determined, the staff calculated the investment of the mining sector and the nonmining sector through application of that ratio adjusted for the stages of development of mineral projects, and by and large the staff considered those projections to be consistent.

As to whether the Bougainville mine situation would affect investment in other mines, he believed that investors viewed that case as exceptional, the staff representative commented. First, the royalties paid to the landowners of the mine had been too low, at only 5 percent; recent contracts called for 20 percent royalty payments to landowners. Second, the authorities were trying to strengthen the environmental monitoring capacity of the Government, an area that was also very important from the point of view of investors. Third, an important element in the case of Bougainville was that the disturbances arose not only because of the compensation issue but also because of the secessionist movement in the province where the mine was located; that situation was unique and did not apply to other mines. Therefore, the staff was confident that the mining projects would proceed as scheduled and that investment would materialize.

Long-term technical assistance had been provided by two central banking experts in the Bank of Papua New Guinea and a fiscal affairs expert in the Finance Ministry, the staff representative said. The Governor had considered that perhaps, after the term of the current central banking experts expired, the services could be financed by the UNDP. The use of UNDP funds to finance long-term assistance should be encouraged, but such technical assistance, particularly in view of the requested stand-by arrangement and the reporting requirements, was essential.

Several Directors had commented that the level of projected national savings seemed exceptional, the staff representative from the Asian

Department commented. The national savings ratio was derived from the difference between investment and the external current account deficit. The behavior of imports and exports during the medium term was reflected in the calculation of national savings, which also included factor income and transfers.

Mr. Goos said that while he appreciated the staff's explanation of how the savings figure was calculated, he believed that the underlying assumptions for imports and exports and the results of the mechanically derived figures should be checked for plausibility. A savings ratio for Papua New Guinea in 1995 of 35 percent seemed exceptional. Some confusion also arose in staff papers with respect to terminology and the definitions of national vis-à-vis domestic savings.

Mr. Enoch commented that the staff stated that in the absence of the Bougainville mine closure the overall balance of payments had been expected to remain in virtual equilibrium, and that the stand-by arrangement was needed in terms of structural measures. He would be interested in the staff's further comments on the request.

Mr. de Groote said that he wished to emphasize that his earlier remarks had not been aimed at demonstrating that Papua New Guinea did not need Fund assistance other than compensatory financing. On the contrary, he wished only to determine that the appropriate form of assistance was being used. The needs of the country were of a structural nature, and he considered the requested stand-by arrangement a first step in the direction of an extended arrangement.

The staff representative from the Exchange and Trade Relations Department, commenting on the justification for the stand-by arrangement, remarked that the shortfall calculated under the compensatory and contingency financing facility was large, and even compensatory financing of 65 percent of quota would not solve the problem. Shocks to the mineral sector could occur in the future, and in the medium term the nonmining sector would need to cushion the vulnerability of mining. That argument led to the need to strengthen the fiscal position of the nonmining corporations--either state-owned or privately owned. There was insufficient access under the facility to repeat such large-scale drawings within a three to five-year horizon.

On a more traditional point, members were encouraged to approach the Fund for policy advice in the initial stage of their difficulties, the staff representative continued. The present case fit that situation for various reasons. While the staff's outlook had been fairly optimistic at the time of the past Article IV consultation, actual developments had revealed weaknesses in the economy. The staff considered that a stand-by arrangement would be useful to address those policy issues.

Another point was the member's financing need, the staff representative stated. The preadjustment projection for the 1990 balance of payments indicated a deficit of SDR 200 million; the programmed deficit was SDR 99 million. Consultative group meetings had been held and, as a result, some financial flows had already been integrated into the balance of payments accounts. The question was whether another group meeting could fill the gap. The staff's main concern at that stage had been to establish a set of policies in Fund-related areas--such as the exchange rate, fiscal, financial, and structural sectors--to strengthen the economy for the future.

It was difficult to state unequivocally that the stand-by arrangement could be transformed into an extended arrangement at a later stage, the staff representative from the Exchange and Trade Relations Department commented. A fresh look would have to be taken at the medium-term scenarios. If the underlying fear about the vulnerability of the mining sector had to be corrected, further structural reforms would be needed; however, the appropriate facility and form to support such reforms would have to be given due thought in the future.

The staff representative from the Research Department noted that although the gold price assumptions used in calculating the shortfall did not fully reflect the recent decline in the price of gold, adjustment on the basis of current prices and projections would reduce the shortfall from gold by only about SDR 1 million. As to previous cases where compensatory financing had been requested at a time of internal political disturbance, he recalled El Salvador in 1981 and Chad in 1985.

Because a determination had been made that purchases amounting to 83 percent of quota were not available, the only option had been to proceed under paragraph 12(a)(ii) of the Decision on the Compensatory and Contingency Financing Facility, which pertained to the test of cooperation, the staff representative from the Research Department explained. Phasing of purchases would have arisen under paragraph 12(b) if the Fund had considered that Papua New Guinea's policies were seriously deficient and its record of cooperation unsatisfactory. However, it was clear that Papua New Guinea was entitled to a drawing of 65 percent of quota.

