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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 90/74

10:00 a.m., May 14, 1990

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
G. K. Arora	L. E. N. Fernando
	C. Enoch
C. S. Clark	G. C. Noonan
Dai Q.	
T. C. Dawson	M. E. Hansen, Temporary
	J. Prader
	P. Péterfalvy, Temporary
E. T. El Kogali	L. B. Monyake
E. A. Evans	C. Y. Legg, Temporary
E. V. Feldman	R. J. Lombardo
	P. O. Montórfano, Temporary
	M. A. Fernández Ordóñez
R. Filosa	A. Fanna, Temporary
	A. M. Othman
	M. B. Chatah, Temporary
M. Fogelholm	I. H. Thorláksson
M. R. Ghasimi	O. Kabbaj
G. Grosche	
	T. Sirivedhin
	S. P. Shrestha, Temporary
A. Kafka	J. R. N. Almeida, Temporary
	L. I. Jácome, Temporary
J.-P. Landau	J.-L. Menda, Temporary
	A. R. Ismael, Temporary
	M. Al-Jasser
	Z. Iqbal, Temporary
	G. P. J. Hogeweg
	S. Yoshikuni

L. Van Houtven, Secretary and Counsellor
D. J. de Vos, Assistant

Also Present

IBRD: U. R. W. Thumm, S. Rahim, Europe, Middle East and North Africa Regional Office. African Department: S. J. Anjaria, G. C. Dahl, A. Jbili, P. Marciniak, T. K. Morrison. European Department: P. B. de Fontenay, Deputy Director; M. Guitián, Deputy Director; B. Banerjee, P. C. Hole, F. M. Lakwijk, T. A. Wolf. Exchange and Trade Relations Department: J. T. Boorman, Deputy Director; A. Basu, H. M. Flickenschild, R. M. Schramm. Fiscal Affairs Department: G. F. Kopits. Legal Department: E. Aguirre-Carrillo, A. O. Liuksila. Research Department: P. Gajdeczka, P. Isard, N. M. Kaibni, T. D. Lane. Secretary's Department: A. Tahari. Advisors to Executive Directors: A. Gronn, J. Basiuk, M. J. Mojarrad, A. Napky. Assistants to Executive Directors: T. S. Allouba, C. Björklund, H. E. Codrington, E. C. Demaestri, B. R. Fuleihan, J. Gold, M. A. Hammoudi, A. Hashim, J. Heywood, K. Ichikawa, M. E. F. Jones, P. Kapetanovic, R. Marino, S. Rouai, H.-J. Scheid, Wang J., Yang J.

1. POLAND - REVIEW UNDER STAND-BY ARRANGEMENT, AND EXCHANGE SYSTEM

The Executive Directors considered the staff paper on the first review under the 13-month stand-by arrangement with Poland approved on February 5, 1990 (EBS/90/77, 4/23/90; Sup. 1, 5/9/90; and Sup. 2, 5/11/90).

Mr. Filosa made the following statement:

On January 1, 1990, the Polish authorities introduced an unprecedented and ambitious program of radical transformation of the economy. The program aimed at stabilizing the economy quickly and resolutely, as the inherited situation was leading the country to a deep and unsustainable crisis. It also aimed at achieving profound institutional changes in order to further transform the economy into a competitive market-economy, capable of sustaining the current stabilization and liberalization efforts over the long term.

It is encouraging for all Directors to see that the performance criteria of the program under the stand-by arrangement for the first quarter of 1990 were all met, and by comfortable margins. Although most of the available economic data refer only to the first quarter of the year, one can say with confidence that the program has been sufficiently credible to economic agents, and that the economy is moving in the right direction.

The first objective of the stabilization program was to break the hyperinflation that, in 1989, surged to about 640 percent, a rate not seen since the end of World War II. All available policies were set mainly toward this aim. The results obtained so far have been more than satisfactory.

Monetary policy under the program was assigned two principal tasks: to prevent an excessive expansion of demand and financial laxity of enterprises; and to restore the attractiveness of the zloty as a store of value. A strict control of credit and a fundamental shift in interest rate policy have been effective to these ends. The National Bank's refinance rate has become positive in real terms, and the expansion of credit to the nongovernment sector in the first quarter has been in line with the program. Combined with the fall of inflation and inflationary expectations, this policy has led to the desired effect of stimulating the demand for the zlotys. Indeed, in the first quarter, reverse currency substitution was substantial, leading to an increase in the share of zloty money in total broad money, from 28 percent at the beginning of 1990 to nearly 50 percent at end-March.

Fiscal policy performance has also been unexpectedly favorable. After a deficit of about 8 percent of GDP in 1989, the budget has been running a surplus so far this year, in contrast with the deficit foreseen under the program for the "core" general government of up to 4 percent of GDP in the first quarter of 1990. Uncertainties surrounding the profit prospects of enterprises in the latter part of 1989 turned out to be more favorable than expected, largely contributing to the surge in revenues. Nevertheless, the strict programmed reduction in expenditure has also been rigorously achieved. Moreover, in January and February, authorized spending was not fully utilized.

The authorities' intention to hold the exchange rate stable during the first three months of the program, after a devaluation of 32 percent on January 1, 1990, has been successfully met. The $1 billion stabilization fund, viewed by officials as a backup line of reserves, was untouched. Indeed, the increase in net international reserves of the banking system has far exceeded any expectation, having reached $1.7 billion during the first quarter. Besides portfolio shifts, an impressive improvement of the trade balance was the principal factor. The parallel exchange rate has remained closely aligned with the official rate.

Incomes policy has also performed better than expected. A limit was placed on permissible increases in wages, and enforced by subjecting excessive increases to high taxes. Enterprises, however, have increased wages in the first quarter by only 20 percent, substantially less than the amount permitted under the program. Although inflation was rising faster than anticipated, resulting in a sharp fall in real wages, little strike activity and only a few labor disputes were seen.

The combination of these policies has had a strong impact on the demand and supply sides of the economy. Inflation has been brought down sharply; after exceeding expectations in January and February, the monthly average rate of inflation came down to 5 percent in March, as anticipated in the program. Preliminary estimates just released in Warsaw suggest that the rate of price increase picked up somewhat in April. In large part, this can be attributed probably to seasonal factors. My Polish authorities, however, consider such increases unacceptably high and expect that in the next few months the policies in place should lower substantially the rate of inflation.

The trade balance in convertible currencies registered a large surplus in the first quarter of the year, following a substantial increase in exports and a fall in imports. This contrasts sharply with an anticipated deficit of the order of $0.5 billion. The output trend, however, appears worse than expected. Sold production of socialized industry was 30 percent lower in the first quarter than one year earlier, and registered unemployment rose in April to 2 percent of the labor force. As the staff rightly points out, however, the data need to be interpreted with some care.

Despite the fact that transitional costs have turned out to be larger than expected, the authorities remain committed to the economic transformation that is taking place, as they are aware that it is the only way to guarantee sustained growth in Poland. The current stance of fiscal, monetary, and exchange rate policy will therefore not be altered, since it is necessary, above all, to maintain the credibility of the program. In order to avoid deepening the recession, several initiatives are under consideration, as described in the staff paper. The approach is to support activity by removing barriers to the response of supply, not by relaxing demand.

Parallel with efforts to counteract inflation and stabilize the economy, the program also contains several significant measures aimed at fostering systemic changes, with the objective to set up a market system akin to the one found in the industrially developed countries.

Liberalization of prices and of the exchange and trade system have been successful in being one of the cornerstones of the desired transformation. Some 80-90 percent of prices in the Polish economy are now freely determined in the marketplace, compared to about 50 percent in 1989. There are no restrictions on the availability of foreign exchange at the official rate for trade transactions. Export quotas are expected to remain on only five goods in coming months, as against approximately 100 in late 1989. All import quotas have been removed and tariffs substantially lowered. Thus, with the exception of energy products, the structure of international prices has largely been imported, bringing efficiency and competition. Relative prices have been brought much more in line with true economic scarcity, and the market now plays its role of allocating scarce goods. Shortages and rationing have been much reduced.

New legislation has been put in place to break up the monopolies that characterize the economy. A number of big conglomerates have already been broken up, but much remains to be done to convert Poland's highly monopolized economic structure into a more competitive one; and the new antimonopoly law must be vigorously enforced. My authorities, however, are confident that this process will be strongly enhanced by the increased degree of competition brought about by the opening-up of the economy to foreign trade.

To strengthen enterprise financial discipline--beside the sharp reduction in fiscal and credit subsidies--new legislation to expedite bankruptcy proceedings has been put in place. My authorities expect a number of enterprise closures to occur in the next few months.

Strengthening and modernization of the banking system is proceeding, and is being helped considerably by technical assistance from several central banks with the coordination of the Fund and the World Bank. The independence of the National Bank of Poland from the budget, together with financial liberalization and banking reforms, will set the basis for the development of capital markets. An infant interbank lending market is developing, while bills of exchange have begun to replace inter-enterprise arrears, paving the way for a commercial paper market. Some government securities and privatization bonds have been sold to the public, albeit in limited quantities. Building on these developments will be essential to create a new environment to facilitate the working of indirect instruments of monetary control.

Framework legislation for undertaking the privatization of enterprises is currently before Parliament to sort out the possible modalities of its implementation. The Government's commitment to wide-ranging privatization remains firm. Privatization of shops and small enterprises has already begun, but large-scale privatizations, although in preparation, will require more time.

An important part of the program is represented by the development of social safety nets, necessary to shelter the most vulnerable segments of society against the immediate effects of adjustment. Arrangements to provide retraining and unemployment benefits are in place. My Polish authorities expect that technical assistance from the World Bank will significantly speed up the process of strengthening other social benefit programs, aimed at providing adequate assistance to the poorest segments of society.

The overall implementation of the program has been impressive. Although transitional costs in terms of output loss and unemployment growth seem to be greater than expected, the initial impact of the new policy and institutional measures should be judged as distinctly successful.

It is of the utmost importance at this stage to maintain the current credibility of the program and to pursue courageously the designed objectives. Poland's heavy foreign indebtedness could severely threaten the efforts of the current Government. In fact, confidence in the viability of the balance of payments over the medium term is essential for macroeconomic stability, and for attracting the foreign capital so important to the country.

Following the generous but temporary relief from official creditors, which hold around 70 percent of the country's foreign debt, my Polish authorities are currently seeking deep debt reduction under the Brady plan on medium- and long-term debt to commercial banks. The authorities' view, however, as recently expressed during the Interim Committee, is that permanent relief from the banks must be accompanied by a deep reduction of debt and debt service on official debt, if the restructuring of the Polish economy is not to be seriously impeded.

Mr. Péterfalvy made the following statement:

It was with great interest and appreciation that I read the staff paper currently before the Board. Despite the short time in which this program has been in place, it seems clear from the information at hand that the desired turnaround of the Polish economy has, at long last, begun. Should this turnaround be confirmed by future developments, the Polish program will become a milestone in the Fund's history, as the first substantial operation of this type in a centrally planned, or a formerly centrally planned, economy.

Accordingly, the first point that I should like to make is that, despite some signs of overperformance, neither the Polish authorities nor the staff should even momentarily consider any relaxation of the program. The whole program, as all Directors know, is built on relatively shaky ground. The institutions and mechanisms of the Polish economy are still very much in a state of transition; many of them still reflect the old system, and the groundwork of certain essential market elements has not, as far as I know, been laid as yet. Such signs of success are result of a delicate balance of demand-management measures and systemic changes, which could easily be disrupted at any moment. The Fund should not try to rewrite or recalibrate the program at this early stage, but concentrate instead on strengthening its basic elements.

The task that has to be focused on at present is to try to establish the framework for the program's continuation, namely, to define what the next steps should be in case the current program is implemented successfully. By doing so, one can prepare--and, if I remember correctly, this is the authorities' intention as well--the proposed transformation of the current program into a policy framework under the extended Fund facility. Furthermore, if the authorities are ready, and the Polish society accepts it, let us try to eliminate as many elements of gradualism as possible from the Polish reforms and strengthen their comprehensiveness. Directors all know that the gradualistic, piecemeal approach tried in programs of other countries in similar circumstances has only exacerbated the difficulties and hardships of change.

It has to be recognized that, because the Polish economy is in transition, it is not easy to analyze and comprehend the individual elements of the positive performance achieved. Even the staff, although the creator of this successful program, seems to have difficulty in understanding why nominal wage awards undershot the norms, why a surge in central government revenues occurred, and so forth. At the same time it is obvious that some clear signs of improvement, such as the shift in household deposits from foreign currencies to domestic currency, the unexpectedly high current account surplus in the convertible currency balance of payments, and the "miraculous" stability of the zloty exchange rate in the parallel markets, are not yet supported by underlying systemic changes. Consequently, the authorities have to, instead of relaxing or becoming complacent, make use of the signs of improvement to speed up the systemic changes, thereby creating a firm basis for sustaining and further strengthening the gains achieved. I believe that both the staff and the authorities share this view.

I have to welcome the consensus in the Board that privatization is the sine qua non for successful implementation of Poland's reform efforts. This chair, and myself, have advocated this position for a long time, and initially without attracting much interest. I understand that the slowness of the privatization process has disappointed both the staff and the authorities. There are reasons for this, of course: in a country such as Poland, there are only two sources of financing for privatization, namely, domestic and foreign capital. To attract the relatively modest and "politically hesitant" domestic capital, it is not sufficient to try to ensure that conditions in the private sector match conditions in the state sector. If the goal is to dismantle the state sector and to make the private sector predominant--as is required for adequate economic development--the favorable conditions that are created in the private sector must not match, but exceed, those prevailing in the state sector. It is as simple as that. There is no social justification for the predominance of the state sector; it was created artificially to satisfy an outdated and failed ideology, and led Poland only to the "poorhouse." I could imagine according the nascent private sector every kind of preferential treatment, in monetary policy, fiscal policies, and in the availability of foreign exchange, for instance. As far as foreign capital is concerned, I should like to put forward an "heretical" notion, without necessarily knowing whether I am correct or incorrect: why should the authorities give foreign investors preference over prospective private domestic investors?

