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Minutes of Executive Board Meeting 90/15

3:00 p.m., February 5, 1990

M. Camdessus, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
G. K. Arora	
F. Cassell	C. Enoch
C. S. Clark	G. C. Noonan
Dai Q.	Zhang Z.
T. C. Dawson	C. S. Warner
	M. E. Hansen, Temporary
J. de Groote	J. Prader
E. T. El Kogali	L. B. Monyake
E. A. Evans	S.-W. Kwon
E. V. Feldman	
	M. A. Fernández Ordóñez
R. Filosa	
M. Finaish	A. M. Othman
M. Fogelholm	I. H. Thorláksson
M. R. Ghasimi	
G. Grosche	B. Goos
	T. Sirivedhin
A. Kafka	L. M. Piantini
	J.-F. Cirelli
	G. Serre, Temporary
Mawakani Samba	D. Saha, Temporary
Y. A. Nimatallah	M. Al-Jasser
G. A. Posthumus	G. P. J. Hogeweg
K. Yamazaki	K. Ichikawa, Temporary

L. Van Houtven, Secretary and Counsellor
K. S. Friedman, Assistant
S. L. Yeager, Assistant

Also Present

IBRD: P. Nouvel, Europe, Middle East, and North Africa Regional Office. Administration Department: H. J. O. Struckmeyer, Deputy Director; T. Cole, D. S. Cutler, U. P. Dimitrijevic, A. D. Goltz, N. S. Jackson, P. J. McClellan, M. Oka, H. Wiesner, L. A. Wolfe. African Department: M. Touré, Counsellor and Director; E. L. Bornemann, Deputy Director; E. A. Calamitsis, Deputy Director; G. E. Gondwe, Deputy Director; A. I. Abdi, S. J. Anjaria, W. J. Byrne, C. V. Callender, G. C. Dahl, M. M. Mateus, O. J. Nnanna, O. Nyawata, E. Sacerdoti. Asian Department: G. Szapary. European Department: M. Russo, Director; C. Cottarelli, P. C. Hole, F. M. Lakwijk, M. Mecagni, R. J. Ossowski, M. R. S. Sebastiao, T. A. Wolf. Exchange and Trade Relations Department: L. A. Whittome, Counsellor and Director; J. T. Boorman, Deputy Director; M. Allen, A. Basu, H. M. Flickenschild, M. Shadman-Valavi. External Relations Department: H. P. Puentes. Fiscal Affairs Department: R. Holzmann, G. F. Kopits. Legal Department: W. E. Holder, Deputy General Counsel; A. O. Liuksila. Middle Eastern Department: E. B. Maciejewski. Research Department: D. Lane, F. Larsen. Treasurer's Department: S. J. Fennell. Western Hemisphere Department: S. T. Beza, Counsellor and Director. Special Advisor to the Deputy Managing Director: W. A. Beveridge. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: N. Adachi, J. O. Aderibigbe, J. Basiuk, M. B. Chatah, A. Gronn, Z. Iqbal, A. R. Ismael, J. M. Jones, K.-H. Kleine, J.-L. Menda, A. Napky, P. Péterfalvy, F. A. Quirós, A. Raza. Assistants to Executive Directors: T. S. Allouba, J. R. N. Almeida, B. A. Christiansen, E. C. Demaestri, A. Fanna, M. A. Ghavam, J. Gold, S. Gurumurthi, J. Heywood, L. Hubloue, A. Iljas, C. J. Jarvis, K. Kpetigo, C. Y. Legg, W. K. Parmena, A. Rieffel, H.-J. Scheid, J.-P. Schoder, M. J. Shaffrey, J. C. Westerweel, Yang J.

1. POLAND - 1989 ARTICLE IV CONSULTATION, AND STAND-BY ARRANGEMENT

The Executive Directors continued from the previous meeting their consideration of the staff report for the 1989 Article IV consultation with Poland and Poland's request for a 13-month stand-by arrangement in an amount equivalent to SDR 545 million (EBS/90/11, 1/18/90). They also had before them a letter of intent (EBS/90/3, 1/3/90) and a letter that the Managing Director had sent to Fund Governors and finance ministers of Fund members that were major creditors of Poland (EBS/90/18, 1/31/90), a statement by the staff at EBM/90/10 (1/22/90) on the closing of Poland's financing gap, and a background paper on recent economic developments in Poland (SM/90/18, 1/23/90). As background material they also had before them a study on market-oriented reform in planned economies (SM/89/202, 10/5/89), and staff papers on the reform experience in China (SM/89/205, 10/6/89), Hungary (SM/89/203, 10/5/89), and Poland (SM/89/204, 10/6/89).