Mr. Evans commented that Papua New Guinea was, as Mr. de Groote had said, a dual economy and would remain so for some time to come, reflecting the country's large mineral and potential petroleum resources. Therefore, in addressing policy decisions, the question was not simply how to diversify the export base but how to live with a dual economy and maximize its growth, which raised important issues of taxation of the mineral sector, equity, and flexibility in the rest of the economy. He did not agree with the comment that the program consisted primarily of stopgap measures. It had been necessary to address the fiscal situation quickly, but nevertheless numerous important measures had been included in the program, particularly in the fiscal sector. The overhaul of the tax system would take some time, but action on the expenditure side was significant. The streamlining of the public service had been long overdue, as its inefficiency had been cushioned by a healthy mineral sector, but the reform would have long-term effects.

Similarly, structural measures adopted in respect of the stabilization fund and the commodity fund had not been described fully in the staff report, primarily because they were part of a cooperative effort with the World Bank and the Asian Development Bank, Mr. Evans remarked. The Asian Development Bank was instituting a major program directed at stabilization funds, while the World Bank program would be directed at the public expenditure side. Those measures, and the World Bank's consideration of a structural adjustment loan, explained to some extent why a stand-by arrangement from the Fund had been requested.

The authorities had not come readily to the decision to pursue a stand-by arrangement, Mr. Evans said. They might well have adopted a comprehensive program in any case; they had in fact adopted measures before the staff's first visit and had implemented the exchange rate devaluation before the staff's recent visit and had already decided to cut expenditures. The program had, however, been enhanced by consultations with the staff. The authorities considered the request to be for a classical stand-by arrangement in support of a program but on which they would draw only if needed.

The question arose as to whether the Bougainville mine closure had been beyond the authorities' control, Mr. Evans noted. For the most part, Executive Directors had accepted the matter as an exogenous episode. In the short term, it was clear that the closure had been beyond the authorities' control. Looking at the issue over a longer period, one could not come too readily to such a conclusion. Justification existed on the side of the landowners; the royalties had been negotiated some 20 years previously at 5 percent while current mining projects provided royalties of 20 percent. The authorities and foreign investors had learned over the years what constituted a satisfactory package. The question dominated political debate in Papua New Guinea, whose democratic parliamentary system was still young. Hence, the fragility of the situation placed a limit on the Government's ability to implement structural change. The authorities' program ranked high in terms of fiscal reaction to the immediate problem and of structural change to allow the nonmining sector of the economy to withstand not only the shocks occurring at present but, more important, the shocks of a dual economy where the exchange rate could again become dominated by mining developments.

The Executive Board then took the following decisions:

Stand-By Arrangement

1. The Government of Papua New Guinea has requested a stand-by arrangement for the 14-month period beginning April 25, 1990 in an amount equivalent to SDR 26.360 million.

2. The Fund approves the stand-by arrangement set forth in EBS/90/61, Supplement 1.

Decision No. 9418-(90/65), adopted
April 25, 1990

Purchase Transaction - Compensatory and Contingency Financing Facility - Fluctuations in Exports

1. The Fund has received a request by the Government of Papua New Guinea for a purchase of the equivalent of SDR 42.835 million for the compensatory financing of an export shortfall under Section II of the Decision on the Compensatory and Contingency Financing Facility (Decision No. 8955-(88/126), adopted August 23, 1988, as amended).

2. The Fund notes the representation of Papua New Guinea and approves the purchase in accordance with the request.

Decision No. 9419-(90/65), adopted
April 25, 1990

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/90/64 (4/23/90) and EBM/90/65 (4/25/90).

3. VOLUNTARY CONTRIBUTION ACCOUNT - ESTABLISHMENT AND ADMINISTRATION FOR COSTA RICA

1. Pursuant to Article V, Section 2(b), and in response to a request by Costa Rica, the Fund adopts the provisions of the Instrument set forth in the Annex to EBD/90/125 (4/20/90) to establish an administered account entitled Voluntary Contribution Account--Costa Rica.

2. The provisions of the Instrument may be amended only by a decision of the Fund and with the concurrence of Costa Rica.

Decision No. 9420-(90/65), adopted
April 25, 1990

4. ZAMBIA - TECHNICAL ASSISTANCE

In response to a request from the Zambian authorities for technical assistance in the fiscal field, the Executive Board approves the proposal set forth in EBD/90/122 (4/18/90).

Adopted April 24, 1990

5. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to Executive Director as set forth in EBAP/90/108 (4/19/90).

Adopted April 23, 1990

6. STAFF MEMBER - LEAVE WITHOUT PAY

The Executive Board approves the proposal set forth in EBAP/90/106 (4/18/90) concerning an extension of leave without pay for a staff member.

Adopted April 25, 1990

7. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/90/109 (4/20/90) is approved.

APPROVED: February 19, 1991

LEO VAN HOUTVEN
Secretary