I wholeheartedly agree with the staff that "given the present strength of the balance of payments," it could be the time to unify the exchange market by bringing transactions currently undertaken in the parallel market into the official market. The current program has played a pioneering role in streamlining the Polish exchange rate system. Is it not a natural step to put the finishing touch on this by implementing a real unification of the exchange rates? In this connection, the staff could usefully comment on the impact such unification might have on Poland's foreign exchange arrangements and restrictions, especially keeping in mind the goal of making foreign exchange available to the private sector and households. A realistic exchange rate is the most important transmission mechanism for linking Poland to the world market, and there is no means for Poland to join the "Common European House" without it.

I should also like to mention Poland's future economic relations with the disintegrating COMECON and its member countries. I was somewhat surprised by the optimistic presentation on this issue in the second paragraph of page 15 in the staff paper. I do not agree with the staff that future trade and payments agreements with the COMECON countries will be more market-oriented; as the staff puts it, "more" will always mean "less" in this context. I believe that COMECON will disintegrate, or, at least, that its system will disintegrate and be replaced by pure market mechanisms between former COMECON members, or by some kind of convertible payments arrangements. If this is the case, the dilemma of the Soviet market will differ completely from that usually propounded: the question will, instead, be whether Polish products will be competitive in the Soviet market with, for instance, U.S. products, and whether the Soviet Union will be able to pay--even by barter--for Polish products. Poland's unexpectedly large surplus in nonconvertible currencies in January and February 1990 is not a positive sign. I would not advise succumbing to pressures from enterprises desiring additional export licenses, but would prefer to pay the price of the needed market orientation, even though this adjustment will be an enormous problem for Poland and the other European COMECON countries.

In this connection, I would like to put forward a further idea. Certain economic and political circles have argued that it would be feasible to establish a sort of multilateral trade and payments union for Central and Eastern Europe, similar to the one introduced in Western Europe following World War II. This question especially concerns my chair's constituency, which has two interested country members. My chair's first reaction to this proposal was that the current situation in Eastern Europe is completely different from the circumstances prevailing in Western Europe in the late 1940s or early 1950s. Then, every West

European country was in a more or less similar situation; after the destruction of war, a substantial increase in supply had to be achieved, the facilitation of which required the establishment of a multilateral trade and payments system among the West European countries. Today, the task is to integrate the Central and East European economies with Western Europe, thereby to create a "Common European House." Any effort not directed primarily at this goal will be a waste of precious time, and could even push the countries of the area further toward the periphery of the continent.

I congratulate both the authorities and the staff on the success of this excellent program, and encourage all parties to persevere.

Mr. Feldman made the following statement:

I am glad to note that the ambitious program that the Polish authorities have been implementing since the beginning of 1990 is on track, and that the immediate objective of stabilizing the economy is being achieved.

The process of systemic reform, nonetheless, is progressing more slowly than expected; inflation has been higher than anticipated; undisguised unemployment has emerged; and output has fallen sharply. When the Board approved the stand-by arrangement (EBM/90/14 and EBM/90/15, 2/5/90), I expressed concern about the risk of a deeper than expected recession. On that occasion, I stressed that in contrast to other recent stabilization plans, real wages would follow a reverse pattern in Poland, namely, that after increasing steadily--prior to the inception of the program--they would decline sharply thereafter. Consequently, the recovery in purchasing power of wages, which usually takes place after a wage anchor is set, would not occur in the Polish case. This projected fall in real wages--combined with strict financial policies, and with the initial unavoidable disruptions derived from market liberalization in a context of administrative controls and price rigidities--could result in a greater than projected decline in output and employment.

I share the staff's consternation about the depth of the recession, but would like to turn to the program's prospects. It needs to be recognized that the program is working and, as the staff states, that a departure from macroeconomic discipline could rapidly prove to be destructive, and should be ruled out. There is a need to preserve the adjustment effort, avoiding, at the same time, those measures that could deepen the recession. Moreover, alleviating the hardships of the less-protected segments of the population is essential for the credibility and sustainability of the program. Some answers to these problems are to be found in the functioning of the "anchors," and the process of structural reforms.

During January-March 1990, socialized enterprises increased their employees' nominal wages by 18 percent, or well below the threshold that would have triggered tax penalties. In fact, nominal wages rose at the maximum rate that would have been allowed, if the expected inflation rate had materialized. Consequently, real wages declined more sharply than projected, and perhaps more than necessary, helping to explain the depth of the recession and overperformance in most targets.

I am somewhat puzzled about the coincidence between the actual increase in wages and the hypothetical wage increase, namely, the one that would have been consistent with the rate of inflation projected under the program. I wonder whether this could be related to the behavior of the managers of socialized enterprises, who, in order to resist the structural changes envisaged by the Government, might have been willing to show improved financial results in their balance sheets and thereby to avoid the acceleration of privatization. The staff could usefully comment on this issue; it is clear, in any event, that Polish markets are far from competitive, and that some enterprises may be taking advantage of this fact. This could also help to explain the acceleration of prices in April 1990, when some enterprises might have continued with their mark-up practices, in the context of some catching up in wages.

Incidentally, on the issue of catching up--particularly as it is likely to arise in the period ahead--I wonder whether the non-utilized wage margins from previous months can be applied later on without being subject to tax penalties. Clearly, some caution is required in this sense, to avoid refueling inflation.

Some flexibility would be appropriate in future wage policies, to compensate for part of the decline in real wages and to provide incentives to production. The authorities' intention to raise the tax-free wage index coefficient to 60 percent in May and June 1990 appears, in this respect, to be fully justified. To promote market competition, the exemption of small-scale enterprises from the tax on above-norm wage awards could also be appropriate, although I do not see the reason for not raising the tax-free wage index coefficient in a more generalized manner. An accelerated rise in this index would be better than allowing firms to pay bonuses out of current profits. It is true that this change may shift the collection of fiscal revenues from 1990 to 1991; but what is more important is that it may have a larger impact on aggregate demand, to the extent that workers perceive that income received via higher wages is of a more permanent nature than that deriving from payments that can be taken as transitory.

Regarding the exchange rate, the other stabilizing anchor, I concur with the authorities and the staff that there currently seems to be no need to take new steps. The strong external trade performance in the first quarter of the program, and the negligible gap between the parallel and official rates, tends to support the appropriateness of the current exchange rate policy. Moreover, inflation is not fully under control, and an exchange rate anchor is still necessary, particularly while the authorities introduce some flexibility in wage policies and proceed with other structural reforms.

After supporting the existing exchange rate policies, I would stress that the exchange rate in real effective terms is substantially lower than was foreseen at the inception of the program. In fact, as noted by the staff, the initial increase in external competitiveness, in terms of relative prices, has been eroded more than anticipated. The staff also suggests that the reverse appears to be the case when competitiveness is measured in terms of relative wage costs. But, as nominal wages have increased since January 1990 approximately as programmed, namely, in line with the initially expected inflation rate, I am not sure about the staff's comment in this area, and would appreciate its clarification.

I see the convenience of allowing some flexibility in exchange rate policy but was somewhat puzzled by the staff seeing some merit in maintaining the current exchange rate until a significant need to change it builds up. In particular, I was surprised by the use of the word "significant," because overappreciation may bring about repressed inflation, lack of competitiveness, and put the program at serious risk.

In respect of systemic reforms, I agree with the staff that an acceleration in the restructuring of the economy is required to achieve economic recovery and to avoid increasing strain of the stabilization efforts. As the staff states, the transformation of the ownership of enterprises is the centerpiece of the reform; while the authorities are demonstrating their efforts in this area, such reform is turning out to be more difficult to manage than expected. The need to accelerate these reforms is critical, particularly as lack of action in this area could also jeopardize the short-run stabilization efforts.

Another area of concern is the implementation of social safety nets, which are particularly important, to avoid a deepening of the recession and to cushion its undesirable effects on the unemployed and the poor, although implementation in this area seems to be advancing more slowly than expected. I welcome the most recent information from Mr. Filosa that arrangements to provide retraining and unemployment benefits are in place already. I support the proposed decisions.

Mr. Menda made the following statement:

At the beginning of 1990, Poland embarked on an ambitious program whose objectives were to tackle simultaneously short-term imbalances and structural rigidities. At that time, this chair insisted that the latter task, namely, creating market mechanisms--thereby giving enterprises complete autonomy in decision making, and ensuring the competitiveness of enterprises through price and trade liberalization--were all sine qua nons to ensuring the success of the program. The program is certainly at an early stage, and it is still difficult to assess fully its results. I will therefore focus my comments on the two main lessons that can be drawn from the staff paper: first, that the stabilization policy met with great success during the first few months of 1990, but has provoked a deeper recession than expected; and second, to stimulate the supply of goods, it is of the utmost importance that the authorities accelerate the pace of institutional changes and do not run the risk of relaxing their adjustment effort.

The measures taken at the beginning of 1990 have been described by all observers as a "shock treatment" to the economy. Price liberalization has led to the sudden end of shortages, but adjustments in this area have been larger than expected; indeed, inflation reached 133 percent during the first quarter of the year, against the 75 percent specified under the program. However, the most recent estimates point to a reduction in the inflation rate to 2-3 percent in May 1990.

Nonetheless, the major development has been the sharp drop in output. One of the reasons for this drop may have been that policies have been more drastic than expected; for instance, wage increases of 18 percent during the first quarter of the year have been lower than they could have been without triggering tax penalties under the incomes policy legislation. Furthermore, with consumer prices rising faster than expected, real wages have fallen by about 50 percent. I agree, however, with the staff that some catch-up in wages may now occur, and that the release of bonuses from 1989 profits could contribute to stimulating internal demand.

Another reason for this sharp decline of output may be found in the tighter than expected fiscal and monetary policies. This is clear when looking at the comfortable margins by which the relevant program targets for end-March 1990 were attained. In particular, higher profitability of enterprises has induced a surge in the central government fiscal surplus, instead of the planned deficit.

Moreover, the external position has turned out to be much stronger than expected. The significant exchange rate adjustment and the compression of internal demand have induced export growth of 23 percent in dollar terms during the first quarter of the year, and a drastic reduction in imports. As a result, the current account has swung into a surplus of $200 million. Under these circumstances--and given the significant buildup in reserves--I welcome the authorities' decision not to modify the exchange rate, particularly as it should help to achieve the objective of eliminating inflation entirely. I would also support the staff's suggestion to proceed expeditiously toward unifying the exchange rate.

Concerning the question of the current account surplus in nonconvertible currencies, the staff appears to be more conciliatory than in previous cases, such as with Hungary. The staff could usefully elaborate its views in the area, particularly in terms of the consequences of such a surplus for the handling of monetary policy.

With respect to the measures to be taken to help output recover, one can understand the temptation to relax the constraints on demand and to use the margins that currently exist under the fiscal and credit ceilings. In this area, the staff could comment specifically on the possibility of the authorities using this room for maneuver. Even so, I fully share its view that an early relaxation of the adjustment effort, before necessary efforts are made to stimulate the supply capacity of the enterprise sector, could be counterproductive, and would only result in a resurgence of inflation. I would like, therefore, to urge the authorities to be cautious in modifying the scope of wage policy, particularly in permitting enterprises to pay bonuses from current profits.

It was indeed clear from the start that structural policies and institutional changes were critical to the transformation of a centrally planned economy into a market system. The authorities have to be convinced that the resumption of growth will rely heavily on these policies; it is therefore worrisome to note that the pace of reforms has been somewhat slower than expected.

The cornerstone of the reforms should be the transformation of the ownership of enterprises and their privatization. The delays experienced in Parliament are certainly a cause for concern, as they postpone the necessary changes, particularly in the state enterprise sector. I note that no bankruptcies have occurred so far in this sector, which is hindering the elimination of loss-making enterprises and the release of resources for more profitable activities.

Encouraging foreign investment is also of the utmost importance. It will be essential, in particular, to eliminate administrative impediments to such investment and to modify accounting standards, which constitute an obstacle to sound evaluation of enterprises, including the problem of the restrictions on profit remittances. The staff or Mr. Filosa could usefully comment on whether concrete steps have been taken in this area.

I would encourage the authorities to give special attention to setting in place the necessary social safety net as early as possible. Delays in this field cannot but be detrimental to keeping the population's confidence, and maintaining the program in the right direction.

I fully agree with Mr. Filosa's statement that, despite the transitional costs of the stabilization in terms of output loss and unemployment, it is of the utmost importance for the authorities to pursue the intended program objectives. In respect of Poland's heavy foreign indebtedness, my authorities wish to encourage the authorities to seek an early agreement with commercial banks on the basis of true equality of treatment between public and private creditors, through either traditional rescheduling or debt and debt-service reduction. They believe that the recent rescheduling in the Paris Club has been generous and that, in the future, the negotiation of an extended arrangement could pave the way to a further rescheduling in the framework of the Paris Club's procedures.

Mr. Enoch said that Poland's path-breaking stabilization program was generally proceeding well. The two nominal anchors had held firmly; both fiscal and monetary policies had been kept tight; and, as a result, Poland's hyperinflation had been stopped in its tracks, despite the impact of price liberalization in January 1990. The authorities' most recent projection, that inflation in May 1990 should fall to 2-3 percent, was especially welcome news. As the authorities were fully aware, both the credibility and sustainability of the program depended critically upon the achievement of an early and decisive reduction in the rate of inflation.

The other welcome feature of Poland's program in recent months had been the highly unexpected strength of the external sector, Mr. Enoch continued. Exports to the convertible area had increased markedly, while imports had slumped, despite the far-reaching liberalization of the trade system implemented at the start of the program. In addition, the exchange rate peg, the maintenance of the attractive interest rates on zloty deposits, and the tightness of credit condition had induced a considerable shift out of foreign currency deposits into domestic currency. As a result, Poland's international reserves had increased sharply, and the authorities had not yet needed to draw on the stabilization fund set up by Western creditors at the beginning of the year.

In contrast, the sharp fall in domestic output recorded in the first few months of the program was much less encouraging, Mr. Enoch observed. Production in the socialized sector appeared to have dropped by nearly one third in the first four months of 1990, and unemployment had reached 350,000 by the end of April. The dramatic fall in imports provided further evidence that demand pressures had abated, while the fact that few large enterprises had yet been forced into liquidation suggested that worse might still be to come.

Nevertheless, as the staff paper made clear, the official statistics might have overstated the extent of the downturn, Mr. Enoch remarked. During a period of rapid structural reforms, existing output indices might quickly become out of date, while seasonal adjustment factors inevitably became less reliable. Moreover, in Poland's case, the official figures might significantly understate the level of activity in the informal sector, which had clearly burgeoned over recent months and which might represent one third of total sales. Thus, it seemed that more figures were needed to gauge the full extent of the current recession. There was some limited evidence in that direction. For example, it was his understanding that one third of the enterprises included in the government sample had, in fact, raised output in recent months. Another indicator could be the rate of establishment of private companies, on which the staff could usefully comment. As far as unemployment was concerned, the staff had rightly noted that much of the recorded increase could be attributed to the rise in the size of the registered labor force, Mr. Enoch said. Clearly, the establishment of a comprehensive unemployment compensation system was a crucial prerequisite for the creation of a flexible labor market, particularly in a society accustomed to almost complete job security. Nevertheless, to maintain work incentives and to ensure that the cost of the insurance system were kept within balance, it was important that unemployment benefits were available only to those genuinely seeking work and were set at a level that did not discourage enterprise. Comments in that area would be useful.

While the depth of the current recession might well have been overstated by official data, there was no doubt that the conquest of inflation had significant output costs, Mr. Enoch stated. Producers had certainly faced a tight demand barrier in the domestic market. But that, in itself, did not explain why production had taken the strain instead of prices or profit margins. Indeed, the remarkable success of the authorities' income policies in the early months of the program and the corresponding sharp fall in real wages suggested that domestic producers--in aggregate--might actually have increased their profit margins in the first quarter of the year, despite the domestic shock from the demand side of the economy.

That, in turn, highlighted the continuing lack of competition in the Polish economy, particularly in the state enterprise sector, Mr. Enoch commented. It was interesting, for example, to compare the contrasting fortunes of the monolithic socialized sector with the more atomistic informal sector. According to the staff, the latter had responded to the reform program by cutting prices and expanding output. In contrast, enterprise management had cut back output in the socialized sector, introduced worker holidays, and maintained prices at levels above those offered in the informal market.

However, the sluggish supply response witnessed in the early months of the program reflected more that simply continuing dominance of monolithic state enterprises; it also highlighted the fact that a thriving private sector could not be established overnight, and that state enterprises could not simply be transformed "at a stroke of a pen" into dynamic, profit maximizing, and technically efficient commercial organizations, Mr. Enoch added. As the authorities were only too aware, many elements were necessary for the social, economic, and institutional infrastructure to be in place. They had to ensure that the banking sector could provide credit on sound commercial terms to help new businesses to become established and prevent funds from being misallocated toward existing enterprises; that the legal, accounting, and financial frameworks were in place to facilitate the conversion of state enterprises into private companies; and that the current shortages in trained personnel were relieved.

Against that background, it was critical that the authorities should not relax their control over macroeconomic conditions, Mr. Enoch emphasized. While the fall in output has been more severe than the authorities and the staff had originally expected, an expansion of domestic demand would, in the current circumstances, be more likely to accommodate a reacceleration of inflation than a surge in production. That would be disastrous for the credibility of the reform program.

Moreover, as the staff had noted, a number of indicators suggested that inflationary pressure had not yet been fully neutralized, Mr. Enoch indicated. For example, the enterprise sector appeared to be considerably more liquid than had been expected earlier; the banking system continued to hold significant excess reserves; and wage pressures might soon build up as workers tried to win back some of the purchasing power lost in the first quarter of the year. The fiscal improvement did not seem to be fully understood, and a number of significant problems with the overall fiscal situation remained, including the position of the local governments. Moreover, the surplus with other CMEA countries had continued to add liquidity to the economy. He would note in passing that the liquidity effect of CMEA trade seemed to be a problem in a number of East European countries, and a background paper on that topic, at some stage, could be useful.

The authorities, instead, should press ahead with their ambitious program of systemic reforms, Mr. Enoch stressed. The progress made so far had been encouraging, but the agenda ahead remained daunting, including continuing with the reforms of the fiscal and monetary systems. Beyond that, a priority over the coming months had to be the acceleration of the process of restructuring.

In that connection, he would lay particular emphasis on three related areas, Mr. Enoch said. First, the authorities should continue their program of breaking up the large state conglomerates and injecting competition into the distribution system. If the retail sector could be liberalized fully, that would make consumers more immediately aware of the benefits of restructuring, and should make it much easier to bring competitive pressure to bear on state enterprises. The recent implementation of the Monopolistic Practices Act was a useful step in that direction. but much would depend on how the Antimonopoly Agency and the Antimonopoly Court implemented the Act. Second, and in a closely related sense, more should be done to expose domestic industry to competition from abroad. Imports had been held back by the squeeze on demand and by the low level of the zloty. Nevertheless, foreign producers should be allowed to compete on an equal footing; and, again, that highlighted the importance of deregulating the distribution system.

Third, and perhaps most important, with the establishment of a comprehensive system of unemployment insurance and with competitive pressures firmly in place, the path should be clear for the wholesale privatization or liquidation of state enterprises, Mr. Enoch stated. Progress in that area had so far been disappointingly slow, as the authorities had struggled to build the required social consensus for rapid privatization. In addition, formidable technical constraints would need to be overcome before the privatization program could proceed in earnest. Nevertheless, more rapid progress in that area would be crucial to Poland's medium-term prospects; it would not only transform incentives within the economy, but would also strengthen the credibility of the reform strategy itself, by emphasizing its irreversibility, and by firmly embedding it within the institutional structure of the economy.

Alongside continuing systemic reforms, the authorities were also considering a number of selective measures to enhance the supply response of the economy, including specific exemptions from the wage tax, Mr. Enoch noted. Those selective measures would come in addition to the concessions made already in the agricultural sector, in the form of direct subsidy and preferential lending rates. While he understood the authorities' desire to get the economy moving again, and could see some merit in the proposal to exempt firms with less than 100 workers from the inflation tax, he would urge the authorities to be extremely cautious about stepping back on the slippery slope of discretionary tax and credit policies. Any specific exemptions should be time limited, transparent, and agreed by the legislature.

He would strongly endorse the staff view that the authorities could, at present, move ahead with the complete unification of the exchange markets, Mr. Enoch remarked. He would also support further efforts to reduce the number of export quotas and to eliminate subsidies on exports to the Clearing Area. With those comments, he could fully support the proposed decisions.

Mr. Fernández Ordóñez said that his chair's great interest in the Polish program had not diminished. It was indeed immensely satisfying to note the positive achievements so far. It was in that light that his remarks would be brief, and also because he fully agreed with the staff's appraisal.

His chair's main concern was the substantial fall in output, Mr. Fernández Ordóñez continued. He was concerned about the problem on its own terms, but especially so because it could provoke a dangerous reaction against the program. If Mr. Enoch was correct, and he believed that that was the case, the fall in output had probably been overestimated, making it crucial to correct the data to avoid the possible negative reaction he had mentioned. He concurred with the authorities that any change in macroeconomic policy was out of the question, and that it would not solve any problems but would lead to the re-emergence of old ones. The concerns about the recovery of output should be channeled into concentrating all efforts at removing the remaining deterrents to foreign investment and implementing, as soon as possible, the proposed changes in ownership, privatization, and joint ventures.

Continuity in macroeconomic policies was the necessary condition for gaining credibility, Mr. Fernández Ordóñez added. He encouraged the authorities in the difficult task of persevering with their reforms, particularly as it was time to accelerate and broaden the systemic changes. He supported the proposed decisions.

Mr. Fogelholm made the following statement:

> My authorities broadly agree with the staff's assessment of the current economic situation in Poland and with its policy recommendations. The authorities merit praise for the decisive implementation of the program under the stand-by arrangement, which has proven highly successful so far. A clear sign of its success is the fact that it has not been necessary to activate the Stabilization Fund. Of the most recent developments, the

preliminary price figures for April 1990 are, however, a source of concern. The staff or Mr. Filosa could usefully comment on these figures.

The overall positive results of the stabilization policies are reflected in the observance with comfortable margins of performance criteria for the first quarter of the program. Despite this success, and as observed by previous speakers, there clearly is a need for continued vigilance, for perseverance, and steady policy implementation to bolster confidence and change the behavior of economic agents. I therefore welcome the authorities' commitment to stay the course, as noted in Mr. Filosa's opening statement, and to introduce further measures as necessary. The introduction and implementation of the stabilization policies, no matter how stringent, can nevertheless be considered the least difficult part of the necessary adjustment. The challenge ahead is, of course, to succeed in a profound restructuring of the economy. This will require, inter alia, the promotion of far-reaching structural reforms by the authorities. Establishing institutional arrangements appropriate to a market economy is no easy task, and will take time, but these arrangements are essential aspects of the efforts to secure sustainable growth.

In particular, I would stress the importance of removing all impediments to the creation of businesses, as this would help reduce the length of the transitional period. For example, I note that implementation of legislation to facilitate private ownership seems to be taking more time than anticipated. I join other Directors in urging the authorities to speed up this process. Another key to a smoothly functioning market economy is the modernization of the financial sector. The comprehensive effort, coordinated by the Central Banking Department, to establish an independent central bank is essential in this respect. In addition, improvements are needed both in assessing risk and in expanding lending capacity, together with increasing the efficiency of the payments system. In this area, an upgrading of the accounting system of nonfinancial enterprises is also necessary.

Regarding other specific structural reforms, this chair agrees with the staff that circumstances now favor the unification of the exchange market. In passing, I would note that I fully support the current exchange rate continuing to serve as a nominal anchor for economic policy. Also, it would be an opportune occasion to increase the pace of liberalization of payments and transfers for current international transactions, given the remarkable strength of the external sector, and in light of the already extensive liberalization of the exchange and trade system. Such a move might also increase confidence in the economic program.

Furthermore, to ensure continued public support for the adjustment program, the difficult task of establishing an appropriate social safety net should be stepped up. It is essential that this support be applied to the most vulnerable groups, and that it be financed separately from the budget, or directly by donors.

I wish to comment on the question of Poland's indebtedness. On the one hand, Poland is not eligible for the Toronto terms, nor as the Brady initiative been applied to countries that have borrowed predominantly from official creditors. On the other hand, it is clear that debt relief would facilitate a sustainable economic recovery and expansion. In this regard, Poland has already obtained a most favorable rescheduling with the Paris Club. It would seem that the Polish case will become a test case for the current debt strategy, and Directors should not rule out the possibility that new and innovative solutions may turn up. With these remarks, I support the proposed decisions.

Mrs. Sirivedhin made the following statement:

The enthusiasm expressed by the Board in February 1990 regarding Poland's macroeconomic and structural adjustment policies does not appear to have been unfounded. The performance criteria under the stand-by arrangement for the first quarter of 1990 were all met by comfortable margins, inflation is showing signs of slowing down, and the external position has improved significantly. These developments are most welcome and point to the appropriateness of the authorities' chosen course for dealing with the task before them.

Nonetheless, despite having been able to pass the "hurdle" of the crucial first three months of the program, the authorities are aware that it is still too early to tell how developments will turn out for the rest of 1990, and caution has to remain the byword. Therefore, despite the disconcerting falls in output and employment, my chair agrees with the authorities that it would not be appropriate at this time to relax monetary and fiscal policy. The credibility that has been achieved for the program must be maintained to ensure its further success.

Continued program success and the shoring up of production requires that emphasis be on institutional measures to enhance the supply response. In this connection, it may be helpful if the authorities implement faster the measures being contemplated in the area of the transformation of ownership, promote small and medium-sized enterprises and foreign investment, taking into account social and political considerations. An early implementation of financial sector reforms would also underpin the market orientation of the economy, and provide the authorities with additional monetary instruments. I am glad to hear that the World Bank will be providing a structural adjustment loan to support Poland's privatization and financial sector reform efforts as well as the social safety net. The staff could usefully provide more details on what has been done already with regard to the social safety net, and the further measures that are planned.

Both wage policy and exchange rate policy have served Poland well as nominal anchors against inflation. With regard to wage policy, the decision to raise the tax free index coefficient to 60 percent in May and June 1990 appears to be appropriate. There should be sufficient flexibility in this policy to respond to changing circumstances in both directions. I tend to agree with the staff that particular caution should be exercised in permitting the granting of bonuses, in order not to let it undermine wage policy. Exchange rate policy also appears to be appropriate under the current circumstances; too fast a rush toward fully market-determined exchange rates could undermine confidence and frustrate the goal of price stabilization. Nevertheless, the exchange rate system must be flexible enough to maintain Poland's price competitiveness.

The strengthening of the external accounts is welcome, particularly with regard to convertible currencies. Nonetheless, the adjustment is still at an early stage, and while welcoming the measures taken already to liberalize the exchange and trade system, as well as the steps for further liberalization, I would--in view of the fragile nature of the external situation--give higher priority to domestic market reforms for the time being. I would be interested in learning about the causes of the relatively large negative short-term capital flows in January-March 1990.

I agree with the authorities and Mr. Filosa that Poland's debt situation remains an area of concern. A viable resolution of the terms of outstanding debt is necessary to underpin Poland's reform efforts. My chair welcomes the generous relief measures that have been provided by official creditors and hopes that a longer-term solution can be achieved, and wishes the authorities well in their negotiations with commercial banks.

I have no problem in supporting the proposed decisions.

Mr. Grosche said that he welcomed the opportunity to review Poland's broad and courageous reform efforts at the current stage of the program. Although the battle against inflation and the inefficiency of the old system was certainly not over, one could not but be impressed by the authorities' decisiveness in implementing the program. It was most gratifying to note from the supplementary staff paper that all performance criteria had been met by comfortable margins. The authorities' firm commitment to the nominal anchor had been a key factor in those achievements; he therefore welcomed their intention to stick to those anchors, which should also help to contain the potential for destabilizing expectations in the market. Notwithstanding those positive developments, the inherent risks to the program had clearly become evident.

Although he had found Mr. Enoch's comments on the growing share of the hidden economy and the weaknesses in the data base to be relevant, it appeared that the drop in output and the rise in unemployment had been more severe than expected, Mr. Grosche stated. A further deterioration could not be ruled out, as no major employer has yet gone bankrupt. The key question was therefore how to prevent a further worsening, and how to bring about an early turnaround of the economy.

The incorrect response would be to relax the tight macroeconomic stance, particularly as inflation had obviously picked up somewhat in April 1990, Mr. Grosche remarked. The authorities would be well advised not to make active use of the scope provided by the fiscal and monetary performance margins in the first quarter of 1990. He shared the staff's recommendation that wage restraint should be continued, and not be undermined by the bonus system. Moreover, additional risks might arise from the much higher than expected trade surplus with the CMEA area and its effects on liquidity. The staff could usefully elaborate on the extent to which exports to the nonconvertible areas were still subsidized, and on whether the proposed phasing out of those subsidies would be sufficient to resolve the problems.

Macroeconomic stability was a necessary but not sufficient condition for more rapid and sustained growth, Mr. Grosche considered. The staff had rightly stressed that the supply response was strongly dependent on the installation of a correct institutional framework. When the Board had discussed the program in February, he had expressed some concerns about the risk of mismatching the steps toward stabilization and transformation. Although progress had been made in implementing systemic reforms, it was with considerable concern that he had noted delays in key areas such as privatization. While he certainly acknowledged that far-reaching institutional reform took time, unless the necessary institutional provision for a market-oriented economy were not established with the same determination as macroeconomic stability, there were substantial risks that the recession would continue, that the benefit of tight financial policy would not emerge, and that the population would refuse to continue on the "hard road" to reform. He therefore encouraged the authorities to step up their efforts in laying the foundations for a functioning market economy.

The international community had shown its willingness to support Poland's ambitious program, Mr. Grosche said. The Fund, the Bank, the Group of Twenty-Four Western industrial countries, the contributors to

Stabilization Fund, and the Paris Club--with its very generous debt-rescheduling scheme--had all gone to the limits of their policy guidelines and beyond. He would therefore encourage the Polish authorities to seek an agreement with the commercial banks as well. With those remarks, he supported the proposed decisions.

Mr. Clark made the following statement:

> In February 1990, this Board approved the stand-by arrangement for Poland with some trepidation. The general view was that the program was unprecedented in its scope and ambition of both stabilization and restructuring, and that there was a high degree of uncertainty and risk attached to it. In view of this background, I wish to congratulate the authorities on what must be considered exceptional progress under the arrangement, although, given the brevity of experience to date, they still face considerable uncertainty. Nonetheless, the record to date is encouraging and augurs well for the future.
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> Among the successes of the program, I would note the elimination of shortages, a lower than planned increase in nominal wages, the dramatic reduction in inflation--although I would note that the most recent data show a rise in the inflation rate--the surprisingly strong performance of the external sector, and the achievement of all performance criteria of the Fund program, most by substantial margins. This record has earned the authorities credibility and has helped retain broad public support for the adjustment effort. There are, however, two areas where the results have been somewhat disappointing, namely, the larger than expected downturn in economic output--although, I would agree with the staff, Mr. Filosa, and Mr. Enoch that the data must be interpreted with some caution--and the slower than planned implementation of systemic reforms. I generally agree with the staff appraisal.
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> The slower than projected decline in the inflation rate should not be a major concern, since it primarily reflects the adjustment in prices following the price liberalization in the first two months of the program. Nonetheless, the rise in the inflation rate from 5.0 percent in March 1990, to 8 percent in April 1990 could be worrying; and I would thus be interested to hear the staff's view on the reasons underlying this increase, and whether the rise would necessitate any revision in the projections. In this regard, on page 14 of the staff paper, the staff indicates that structural rigidities may limit the extent to which inflation can be reduced as planned in the program. It indicates that, if this were the case, exchange rate policy would need to be reconsidered. In my view, the issue of structural rigidities

merits some further discussion. What are these rigidities? How can they be eliminated? And what implication do they have for other major policy variables?

I share the authorities' concern about the marked decline in output in the first quarter of 1990. However, the "softness" of the output data, as discussed at greater length by Mr. Enoch, together with the fact that there have not yet been any state enterprise bankruptcies, suggests that the downturn in economic activity may have been less dramatic than implied by the data. Moreover, although unemployment has risen, the unemployment rate has increased to only 2 percent. Nevertheless, I recognize that the economic downturn may in fact deepen in the second quarter of the year, as the tight policy stance is maintained, and as the least efficient of the state enterprises begin to fail. This should not, however, be cause for the authorities to ease policy conditions. They must persevere with the adjustment efforts, as the declines in output and increases in unemployment are an inevitable part of the stabilization and transformation process. Even so, I would urge them to move more rapidly to develop a social safety net to protect the affected groups and, in this manner, reduce some of the associated costs of adjustment. This will be essential if the authorities are to maintain popular support not only for the adjustment program, but also for systemic reforms.

Like other speakers, I note the slower than expected progress in one of the key areas of systemic reform, that of privatization. Privatization is difficult in any economy, but particularly so in an economy with little experience with private ownership. The issues are complex, and the process can be slow. I recognize that political and procedural issues must be resolved but, in doing so, I would urge the authorities not to ease their efforts to impose financial discipline on state enterprises. The road toward privatization could be considerably longer than initially thought, which only increases the importance of ensuring that state enterprises become financially viable concerns.

There have been important successes in the first four months of the program, which augur well for the future. Nonetheless, the coming months could be difficult, and the authorities must continue to remain vigilant and stand ready to alter and modify policies to ensure that the program stays on track. With these remarks, I can fully support the proposed decisions.

Mr. Almeida remarked that he agreed with previous speakers that the program was working well. Even so, there had been some surprising developments, with output and unemployment deteriorating much more than had been expected in February 1990, and the current account and government finances performing much better than envisaged. Moreover, the rebirth of the private sector had also been proceeding more slowly than expected. The formulation of quantified programs for the unprecedented task of transforming centrally planned economies into market ones was unavoidably subject to wide errors, and the Board's attitude to granting waivers and modifications to such programs had to take that fact into account. Even market economies applying shock treatment programs might face similar problems.

While the staff considered that the Central Government's fiscal balance had been the cause of the unexpectedly favorable developments in the budget, it was still not clear how its balance had improved, Mr. Almeida pointed out. Consequently, the Fund should intensify its technical assistance to help Poland devise better short-term indicators and to improve its reporting system, particularly in the monetary and fiscal areas.

It was remarkable that enterprises had been able to reduce real wages as they had in the first quarter of 1990, without labor unrest, Mr. Almeida observed, but that might not continue, and output losses had further increased the pressures for relaxation of policies. It was important that financial discipline be maintained at present--so that inflation would not reignite--and that the supply side of the economy be addressed, particularly through strengthening the nascent private sector. One of the mechanisms that could be used to increase supply would be to reduce taxation of small businesses, if for no other reason than because of the difficulties in implementing such taxation.

He was not sure of the validity of the staff view that it was time to unify the exchange market owing to the more favorable than expected balance of payments position, Mr. Almeida indicated. Despite its thinness, the parallel market was an invaluable independent instrument, and should be maintained for precautionary purposes. Its disappearance would occur naturally, when there was full freedom in the price system. He supported the proposed decisions.

Mr. Hogeweg made the following statement:

> I warmly welcome the fact that Poland has been able to meet all performance criteria for end-March 1990, with sizable margins. The fiscal and external accounts have been very strong and inflation fell to 5 percent in March, as envisaged. Although preliminary inflation rate figures for April show an increase, the stabilization effort has been highly successful.
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> Stabilization, of course, is no end in itself, but a means toward sustained growth of the economy. At the same time, stabilization will come under severe pressure if the supply response of the economy takes too long to materialize. It is thus of serious concern that the costs of transition in terms of output losses and unemployment have turned out to be much higher than anticipated.

In the final analysis, the success of Poland's program will depend on, and be judged by, its ability to create lasting growth.

It was of course well known from the start of this program that the most immediate need was stabilization, but that, at the same time, the economy was in need of a complete overhaul, to which this program could contribute only the very beginning stage. In that sense, the imbalance between systemic changes and the stance of macroeconomic policies--mentioned by the staff as a clear factor exposing the economy to higher transition costs--is not surprising. It does point, however, to the soundness and urgency of the approach, as described by Mr. Filosa, of supporting activity by removing barriers to the response of supply, not by relaxing demand. In this connection, it is worrisome that the centerpiece of reform--the transformation of ownership of enterprises and privatization--is turning out to be more difficult to agree, and to implement. One might question the merit of starting with relatively efficient companies as pilot cases. Loss-making enterprises can be privatized too, which might well be the quickest means of making them efficient. I understand that the first bankruptcy of a state enterprise has not yet occurred. I much agree with the staff that bureaucratic obstacles need to be reduced further and that the development of small and medium-sized enterprises needs to be promoted more positively. In sum, although important steps have been taken on the way to a market system, the Polish economy is still essentially operating within the old institutional framework.

At the same time, it is crucial that demand-management policies not be relaxed. I note that the staff cautions against utilizing the existing leeway under the fiscal and credit ceilings, a warning that seems well taken in view of the stronger liquidity position of enterprises than assumed earlier, and the granting of wage bonuses. It will be important to adhere as closely as possible to both anchors of the program, wages, and the exchange rate, and I agree that unification of the exchange rate would be in order at this point. I would also caution against unduly fast decreases in nominal interest rates.

It is clearly too early to judge the overall performance of Poland's program. I realize that the data on macroeconomic variables need careful analysis, because they seem to measure primarily the performance of the existing socialized economy, as opposed to the smaller-scale private activities that, hopefully, will become increasingly important. The risks identified at the outset of the program clearly still remain. In the meantime, it is gratifying that Poland has reached agreement with the Paris Club and is currently discussing comparable terms from commercial banks and its CMEA creditors. In working toward the necessary significant cuts in the debt burden, it is important to bear in mind that the different creditor groups tend to employ different techniques in granting debt relief. I support the proposed decisions.

Mr. Ismael stated that he would join other speakers in commending the Polish authorities for the firm implementation of their bold and far-reaching economic and financial adjustment program. Indeed, the staff paper and Mr. Filosa's opening statement had indicated that remarkable progress had been made in stabilizing the economy quickly, and reducing the rate of inflation. In addition, there had been surpluses in the fiscal and external accounts, and all performance tests for the first quarter of 1990 had been met with comfortable margins.

However, one disappointing aspect of the picture was the sharp decline in output and employment, Mr. Ismael commented. That situation would most likely worsen in the near future, with the expected closing of some state enterprises. Therefore, the various incentives that the authorities were contemplating--including wage incentives--to avoid deepening the recession were appropriate. He would encourage them to speed up the development of the social safety net so as to minimize the hardships of the unemployed.

The success achieved so far in stabilizing and liberalizing the economy should give the authorities additional leeway for proceeding further with the restructuring of the economy, Mr. Ismael considered. In that context, he welcomed the substantial legislation under way to accelerate the development of the private sector, particularly in view of the many existing bureaucratic impediments to the development of that sector and to private foreign investment, as had been noted in the staff paper. A more vigorous effort to eliminate those impediments could have a more immediate positive effect on output and prices.

In the external sector, he welcomed the fact that the liberalization of the exchange and trade system had proceeded further than anticipated, and that the balance of payments position has strengthened significantly, Mr. Ismael remarked. He noted the generous restructuring of Poland's debt obligations by the Paris Club, which was a significant contribution to the Polish authorities' efforts and achievements. However, as had been noted by Mr. Filosa, the country's heavy foreign indebtedness could threaten its restructuring efforts. Therefore, additional debt relief, both from commercial banks and official creditors, would be needed.

Despite the progress achieved, much remained to be done in transforming the Polish economy into a more competitive one, Mr. Ismael added. The authorities had indicated that they were keenly aware of that fact, and their commitment to continue their adjustment efforts steadfastly was therefore reassuring. He supported the proposed decisions.

Mr. Iqbal made the following statement:

The determined implementation of the adjustment program by Poland should be commended. The Polish case is particularly interesting because it highlights the dilemma of balancing short-term stabilization and long-term growth objectives. It is evident that the stabilization component has been effective. The rate of inflation has been cut, the exchange rate has been stabilized, and the deterioration in the external account has been reversed. However, there has been a sharper than planned contraction in domestic economic activity, and unemployment has grown rapidly. It seems that the improvement in the external accounts for the first quarter of the program period reflects more the sharply contractionary effects of lower domestic economic activity than a fundamental correction. Such a correction, of course, will take time.

Although experience has been too brief to come to definitive conclusions, it could be said, as emphasized by Mr. Grosche, that there may have been difficulties in properly sequencing stabilization and basic economic reforms. Clearly, the implementation of the proposed widespread structural reforms has been more time consuming than anticipated. A lesson that could be learned from the Polish and similar experiences is that preparations for time-consuming structural reforms should not necessarily await the traditional correction of demand. Clearly, the Fund will need to develop promptly sufficient expertise in the sequencing of policy measures and the assessment of members' administrative abilities to implement structural reforms.

It is essential that the early achievements in Poland are sustained and exploited, in order to restore quickly viable economic growth. Visible signs of recovery will be essential to retain popular support for the continued pursuit of the program. I generally agree with the staff appraisal, which calls on the authorities to accelerate structural reforms while retaining tight control of domestic demand. Nevertheless, the appraisal raises a few imponderable issues.

While I endorse the view that recovery cannot be hastened by a departure from the macroeconomic program, it may not be advisable to squeeze domestic demand any further. It is not clear that the built-in stabilizers and the proposed modifications of the limits on wages would be sufficient to "kick in" an early correction of domestic demand. However, it seems that the economic structure is not sufficiently flexible to translate a relaxation of domestic demand into productive output. Therefore, ways will have to be found to undertake the time-consuming reforms quickly, in order to ensure durable supply responses. Clearly, what matters is how much relaxation can be undertaken without reigniting inflation or an excessive loss in external reserves. Also, is it possible to accelerate the desired structural adjustment? However, I am not sure that structural reforms should necessarily call for a quick and large delinking from the CMEA countries, as the original program implied, if it were to cause a further slump in domestic activity in the near term. The Fund and the World Bank will have to address these issues constructively.

I fully agree with the staff's assessment that the exchange rate has served as an efficient anchor against inflation, and that there is no need to change the nominal rate. The staff has shown foresight in not following a mechanical interpretation of the price-based calculation of the real effective exchange rate. A similar approach should be applied in other countries when changes in the exchange rate are contemplated. I also support the staff's suggestion for using the current, comfortable reserve position to move toward unifying the exchange market and considering an early elimination of the remaining restrictions on certain current international transactions. I support the proposed decisions.

Mr. Ghasimi commended the Polish authorities for their commitment to rapid action, and implementation of the comprehensive adjustment program with determination. Indeed, the progress achieved so far in laying the foundation for changing the controlled economy into a market-oriented one, and in reducing the inflation rate from 640 percent in 1989 to a monthly average rate of 8 percent in April 1990, were encouraging. Moreover, the expected trade deficit in convertible currencies had shifted into a surplus in the first quarter of 1990, and the trade surplus in nonconvertible currencies had also strengthened far beyond expectation. Even so, output had dropped sharply, and registered unemployment had risen more than expected. In those circumstances, the achievement of a delicate balance between reducing inflation and avoiding a deepening recession was indeed a real challenge facing the authorities. In that connection, the systemic reforms initiated by the authorities to remove barriers to the response of supply and the increased emphasis given to increasing efficiency were definitely steps in the right direction. He broadly agreed with the thrust of the staff appraisal.

He was pleased to note that the Government has succeeded in achieving a surplus in its general budget, in contrast to the deficit of up to 4 percent of GDP that had been expected for the first quarter of 1990, Mr. Ghasimi stated. However, owing to uncertainties in central government revenues, he encouraged the authorities to continue their policy of restraining expenditures. In that respect, he welcomed the Government's firm commitment to stand ready to reduce expenditure, if necessary, by more than had been envisaged in the program.

The Government's financing requirements with the domestic banking system had been reduced during the first quarter of 1990, and the expansion of credit to the nongovernment sector had been in line with the program, Mr. Ghasimi observed. However, given the possible emergence of pressures on the budget in the period ahead, and of considerable excess reserves in the banking system, the authorities should definitely resist any faster expansion of liquidity than had been envisaged for the second quarter of the year. Needless to say, failure to maintain proper control of liquidity might jeopardize the efforts and initiatives made so far to combat inflationary pressures in the economy. With those remarks, he supported the proposed decisions.

Mr. Yoshikuni made the following statement:

> I welcome this opportunity to review the encouraging adjustment performance of both the Polish authorities and population in the context of a radical and comprehensive economic transformation. Indeed, the early results are more than satisfactory: all performance criteria were met with comfortable margins; the program's two nominal anchors of wage restraint and a fixed exchange rate--at a competitive level--have stabilized the economy successfully; and the tight fiscal and monetary stance has also firmly supported the pursuit of the adjustment objectives. I therefore endorse the authorities' intention to maintain the current macroeconomic framework, particularly the two nominal anchors, into the second quarter of the year.
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> Nevertheless, the sharp decline in output is a source of concern. While the statistical base is limited to socialized industry, the data do point to a considerable delay in the adjustment of productive activity by economic agents. This should be addressed through further enhancing structural adjustment, but certainly not through weakening of the macroeconomic framework--as inflation still needs to be monitored with caution.
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> In this regard, I have some concerns about the possible negative implications of policy developments in several areas. On wage policy, the bonuses from 1989 profits were much larger than expected, and would imply increased demand. Permitting the payment of further bonuses from 1990 profits during the year may have the effect of considerably weakening the current restrictive wage policy. In this connection, the staff could usefully elaborate on the possible impact of the other proposal, namely, the tax exemption of salary increases by small enterprises with fewer than 100 employees.
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> There has been a significant increase in the supply of credit to the nongovernment sector. The authorities were right in taking precautionary measures to absorb excess liquidity in the banking

sector. However, their intention notwithstanding, the sale of 30-day fixed deposits at auction was not encouraging. Improvements are required in the terms and conditions of such monetary instruments, so that they can be effective in controlling the overall amount of broad money. In light of the continued reduction in the refinancing rate, the authorities should maintain tight control on the increase in broad money.

Meanwhile, I fully agree with the staff that structural reforms should be accelerated; of particular importance would be the removal of structural impediments in bureaucratic control of enterprises. Also, I join Mr. Enoch and other Directors in emphasizing the importance of privatization.

The strengthening of the trade balance with the convertible currency area is welcome. At the same time, however, the trade surplus with the nonconvertible currency area has grown as well. There is still strong demand for export licenses for the latter area, which is partly supported by the export subsidies provided to exporters to the nonconvertible currency area. It may be necessary for the authorities to abolish the export subsidies, at least, in order to achieve a sustainable balance with the nonconvertible area.

While I firmly support the maintenance of the current nominal exchange rate, I note the continued weakening of the parallel market exchange rate since March 1990. The staff might wish to analyze this movement. In addition, in view of the limited coverage of the parallel rate, I endorse the staff's recommendation to unify the exchange market at an early stage.

In respect of the financing of the program, I welcome the agreement reached with the Paris Club, providing generous terms of rescheduling. I hope that the negotiations on rescheduling, along with debt and debt-service reduction with the commercial banks, will be expedited further. However, at the current critical juncture, the authorities should be wary of the risk of assuming an unsustainable fiscal burden in seeking a debt-reduction arrangement. In this connection, I note with concern the authorities' intention, as noted in Mr. Filosa's opening statement, to seek permanent debt and debt-service reduction on official credits. While it is the case that 70 percent of Poland's external debt is owed to the official sector, my chair would emphasize that there is a decisive difference in nature between official credits and private credits. As my authorities stated to the Interim and Development Committees, the introduction of debt and debt-service reduction on official debt may well run the risk of stopping the flow of new money from public sources, not only in a bilateral, but also in a global, sense. The authorities would therefore be well advised not to count on such relief in designing a medium-term policy framework. Instead, they should concentrate on building a sound macroeconomic and structural environment over the medium term, which would encourage the necessary financing and investment. With these remarks, I support the proposed decisions.

Mr. Dawson made the following statement:

When the Board considered Poland's request for a stand-by arrangement in February 1990, the course that the authorities had set for transforming the country from a centrally planned economy into a market system was largely uncharted, and potentially stormy. In the event, Poland has weathered the first critical months of the program well, with the wage and exchange rate anchors having held against inflation, and inflation converging along its programmed path. Exports to the convertible currency area have been markedly stronger than expected, and the rise in net international reserves has been dramatic. Meanwhile, Poland's reform program is gaining increasing credibility, as the recent absence of exchange rate pressures shows. These are considerable achievements for which the authorities should be highly commended.

Despite these accomplishments, the authorities are understandably concerned about signs of declining output and the increase in registered unemployment. Although these are not unexpected developments, they nevertheless pose difficult questions. I agree with the authorities, however, that it is much too soon to declare inflation beaten. Although the deceleration of price increases has been dramatic, inflation, by any measure, is still unsustainably high, and inflationary pressures persist, as the uptick in the April 1990 inflation rate shows. Moreover, the authorities should probably not place too much weight on the data at hand. As the staff points out, the relatively sketchy and incomplete output figures probably do not give an accurate picture of activity in the economy as a whole, while the unemployment data overstates the extent of job losses. In any event, pressures to relax macroeconomic policies will undoubtedly intensify in the months ahead, as the nonviable enterprises are forced to close, and layoffs increase. Thus, it is particularly important not to relax policies prematurely.

So far, the authorities have done a commendable job in maintaining fiscal and monetary discipline. Budgetary expenditure has been kept under tight control, and the Government was able to reduce its net indebtedness to the banking system during the first quarter of the year. I also note the authorities' readiness to take precautionary measures to restrain credit expansion, in view of credit developments in February and early March 1990.

In the months ahead, it will be important for them to continue to proceed cautiously and to be prepared to take additional measures if the situation so requires. In this connection, I wonder whether the progressive reductions in the Central Bank refinance rate have not been somewhat premature. As the data currently indicate, the refinance rate of 8 percent in April may have been barely positive in real terms; and the decision to lower the rate to 5.5 percent as of May 1, 1990--in the expectation that the inflation rate would decline to 2-3 percent in May--might also have been precipitous.

With regard to wage policy, I can support the authorities' decision to raise the coefficient for the tax-free increase in enterprise wage bills to 60 percent in May and June 1990. This appears to be consistent with the programmed downward trend in the inflation rate. However, I share the staff's concern about the proposal to allow certain enterprises to pay bonuses out of 1990 profits during the course of 1990, since such a move could intensify price pressures and, absent more reliable accounting, could undermine the financial position of enterprises.

The larger challenge will be to ensure that the necessary structural changes indeed occur in the economy, so that the desired supply response materializes, and output and employment increase. The staff paper and Mr. Filosa's opening statement indicate that reform is underway in a number of important areas, including the liberalization of trade, the breaking up of monopolies, the expediting of bankruptcy proceedings, the strengthening of the banking system, and the development of modern capital markets. In addition, the staff paper outlines a number of areas in which additional steps would help hasten economic recovery. I would urge the authorities to expedite reforms in these areas.

I have noted already my satisfaction with Poland's stronger than expected balance of payments position and the absence of pressure on the exchange rate. I agree with the staff that this favorable situation provides a good opportunity to make further progress in liberalizing Poland's trade and exchange systems, by easing or eliminating the remaining restrictions on payments and transfers for current transactions and by unifying the exchange rate. Among other advantages, such changes would encourage further foreign investment in Poland and help integrate the country more fully into the international economic system.

I am concerned, however, about the large increase in Poland's current account surplus in nonconvertible currencies. The surplus reportedly exceeded $300 million in the first quarter of 1990, in contrast to $50 million in the same period in 1989, and to a $120 million target for all of 1990. It is curious that, despite their desire to reorient trade toward the convertible currency area, the authorities are still subsidizing exports to CMEA. It is hardly surprising, therefore, that they must also resort to administrative means, namely, the denial of export licenses, to keep exports to the ruble area in check. This appears to be an area where some policy reform is needed, involving an end to export subsidies, which might also reduce the need for export controls.

There is another aspect of Poland's trade with the ruble area that also gives me some concern. The staff paper notes that the current account surplus with the ruble area is being applied by the International Bank for Economic Cooperation to reduce Poland's accumulated debt in nonconvertible currencies. Although this is admittedly a grey area, it does raise some questions about the comparable treatment of creditors. Certainly, some of Poland's exports to CMEA countries could be sold in the West, and generate hard currency with which to pay convertible currency debts. To the extent that these exports are used to reduce nonconvertible currency debts, creditors are obviously not receiving comparable treatment.

On a more positive note, the staff paper also states that Poland has approached commercial banks for debt and debt-service reduction. I believe that Poland is a suitable candidate under the strengthened debt strategy for commercial debt and debt-service reduction, and I look for rapid agreement between Poland and its commercial banks on a financing package that includes provision for such reductions.

I am impressed by the outstanding results achieved under the program so far, but expect that there may still be some difficult days ahead as the economy begins to undergo more fundamental adjustment. Nevertheless, with the authorities and the Polish people's continued perseverance, the outlook for Poland should continue to brighten. I support the proposed decisions.

Mr. Chatah made the following statement:

It was clearly recognized during the Board's discussion on the stand-by arrangement in February 1990 that Poland was, in many ways, moving into uncharted territory--at least during the initial phase of the transformation process--and that deviations from the assumed path were therefore likely to occur. Although deviations indeed did materialize, particularly in output, unemployment and, to some extent, in aggregate price movements, developments during the first four months of 1990 seem on the whole to reconfirm the validity of the basic adjustment strategy underlying the program.

My chair shares the general message of the staff about the need to maintain the thrust of the macroeconomic program and to speed up some of the structural and institutional reforms, in order to accelerate the supply response of the economy. It also agrees with the need to solidify the social safety net, particularly in light of the larger than expected losses in employment and purchasing power.

The basic objective of interest rate policy as stated in the program, namely, to control liquidity and to maintain competitiveness with foreign currency deposits, remains valid. However, recent changes in the refinancing rate seem to be based on short-term fluctuations in inflation. I am not sure that such a pre-occupation with monthly movements in prices is fully justified. To the extent that much of the fluctuations in inflation are associated with structural price effects and their complex lags, one should be careful in calibrating interest rates to those fluctuations. Broadly speaking, and given the difficulty of separating the underlying inflation rate from actual price movements, it may well be wise to err on the safe side. Interest rate policy should, in my chair's view, be geared toward the convergence of price and exchange rate objectives over the full span of the program, and not be narrowly focused on short-term price movements. In this connection, it would be useful if the staff could tell Directors how deposit rates have been moving in comparison with returns on foreign currency holdings.

The shift from foreign currency to domestic currency deposits is an important achievement of the macroeconomic stabilization program, which Mr. Filosa has correctly emphasized. This confidence in the national currency should be preserved. Although interest rate policy has played a positive role, I would put more emphasis on exchange rate stability as the basic factor behind the shift. My chair, therefore, sees much merit in maintaining the nominal exchange rate anchor in the period ahead. The staff has argued in favor of exchange rate unification, although it has not spelled out fully the exchange rate management that it has in mind following unification. To the extent that balance of payments and reserve developments can support such unification--and recent developments indicate that they do--it seems that the move toward unification should be achieved gradually by moving more and more of the remaining transactions from the parallel to the official markets, while maintaining the nominal anchor--which has proved instrumental in the stabilization effort so far--at least for the time being.

The staff seems to be somewhat concerned about the distribution of wage bonuses from enterprise profits. Given the lack of sufficient control and accountability in these enterprises, I share some of the staff's concerns. But, to the extent that these considerations could be mitigated, one should, in principle, allow some profit-making enterprises to provide increased incentives to employees. Wage differentiation across enterprises is a natural product of a more market-oriented system, not to mention equity considerations, which suggest that labor should not be excluded from the fruits of genuine profitability. My chair can support the proposed decisions.

Mr. Evans made the following statement:

It was widely acknowledged by the Board in February that this program, ambitious though it is, involved significant risks and warranted close monitoring by the staff. It is therefore gratifying to see that, in the short time that has elapsed since the program's approval, considerable progress has been made by the authorities in reducing inflation and stabilizing the exchange rate. I have no difficulty in endorsing the staff appraisal. One short-term development that causes some concern--namely, the larger than forecast deterioration in both output and unemployment--reflects risks that were clearly identified in February. I note the staff's argument that recent figures may overstate the extent of the slowdown; and, in an economy undergoing structural change, it is almost inevitable that output will be understated. The labor market can prove to be a more useful indicator in such circumstances--so too, can inflation. However that may be, the authorities have to keep their eye firmly on the medium term. Therefore, I fully endorse the staff's judgment that the authorities would be ill-advised to adjust the stance of macroeconomic policy at this time. And I am encouraged by the authorities' understanding that such action could seriously threaten the success of Poland's longer-term structural adjustment agenda. The apparent resurgence in inflation in April is a clear concern; in an economy that is witnessing falling output and incomes, the April figures suggest that inflationary expectations are still firmly entrenched.

The only other issue on which I wish to comment in any detail is that of wages policy and its link to broader-based systemic reform. As emphasized by several chairs in February--and acknowledged by staff--there is an obvious tension in the design of the program between the degree of real wage restraint needed for macroeconomic stabilization and the extensive reallocation of resources required if sustained longer-term growth is to be achieved.

I note that the success in lowering the monthly inflation rate has allowed an increase in the tax-free wage index coefficient. The staff is right to be cautious with regard to the pace with which the authorities introduce modifications to the current wage policy arrangements, but if the necessary changes in the structure of the economy are not to be hindered, the authorities will need to apply this policy flexibly.

Moreover, while I do not wish to understate the considerable progress made in a number of important elements of broader structural reform, the delays highlighted by the staff in the area of privatization--correctly identified as the centerpiece of current structural policy--are disturbing, if not surprising. In many ways, such delays merely reflect the real political and practical constraints that attach to this issue, constraints that may not have been fully reflected in a number of recent public commentaries on East European reform, including perhaps the analysis in the most recent world economic outlook.

Nevertheless, I would be interested in any further information that the staff could provide on the authorities' privatization strategy. In particular, to what groups in society are the authorities expecting to sell these enterprises, and where are the resources to come from? What is the scope to approach this issue through the "backdoor," by encouraging an increase in the number of small and medium-sized, unregulated enterprises? In this latter context, what precisely does the staff have in mind when it refers to the need to promote more positively such enterprises?

That being said, the authorities' commitment to date has been commendable, and I can support the proposed decisions with regard to both the review of the stand-by agreement and the exchange system.

Mr. El Kogali made the following statement:

My chair's special concern with the Polish experience stems from the fact that it has four countries in its constituency categorized as centrally planned economies. In any event, three months are obviously a short time to be able to come to firm conclusions on a bold exercise of economic reform such as in Poland. However, according to the staff paper, the authorities continue to stand by their commitment to rapid economic change. I hope that the economy will respond quickly to the "shock therapy" that is being applied, and continued assistance from the international community, including additional debt relief from commercial banks, will be an important catalyst in this regard. Seeing the benefits of reform within a reasonable period is important for sustaining popular support.

The program has been relatively successful in a short period in stabilizing the economy, but this has come at a high price. In recent months, Poland has seen a sharp decline in output and a rapid increase in unemployment. In the circumstances, the question of developing appropriate safety nets takes on added importance, although this is easier said than done, as demonstrated again by the Polish case. Looking back on some other Fund-supported programs, the experience seems to point to the need for specific schemes to alleviate the cost of adjustment on the most vulnerable groups, which should be incorporated into these programs at their formulation. The integration of safety net provisions into Fund-supported programs is particularly important when dealing with low-income countries.

In view of the interest that many observers have shown in the Polish experience, the questions that arise are: how successful will this program be, and to what extent can this model be applied to other developing countries? After all, the basic problem for Poland and many other developing countries is essentially how to achieve economic transformation in a situation of structural deficiency. Although it is too early to come to firm conclusions, one could wisely urge caution in making generalizations. In this connection, a major consideration is the cost of adjustment that "shock treatment" imposes, and the capacity of a country to carry such a burden over a given period of time. In making comparisons between Poland and other developing countries, it is pertinent to note that the Polish economy--although centrally planned--has some attributes that place it in a much better position to respond to market signals than many developing countries. One attribute is that Poland is much more diversified, with a relatively significant industrial base and a well-educated and skilled labor force, than other developing countries. Moreover, Poland is ideally situated, close to highly industrialized countries in Europe, and it has recently received a massive dose of external assistance. Even with all of these factors, the decline in output has been sharp, the unemployment rate has risen quickly, and inflation remains a problem. The authorities themselves have made the point that time will be needed for the economy to adjust, and not simply to stabilize.

It seems pertinent to ask whether the backbone of the reform rests on the question of ownership per se, the efficiency of management, or the authorities' policies. Indeed, the rationale for breaking up big businesses in Poland is not clear to me. Is it because of the problem of size--or diseconomies of scale--or because of ownership, or policies? The staff could usefully comment on those issues. I support the proposed decisions.

Mr. Dai made the following statement:

Since the discussion on Poland in February 1990, the Polish economy has shown improvements in inflation and external performance, even though output and employment have fallen sharply. The latter are not unexpected in the case of such a drastic adjustment program. I agree with the authorities that, since the program was only begun three months ago, it is still too early to speculate on the outlook for the economy in 1990 as a whole. However, the challenges confronting Poland require that both the adjustment and the stabilization efforts not be slackened. In particular, structural problems inhibiting output growth should continue to be dealt with earnestly, while monetary and fiscal policies should remain restrictive in order to keep macroeconomic performance on track. I generally agree with the staff appraisal.

It appears that the major causes behind the sharp fall in output lie in the restructuring of production and the market. As the staff mentioned, the downturn in demand and activity in the domestic market requires that enterprises seek new markets abroad in the convertible currency area. However, the existing production structure hampers this quest. While agreeing with the reasons for a shift in activity and trade toward the convertible area, I believe that this transitional process might take some time to achieve, especially when taking into account the accompanying dilemma spelled out by the staff. Direct foreign investment has therefore become vital to the restructuring of production and the market. Such investment would facilitate the introduction of new technology and expertise that would help Polish enterprises expand their markets in the convertible area, thus enhancing economic activity and creating jobs. It is important that the authorities make every effort to improve the environment for direct foreign investment. While inflation and wage costs continue to be kept in check, the current rapid progress in liberalizing the exchange and trade system should be sustained. Furthermore, given the limited resources and domestic market of Poland, an outwardly oriented strategy should be encouraged.

Concerning the thrust of macroeconomic policies, I note from Mr. Filosa's opening statement that while the transitional costs have turned out to be larger than expected, the authorities remain committed to the current restrictive stance of fiscal, monetary, and exchange rate policies. I fully agree with them that it is too soon to declare inflation beaten. Therefore, although the fiscal and credit performances have been favorable, and hence give some leeway for maneuver during the remaining period of the program, the restrictive thrust of the fiscal, monetary, and income policies should be maintained. In this regard, I have two specific points to make: first, given the continued sizable excess reserves in the banking system and the possible impact of an increase in wage bonuses from 1989 profits on inflation--especially in view of the picking up of the inflation rate in April 1990--it might not currently be appropriate to lower the refinancing rate of the National Bank. The staff could usefully comment on this point. Second, wage costs should be kept at a reasonably low level, to avoid aggravating inflationary pressures induced by price adjustments, and to maintain the competitiveness of Polish exports. Therefore, I tend to agree with the staff that the payment of wage bonuses from current profits should be postponed. In the existing circumstances, incentives to promote output and investment should not come mainly by relaxing demand, but by removing barriers to a supply response, through effective restructuring of production. I support the proposed decisions.

The staff representative from the European Department said that the staff certainly agreed that there was substantial inertia and unresponsiveness in the productive structure of Poland, a significant degree of monopoly, and an urgent need to break up large conglomerates, thereby to induce greater competition, efficiency, and increased industrial responsiveness. The private sector, in that regard, seemed to have been as equally affected in the early months of 1990 as the socialized sector had been by the compression of demand. Licensing figures indicated that some 30,000 activities in the nonsocialized sector had been closed down, compared with the issuance of 50,000 licenses for new activities during that time. Net private sector activity had thus not grown as rapidly as it had in previous years.

The rise in inflation in April had been higher than officials had expected, the staff representative continued. While the staff had not yet had an opportunity to discuss the April figures with the authorities, the uptick in prices was clearly related to the increase in total wage compensation in March and seasonal expenditures connected with Easter. As such it was symptomatic of the tenuous balance in the consumer market and underscored the need for continued caution in wage policy and financial policy. Looking ahead, three factors were perhaps worth noting in assessing the underlying inflationary trend. First, the price increases in April had been concentrated in the area of food products, whose prices had risen by 10 percent that month. Second, as Supplement 2 to EBS/90/77 showed, total nominal wage compensation had fallen in April, with none of the March bonuses being repeated; that should reduce demand pressures somewhat in the period ahead. Third, producer prices of industry had been unchanged in March and April 1990. To the extent that that index was a forward price indicator, the inflationary outlook should probably be seen as good.

The large short-term capital outflows in the balance of payments in convertible currency essentially reflected the classification system used, the staff representative commented. Those outflows were the counterpart of the foreign exchange banks' placement abroad of their net reserve gains. As presented, Poland's balance of payments figures solved for gross official reserves, not net international reserves. Net international reserves were, however, shown as a memorandum item.

In regard to the development of wages, it was difficult to know why the actual increase in wages had been identical to the hypothetical increase that would have been consistent with the inflation rate projected under the program, the staff representative stated. The coincidence was puzzling, especially in view of the fact that there was not yet in place a management system motivated by profits; in most Polish enterprises, a key input into decision-making continued to be made by workers' councils, which had been more concerned in the past with securing employee benefits than with long-term enterprise efficiency and profitability. But it was perhaps no more than a coincidence; it was unlikely that the behavior of wages had reflected an effort to delay structural change. It was significant, in that context, that there had been no obvious pressure on the labor markets during the first three months of the program; labor disputes had been few, and had typically been unrelated to wage issues. The modifications to wage policy under consideration by the authorities, including the possible exemption of enterprises of less than 100 employees from the excess wage tax, was seen as a way of promoting private sector production. Most enterprises of less than 100 employees were nonsocialized ones. Those enterprises and their wage bills, however, were still a small fraction of the Polish economy and its total wage bill, implying that the impact of any such exemption in terms of price pressures should remain insignificant--particularly if one assumed that the wage adjustments would be matched by productivity increases.

The question of wage differentiation remained a fundamentally difficult one for the authorities to deal with, the staff representative remarked. It would currently be premature to move away from a system of wage control, particularly when the ownership issue had not yet been resolved--with there being no advocates for capital in most enterprises yet--and when the establishment of firm financial discipline in enterprises was not yet certain. While he had noted the point made by a Director that maximum flexibility should be used in implementing the existing system, he would point out that one of the great failings of wage policy in Poland in the past had been the multiplication of exemptions and preferential treatment. Movement from simple rules risked embarking on a "slippery slope" in Poland's case.

In regard to the possible room for maneuver under the performance ceilings, a few reassuring points might be made, the staff representative commented. Pressures on the budget had not arisen during the second quarter of the year, although they had been considered a possibility when the staff paper had been drafted. The fiscal budget had been in moderate surplus in January, substantial surplus in February, and in approximate balance in March, a pattern resulting in some concern--together with the output figures--that the budget would come under pressure over time. However, the preliminary fiscal figures for April 1990 suggested that the budget was again in substantial surplus, with a consequent lessened threat of monetary financing. The authorities at the highest level had stated, furthermore, that they would not ease financial policy. That stance had been reiterated by Deputy Prime Minister Balcerowicz during his recent visit to Washington, D.C. The authorities had responded appropriately in the past to any tendencies giving rise to concern; in particular, they had continued to be watchful of developments in the money supply, even though net domestic assets had been expanding much less rapidly than allowed in the program.

The National Bank was somewhat of a "prisoner" of the structural rigidities in the financial system, the staff representative pointed out. As had been mentioned at the time the stand-by arrangement had been approved, it remained extremely difficult to adjust the refinance rate more than once a month without putting, at the same time, at least one substantial bank--with many branches--into considerable financial difficulties. On the basis of the information available at the end of each month, the National Bank had to take a decision on the refinancing rate for the next month. The decision on the rate for May 1990 had been taken in the light of an expectation that inflation would fall back significantly from the "erratically" high April figure. Concerning deposit rates, they were adjusted relatively flexibly, and had been substantially more attractive than rates on foreign currency deposits. For instance, the rate on one-year zloty deposits had been 12 percent a month in March 1990, compared with the rate on foreign currency deposits--varying according to currency--of approximately 8 percent a year.

The staff and the authorities agreed substantially that Poland, in seeking to buttress economic activity, had to concentrate increasingly on promoting a supply response, not augmenting demand, the staff representative observed. Directors had rightly focused on the slow process of transforming ownership and privatization, which needed to be accelerated. The impediments, though, should not be underestimated. Privatization had not been straightforward in Western countries, and there were additional difficulties in Poland's case. No valuation of company assets was yet available, and neither were the resources or purchasing power available in Poland to acquire those assets. However, consideration was being given to the possible creation of a national mutual fund to which wage deductions or wage compensation could be fed to finance privatization. A further obstacle to privatization in Poland was that it was not obvious at the current stage of the reform that there was a large stock of enterprises that would be attractive to foreign capital holders. Potential foreign investors, too, seemed to be adopting a "wait and see" attitude. One therefore had to expect that socialized or state industry would remain the preponderant form of activity in Poland for some years, and it was therefore important to improve such industries' efficiency and discipline.

With respect to specific steps for facilitating foreign investment, the authorities had not taken concrete measures yet, the staff representative explained. Work on easing restrictions on profit remittances and in the country's accounting system was being promoted in the context of the discussions on a structural adjustment loan with the World Bank. It was an important area targeted for improvement in the period ahead.

The Labor Fund was already in place and the unemployment safety net seemed adequate for coping with the probable growth in unemployment in 1990, the staff representative remarked. The World Bank had gone to great lengths to ensure that the terms of unemployment compensation were adequate to prevent increased incidence of poverty among the unemployed. As it was currently structured, the unemployment insurance scheme would not likely inhibit the search for new employment, because the benefit rate fell comparatively quickly over time, also a relatively higher rate of compensation was given for retraining, presumably thereby increasing the ability of the unemployed to be reabsorbed into the labor force. In areas other than unemployment compensation, progress with social benefits had been slower, reflecting primarily the great difficulty of identifying the poor and in devising cost-effective delivery systems. Discussions with the World Bank had focused, in part, on addressing the identification problem, collecting appropriate data, consolidating a variety of social benefits, and moving toward a more rational, means-tested general system of such benefits. That shift should occur in the second half of 1990 and in early 1991.

The staff shared Directors' concern about Poland's growing surplus with the CMEA area, particularly in view of its monetary consequences via direct feedthrough into domestic liquidity, the staff representative said. It was important to recognize, nevertheless, that the surplus so far in 1990 had derived primarily from a fall in imports beyond the authorities' control, with the volume of export growth to the CMEA had remained basically unchanged in the first four months of the year. Indeed, imports from the CMEA have fallen by 30 percent in those months, in large part reflecting supply difficulties in the Soviet Union and in other neighboring countries, but including, as well, reduced Polish demand for energy imports in consequence of the mild winter. The staff considered that it would not make sense to add to the surplus by facilitating export growth to the CMEA, particularly given the need for structural change in the Polish economy. Detailed information was not available on the extent of subsidization of trade to the CMEA area, although policy in the latter part of 1989 had been to depreciate the zloty less against the transferable ruble than against the U.S. dollar. Some subsidies, however, were designed to equalize export and domestic profitability and would rise pari passu somewhat. The whole subsidy network vis-à-vis CMEA trade was very much a matter for negotiation between state enterprises and the Government.

The form and pace of possible reform of the CMEA was still largely unknown, the staff representative indicated. Poland had yet to formulate its position on the modalities of such reform, although its medium-term objective of moving to free pricing and hard currency settlement was clear. Similarly, the Union of Soviet Socialist Republics, which was Poland's largest CMEA trading partner, had not yet disclosed its position. Two possibilities were being mentioned, namely, a trade arrangement similar to that currently in place between the Union of Soviet Socialist Republics and Finland, or a simple shift to free pricing and free currency settlement. Poland would clearly face an adjustment problem when reform of the CMEA took place, the extent of which would depend on the transitional arrangements. The adjustment problem would arise because about 80 percent of Poland's exports were considered to be "soft" goods--overpriced relative to world prices--while only about 50 percent of its imports from the CMEA took that form, with the result that a substantial terms-of-trade effect was to be expected. That effect would not be equivalent to the foreign exchange impact, however, as Poland did have a trade surplus with the CMEA.

Mr. El Kogali commented that macroeconomic policy, particularly fiscal, was probably more important at first in the path-breaking Polish case combining adjustment with restructuring. It was in that context that he had raised the question of whether enterprise size per se was more important than efficient management and appropriate macroeconomic policies. While economies of scale might be maintained if enterprises of a certain size were retained--and although antitrust and monopoly laws were already well established in countries such as the United States--breaking up monopolistic state industries at the outset of reform in a country in the process of transition with many accompanying structural deficiencies, such as in Poland, might have undesirable consequences. The restructuring of enterprises and their privatization required effective accounting systems, a technical and time-consuming task. At the outset of reform, the question of macroeconomic policies was probably more urgent than structural policies, a point on which the staff could usefully comment.

The staff representative from the European Department responded that simultaneity of financial and structural policies had to command it, with the former being needed to tighten enterprise financial discipline. Nonetheless, industrial concentration and lack of competition in Poland were very marked. Even with an open foreign trade system, prices of many Polish products remained low by international standards. Moreover, the monopoly position of some state enterprises gave them bargaining power vis-à-vis Government and could blunt the impact of indirect macroeconomic policy instruments.

The Deputy Director of the Exchange and Trade Relations Department, noting that a few Executive Directors had commented on the envisaged unification of the exchange rate, said that the staff had seen the parallel and official foreign exchange markets as in fact closely related in Poland. There were mechanisms that limited the segmentation between the two markets, via individuals' foreign currency deposits. Moreover, official intervention during the first four months of 1990 to keep the parallel and official exchange rates fairly close had been relatively minor. The situation was thus not one in which fundamental questions about an appropriate rate remained; a rate had been established which had proven workable. The parallel market, furthermore, was not an isolated one subject to restrictions, but was almost completely open and therefore unlike many such markets under Fund-supported programs. It would be important that any move toward unification be done in a manner that preserved the most liberal aspects of the current parallel market. The signaling function would not be lost, even in a managed floating system. Official intervention could serve as a signal.

The staff would tend to agree with an Executive Director's skepticism about a possible payments union in Eastern Europe, the Deputy Director of the Exchange and Trade Relations Department indicated. The aim of East European countries should be, and was, integration into the world economy, and a possible payments union among a more limited number of countries in that region should be considered in light of that ultimate aim. Given the limited trade among the East European countries at present, it would be difficult to envisage a payments union in the region.

Mr. Filosa observed that Executive Directors had expressed some concern at essentially three or four critical issues. Directors' concern at the fall in production and employment was of course shared by the authorities, whose macroeconomic policy commitments--nonetheless--clearly remained unchanged. As envisaged from the start of the program, the nominal anchors of the exchange rate and wages would remain the principle means of controlling any possible resurgence of inflation, and would not be relaxed.

The staff representative from the European Department had indicated that there had been some resumption in private activity, reflected in the increasing numbers of private firms in the market, Mr. Filosa continued. The productive system has also shown some encouraging flexibility through the shift in production from the domestic market to the export market. A further qualifying factor to the recorded fall in production was the point that the January 1990 figures for socialized industries' output might probably reflect a fall originating in 1989. Production trends have been carried over between the two years. It was difficult, nonetheless, to evaluate the evidence in Supplement 2 to EBS/90/77 indicating that there had been somewhat of a stabilization of production.

Compared with the Board discussion in February 1990 approving the stand-by arrangement, Directors seemed to be anxious to speed the process of structural reform beyond what was probably possible, Mr. Filosa remarked. That was especially the case with respect to privatization. The staff paper had noted, importantly, that the authorities were clearly committed to establishing a transparent system of privatization, including the creation of an agency for privatization under the Prime Minister's office. A second, and critical, element to the credibility of the whole process of privatization--and somewhat more encouraging than in previous such undertakings--was the need to have precise and transparent valuation procedures for enterprises. With Western help, the authorities would establish those procedures and value, select, and sell viable firms. On his recent visit to Washington, D.C, the Prime Minister had informed him that the Government intended to proceed quickly in the area, and that it did not intend to maintain the existing predominance of the state enterprise sector, but that Poland needed assistance in making the valuation process transparent and in organizing the transfer of technology. The time required was an important consideration in considering the transformation of Poland's economy. Even in the West, the privatization would require several years to complete. In any event, the creation of new firms would take time in view of, inter alia, the question of the sheer physical availability of new machinery.

The process of privatization was under way and the authorities had adopted the appropriate--and critical--principle of establishing a privatization agency and transparent procedures for selling state enterprises to domestic and foreign concerns, Mr. Filosa concluded. Those clearly enunciated principles should be taken into account when evaluating the speed of privatization and the many problems that would arise.

The Executive Board then took the following decisions:

Review Under Stand-By Arrangement

1. Poland has consulted with the Fund in accordance with paragraph 4(b) of the stand-by arrangement for Poland (EBS/90/11, Sup. 2, 2/8/90) and paragraph 20 of the Memorandum attached to the letter dated December 22, 1989 from the Deputy Prime Minister and Minister of Finance and the President of the National Bank of Poland.

2. The letter dated April 17, 1990 from the Deputy Prime Minister and Minister of Finance and the President of the National Bank of Poland shall be annexed to the stand-by arrangement for Poland, and the letter and Memorandum dated December 22, 1989 shall be read as modified and supplemented by the letter dated April 17, 1990.

3. Accordingly, paragraph 4(a)(i) and (v) of the stand-by arrangement for Poland are amended to read:

"(i) the limit on the development of wages referred to in paragraph 11 and Appendix A of the Memorandum, as modified by the letter of April 17, 1990; or"

"(v) the target for the minimum cumulative change in net international reserves in convertible currencies of the banking system referred to in paragraph 19 and Appendix E of the Memorandum, as modified by the letter of April 17, 1990; or"

4. The Fund finds that the first of the reviews contemplated in paragraph 4(b) of the stand-by arrangement has been completed.

Decision No. 9427-(90/74), adopted
May 14, 1990

Exchange System

Poland maintains multiple currency practices arising from the operation of a parallel exchange market and a convertible foreign exchange coupon scheme, both of which are subject to approval under Article VIII, Section 3. In view of the authorities' intention not to allow the divergence of the parallel rate from the official rate to become significant and the measure the authorities have taken to phase out the coupon scheme, the Fund grants approval of these multiple currency practices until the completion of the next Article IV consultation with Poland or February 28, 1991, whichever is earlier.

Decision No. 9428-(90/74), adopted
May 14, 1990

2. TUNISIA - REVIEW UNDER EXTENDED ARRANGEMENT

The Executive Directors considered the staff paper on the third review under the extended arrangement for Tunisia approved on July 25, 1988 (EBS/90/71, 4/18/90).

The staff representative made the following statement:

> Since the issuance of the staff report (EBS/90/71), the following information has been received by the staff.
>
> Preliminary information received from the Tunisian authorities on the first months of 1990 shows that the program remains broadly on track. At end-April, gross official reserves stood at the equivalent of about 2.6 months' of imports. The net foreign assets of the Central Bank were SDR 423.1 million, and official external borrowing of 1-12 years' maturity reached SDR 4.7 million. Data are not yet available on the other performance criteria for end-April, but it is probable that they have been attained, even though preliminary first-quarter data indicated that net credit to the Government and total domestic credit were both somewhat above the indicative end-March targets. As regards the budgetary position, both receipts and expenditure were higher than the indicative targets for March, but the overall fiscal

targets appear attainable. Inflation continued to decelerate, reaching a rate of 6.4 percent on a 12-month basis in February.

The overall balance of payments evolved better than expected. According to preliminary data for the first quarter of the year, imports and exports grew more strongly than expected. Loan drawings were higher and external debt-service lower than programmed. The authorities are closely monitoring the performance of imports, which will need to slow considerably in the coming months if the trade deficit is to remain within easily manageable limits.

In April and early May 1990, new measures were taken to reduce the expenditure on consumer subsidies by the Caisse générale de compensation. These are estimated to produce savings of D 26 million on a full-year basis and D 18 million in 1990. Prices of barley were raised by about one third, and of the corn and soybean cake used for animal feed by about one fourth. In addition, fertilizer prices were raised substantially, and are expected to reduce subsidy costs by about 50 percent on a full-year basis.

Mr. Ghasimi made the following statement:

My Tunisian authorities consider that the staff paper provides a fair and reasonable assessment of the economic performance in Tunisia, and concur with the staff's analysis and conclusions.

In evaluating the progress made so far, the authorities continue to be cautious. On the one hand, they are encouraged by the indications of a positive reaction from the private sector to a much more open economic environment, evidenced by the recovery of private sector investment after several years of decline, and by the continued satisfactory performance in the export sector. On the other hand, the vulnerability of the economy to exogenous factors, as well as the necessity of accommodating employment needs, continues to pressure the authorities in their efforts to achieve a delicate balance between adjustment and growth.

Directors may recall that the discussions during the past Board meeting on Tunisia (EBM/89/167, 12/20/89) centered around three main areas of interest: first, the importance of adopting a tight monetary stance to bring the program back on track; second, the need to move more expeditiously toward removing the remaining preferential lending rates; and third, the importance of reassessing the subsidy policy.

With regard to monetary policy, the staff paper details the measures introduced in late 1989 that facilitated achievement of the objectives of the monetary program. These measures included a sizable reduction in the volume of liquidity offered by the Central Bank in the money market, the sale of treasury bills--essentially to nonbank institutions--for an amount exceeding the programmed level, and the introduction of a temporary additional reserve requirement. As a result, interest rates in the money market increased substantially and all performance criteria for December 1989, including those on domestic credit and on net foreign assets of the Central Bank, were observed.

The authorities believe that, beyond the attainment of the quantitative targets of the program, the major gain in 1989 was the realization that macroeconomic policies and, more importantly, their timely adaptation to changing circumstances, continue to remain critical elements of the adjustment program. In this connection, and with the benefit of hindsight, the minor deviations from the program were, in the final analysis, helpful in testing the authorities' preparedness, as well as the availability of appropriate instruments, to deal with unexpected factors and to introduce the necessary corrective actions.

With respect to subsidy policy, further momentum was gained in early 1990 with the finalization of a comprehensive study providing a set of alternatives and recommendations for better and more efficient targeting of intervention by the Subsidy Fund, and for reducing the overall cost of the scheme. This reform is being supported by a policy of gradual price adjustment initiated in August 1989. For 1990, and as a first step, the prices of fertilizer and animal food were increased in early May, thus providing a saving of about D 18 million over the remainder of 1990. Further price increases are planned and will be spread over the rest of 1990.

Regarding the preferential lending rates policy, the authorities wish to reaffirm their commitment to phasing out this scheme, which is no longer compatible with the objective of achieving better allocation of resources. To this end, specific measures will be implemented before June 1990 with the objective of reducing by one third the proportion of credit offered at preferential rates, namely, from 22 percent to 15 percent of total credit.

Directors may note that the Tunisian authorities have not made any purchases under the extended arrangement in 1988 and 1989. Furthermore, they are currently requesting a reduction in access under the arrangement, from 150 percent to 100 percent of quota. They have also indicated that they do not intend to use the Fund's resources for the time being, and that the issue of purchases during the remaining period of the arrangement will be considered on the occasion of the next program review.

Mr. Landau made the following statement:

I am pleased to acknowledge the favorable economic performance of Tunisia under the extended arrangement. Despite adverse exogenous developments, the authorities reacted quickly in 1989, with restrictive fiscal and monetary measures, and succeeded in bringing the program back on track. Tunisia's economic performance in 1989 resulted from the impressive set of economic reforms undertaken since 1986: GDP grew by 3.1 percent despite the prolongation of the drought; inflation was kept under control; and the current account deficit was limited to 3.6 percent of GDP. I also note that the debt-service ratio was reduced significantly.

But the most positive development is that private investment has finally recovered from several years of decline, with estimated growth of such investment of 8.5 percent in 1989, and 44,000 new jobs have been created in the nonagricultural sector. These developments bear witness to the considerable success of the authorities' strategy and underline the priority to be given to the pursuit of strict demand-management policies and steady implementation of structural reforms.

On the expenditure side of fiscal policy, the main area of concern remains the level of consumer subsidies. Further overruns occurred in 1989 as a consequence of the second year of drought and high international cereal prices--although the overruns could have been larger had the authorities not taken corrective price measures in August 1989. I note with satisfaction the planned decline in subsidies from 3.7 percent of GDP in 1989 to 2.8 percent in 1990, and I encourage the authorities to initiate as soon as possible a reassessment of their subsidy policy, with the help of the World Bank, pending the near conclusion of the study under way. I also welcome the strict orientation of wage policy in the public sector.

On the revenue side, I am pleased to note that the authorities have reached their objective in this area, and that a comprehensive direct tax reform has been introduced, including a broadening of the tax base, a substantial reduction in exemptions, and a lowering of tax rates. Nevertheless, I agree with the staff that the authorities should monitor tax receipts closely in order to ensure the revenue neutrality of the tax reform.

I welcome the restrictive monetary stance adopted in 1989 and the use of more instruments to control the volume of liquidity; in particular, the introduction of a weekly treasury bill auction is a welcome development. However, I wish to insist on two important issues: first, I encourage the authorities to eliminate the additional reserve requirement, which is similar to a credit control mechanism, and to rely more exclusively on flexible interest rates; second, a further phasing out of preferential lending rates--which still cover 22 percent of total credit--and the elimination of the limits on lending rate spreads are of some importance to ensuring better allocation of resources.

The authorities have to be commended for the broad range of structural reforms that they have implemented already. However, I would like to stress the need for them to pursue price liberalization and the opening of the economy. In both areas, some delays occurred in 1989, with 70 percent of the prices of manufactured goods being liberalized against only 22 percent of distribution margins. Furthermore, the program has been lagging somewhat in the area of import liberalization, with only 64 percent of imports freed of quantitative restrictions at end-1989. I fully share the staff's view that the authorities should avoid providing excessive protection to domestic industries and proceed promptly with the planned reforms.

I commend Tunisia for its careful management of external debt and limited recourse to nonconcessional loans. This is all the more warranted, since external debt payments constitute 12 percent of current budgetary expenditure.

I stress that Tunisia is starting to accrue "dividends" from the far-reaching economic reforms introduced in 1986. My authorities fully support the authorities in their endeavors, and encourage them to pursue their efforts steadily.

Mr. Al-Jasser said that it was encouraging to note that the authorities' efforts to tighten their fiscal and monetary policies had succeeded in bringing the program back on track. Indeed, not only were all end-December 1989 performance criteria met, but policies were tightened sufficiently to meet virtually the initial, unmodified program targets. He was confident that Tunisia's unwavering commitment to the program would ensure that any necessary policy adjustments would be made if and when the need arose. He especially wished to commend them for their decision to forsake a portion of the access under the arrangement in light of the success of their adjustment effort. It was to be hoped that other members persevering in their adjustment efforts would be able to follow Tunisia's exemplary performance.

Since he broadly agreed with the staff paper and with Mr. Ghasimi's opening statement, he would make only a few comments, Mr. Al-Jasser continued. It was clear that the primary task facing the authorities at present should be to consolidate their achievements through maintaining the broad thrust of their previous policies, in order to attain sustainable growth and external viability. In that context, it was reassuring to note that strong export performance had been realized in the nontraditional sectors, such as textiles and mechanical industries. Nonetheless, given that Tunisia's traditional sectors remained highly vulnerable to exogenous shocks, it was imperative that the economic diversification and the economy's outward orientation were reinforced. Therefore, the authorities needed to adopt further measures to enhance the attractiveness of Tunisia to foreign direct investors.

Naturally, that was predicated on the need to maintain external competitiveness, Mr. Al-Jasser stated. In that context, he warmly welcomed the authorities' intention to rely on domestic policies in preserving the economy's external competitiveness, as demand-management policies should continue to target a reduction in inflation. In that regard, the intention to pursue a strict wage policy based on merit increases was especially warranted. In addition, he urged the authorities to persevere in their fiscal reform effort. And, in that connection, he welcomed the recent measures mentioned by Mr. Ghasimi giving special attention to the rationalization of the subsidy scheme, with a view to improving its efficiency and to enhancing equity.

With respect to monetary policy, the tight stance envisaged for the 1990 program was appropriate, Mr. Al-Jasser commented. Although the increased reliance on market-based instruments was commendable, the temporary prudential measure of increasing the reserve requirements seemed warranted in light of the need to acquire greater experience with market-based instruments. He also welcomed the authorities' intention to reduce by one third the proportion of credits offered at preferential rates, and encouraged them to proceed further along those lines.

The proposed measures for the 1990 program were in line with the broad targets of the extended arrangement, Mr. Al-Jasser remarked. Moreover, he agreed with the authorities' view, as expressed by Mr. Ghasimi, that a major gain from the adjustment in 1989 had been the realization that the ability to respond to changing circumstances was critical to the longer-term adjustment of the economy. There was thus a need to develop credible policy instruments in the macroeconomic area. Clearly, that need transcended the individual case of Tunisia. With those comments, he supported the proposed decision.

Mr. Othman made the following statement:

> My chair is pleased to note the continuing improvement in Tunisia's economic situation and the fact that, despite adverse exogenous factors, particularly the prolonged drought, high cereal import prices, and the large decline in the tourist receipts, the program objectives were met. Tighter fiscal and monetary policies succeeded in bringing about this commendable result while avoiding, at the same time, the negative impact of the exogenous factors. The authorities are to be commended for this performance and for their continued firm commitment to the macro and

structural adjustment process. The 1990 program reflects their determination to achieve their growth and adjustment objectives, and I am hopeful that, with continued and sustained efforts, they will be able to steer the economy toward internal and external viability.

The positive reaction from the private sector to an open economic environment is a healthy sign, which should be further strengthened through further liberalization of market forces. As the staff paper provides a fair and reasonable assessment of Tunisia's economic performance, with which the authorities concur--as indicated in Mr. Ghasimi's opening statement--I shall limit myself to making a few remarks.

Employment creation and a reduction in the high rate of unemployment remains a major challenge to the authorities. It is therefore important that firm and timely implementation of the program be pursued vigorously so as to promote growth and investment. In this regard, it is encouraging to note the expected, stronger growth in investment, particularly after its decline over the past several years, as well as the continued satisfactory performance of the export sector. I hope that this improvement will be sustained in the coming years.

I welcome the intention to phase out preferential lending rates as well as to decontrol lending spreads in the future, and to replace them by a more market-oriented system, which should, inter alia, impart greater flexibility to the determination of interest rates. However, it is important that a cautious approach be pursued, pending the process of liberalization of the financial system. In this connection, I share the authorities' concern about the current inadequate competitive environment in the banking system, which might trigger an unwarranted surge in interest rates subsequent to decontrol of the spreads.

The process of public enterprise reform has gathered some welcome momentum, with some 40 enterprises having been privatized so far. However, most of the privatized enterprises are those that are financially sound, and further privatization will cover only those enterprises that require restructuring prior to sale. This phenomenon--together with the authorities' legitimate concern about the rate of job losses associated with the privatization process--raises some questions regarding the impact of those developments on the momentum gained in the area already. The staff or Mr. Ghasimi could usefully comment on this point.

I note the concern expressed by the staff with regard to Tunisia's unjustified or excessive protection of domestic industries, and its advice to the authorities to proceed expeditiously with the planned price and trade liberalization. I share the staff's concern and advice, and would like only to extend this advice to Tunisia's trading partners, given that the country's medium-term balance of payments viability hinges significantly upon the assumption of export growth.

The authorities, I would stress, have undertaken courageous measures. Their decision not to make any purchase under the extended arrangement in 1988 and 1989, as well as to forsake a portion of the access under the arrangement, reflects not only the success of their adjustment effort so far, but also their confidence in the future of the adjustment. My chair has no doubts about Tunisia's commitment to face the challenges ahead, and can fully support that country's endeavors.

Mr. Yoshikuni made the following statement:

During the second year of the extended arrangement, Tunisia faced severe economic challenges, caused mainly by exogenous factors, such as drought and a rise in import prices. I am pleased to note, therefore, that the authorities have succeeded in bringing the economy back on track, although the program targets had to be adjusted slightly. Also, I commend their decision to reduce access under the arrangement on the occasion of the current review. Since Tunisia has made no drawings so far, it has accumulated rights to draw approximately SDR 110 million in Fund resources, which is a fairly large amount for the Tunisian economy. Although Tunisia's drawing rights are completely justified by the nature of Fund drawings, such a large drawing might not be helpful if the country were not in need of immediate liquidity. Furthermore, such an accumulation of undrawn rights would give rise to uncertainty about the Fund's liquidity position. Therefore, to the extent that the undrawn rights are unnecessary, a reduction in the access of the original arrangement is a prudent step to buttress the monetary character of the Fund.

I broadly agree with the staff paper and Mr. Ghasimi's opening statement on the program for 1990. In particular, I broadly support the authorities' market-oriented approach to monetary policy. Especially noteworthy is the successful implementation of the treasury bill auction system. However, the slow progress in the area of preferential lending rates and lending spreads is a cause for concern. Market-based instruments cannot work efficiently unless they are supported by comprehensive measures, including, inter alia, the liberalization of interest rates. There are some occasions on which the coexistence of liberalized policy instruments and controlled interest rates would be more harmful than a completely controlled system. I would therefore urge the authorities to expedite the process of phasing out preferential lending rates and decontrolling lending spreads.

I fully support the comprehensive direct tax reform aimed at simplifying the tax brackets while broadening the tax base, although, like the staff, I would stress the importance of monitoring its implementation closely. Nevertheless, I am somewhat concerned about the decline in petroleum-related revenues, resulting from the progressive depletion of petroleum extraction. In this connection, postponing the increase in excise taxes on petroleum products does not seem to be an appropriate decision, even if it has not exacerbated the fiscal position, thanks to higher oil prices.

In the external area, I associate myself with the views of Mr. Al-Jasser in emphasizing the importance of foreign direct investment.

Much remains to be done in reducing consumer subsidies, expected to amount to 2.8 percent of GDP in 1990, even after the substantial decline in those subsidies in 1989. In this connection, I would recommend a substantial across-the-board reduction in all subsidies, instead of a targeted policy, involving product or income-group differentiation, which would be too complicated to manage and would result in inefficiency and distortion of the economy. While I recognize the need to protect low-income groups from the effects of price adjustments, particularly in the difficult period following the January 1990 floods, this need would be met more efficiently through direct and properly targeted social security assistance, instead of through maintaining a complex subsidy system. With these remarks, I support the proposed decisions.

Mr. Grosche said that Tunisia's performance under its extended arrangement confirmed his view that there was indeed no trade-off between trade adjustment and growth. The authorities' program of cautious macroeconomic policies combined with structural reforms was bearing fruit; Tunisia's economy was currently in much better shape than a few years previously. He welcomed, in particular, the active response of the private sector to the progressive liberalization of the economy.

Given the positive impact of the economic program, it had been possible for the authorities not to draw under the arrangement to date, Mr. Grosche noted. That fact, and the authorities' request for a reduction in their access under the arrangement, from 150 percent of quota to 100 percent of quota, could both serve as good examples of the "stand-by" character of Fund resources. Tunisia was a remarkable case, particularly at a time when many other indebted countries were requesting ever more financial assistance from the Fund.

He was intrigued by the information provided in Chart 1 of the staff paper, indicating that, after a substantial initial depreciation of the exchange rate at the beginning of the adjustment process, the rate had been held approximately stable thereafter, Mr. Grosche continued. The generally firm demand-management policy and the exchange rate policy pursued since 1986 had helped greatly in the structural adjustment of the external sector.

To consolidate the gains achieved to date, it remained essential for the authorities to ensure that no domestic policy slippages arose, Mr. Grosche commented. Tunisia demonstrated the dangers of a monetary policy that was not been kept on an even keel; domestic credit of the banking system had exceeded the performance criterion in the first, second, and third quarters of 1989, and interest rates had been allowed to decline significantly. He could not but agree with the great emphasis that the staff placed on the pursuit of an active interest rate policy, for achieving the program's macroeconomic and structural objectives. Other areas in which constant vigilance, and more, and faster, progress were desirable were in the fields of consumer subsidies and price and import liberalization. The staff would look more closely into those areas when it conducted the fourth review of the arrangement; he was confident that appropriate understandings would be reached. Tunisia's track record spoke for itself. The country was deserving of continued Fund support, and he therefore supported the proposed decision.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/90/73 (5/11/90) and EBM/90/74 (5/14/90).

3. PARAGUAY - TECHNICAL ASSISTANCE

In response to a request from the Paraguayan authorities for technical assistance in the central banking field, the Executive Board approves the proposal set forth in EBD/90/141 (5/8/90).

Adopted May 11, 1990

4. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 89/124 through 89/126 are approved.

5. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/90/125 (5/10/90) is approved.

APPROVED: March 21, 1991

JOSEPH W. LANG, JR.
Acting Secretary