The Director of the European Department recalled that Mr. Cassell had raised three very difficult issues concerning the design of the program in Poland: the sequence of measures; sustainability; and whether measures could succeed now when they had not done so before. Both the authorities and the staff had had little choice in the area of sequencing, as the rate of inflation was already very high--50 percent in the month of October alone--price liberalization, particularly in certain areas, had already taken place throughout most of the year, and wages had kept ahead of prices for various reasons, increasing by about 30 percent in real terms by the end of September. In the circumstances, the authorities had had no choice but to implement a program that was bold and comprehensive. Past efforts to go step by step and tackle one area at a time had not been credible and had not succeeded. The new Government that had assumed office in September had both the opportunity and the determination to act differently from the past.

The question of sustainability was of course crucial, the Director continued. Sustainability was linked to the immediate attack on inflation and later to an adequate supply performance in response to the reform effort and the improved incentives in the system, including the incentive to save in zlotys. The staff could not yet say whether the various risks involved had been overcome, or whether the rate of inflation was likely to fall more or less in line with the target in the program scenario. The staff harbored no illusions about its ability to predict the monthly rate of inflation with great accuracy. Indeed, the inflation figures contained in the scenario were based on certain policy assumptions; they were not an independent forecast.

The staff certainly felt that the program could succeed, but with the risks that the staff had openly indicated, the Director said. The program's success would depend in part on the political situation in Poland. The present Government had much stronger support than any previous government that had attempted to introduce reforms. The Government was determined to build on that support and knew that that support could not last if inflation continued at a very high rate over a long period. It was for that reason that the authorities had decided to implement a stabilization program that was bold enough to address the inflation issue head on; this was not a technical judgment made by the staff and the Minister of Finance; it was clearly a political judgment.

The staff and the authorities had discussed several possible policy mixes involving wage policy, monetary policy, and exchange rate policy and had concluded together that the proposed program offered the greatest advantages while minimizing the risks, even though those risks remained high, the Director commented. The importance of the safety net was underscored by the fact that the staff and the authorities could not foresee with any degree of certainty the likely impact of the program on employment and production, given the rigidity of the system and the completely changed environment in 1990. The authorities' figure of a 5 percent decline in production was a guesstimate, not a projection based on the impact of policies on economic variables. Much would depend on the amount of external support, too. Imported inputs were crucial, and the decline in 1989 in production had been caused partly by the disruption of imports of raw materials from the nonconvertible currency area. In persistently stressing the importance of the safety net, the staff had underscored the need to provide funds in the budget for the safety net and, more important, had insisted on the need to build the institutional framework, so that institutions could then spend funds in the most efficient possible manner in coming to the help of those in need. In that connection, financial and technical assistance from abroad was urgently required and was clearly welcomed by the authorities.

The staff did not have any forecasts for unemployment, the Director said. The program provided funds to support 400,000 unemployed persons, about 2 1/2 percent of the work force in manufacturing. However, that figure covered only 1990. Since the program of restructuring would continue in 1991, the staff would not rule out a possible further increase in unemployment, particularly structural unemployment, in 1991. Therefore, strengthening the safety net and support from abroad would have to be sought under future programs with Poland.

The staff and the authorities had concluded that, given the very high rate of inflation and the fact that price liberalization had already been started, a price freeze would not have been appropriate under the proposed program, the Director said. The price distortions in the country were such that a freeze on prices at the current distorted level would probably have had deleterious effects. Poland did not have competitive markets, and the authorities were well advised to strengthen legislation in that area as much as possible. The movement to free price formation was not universal: some key prices, such as energy, rents, transportation, and some other social services, had been adjusted but not fully liberalized. Some observers might feel that the pace of liberalization was too slow. The staff, however, felt that the pace was sufficiently rapid--perhaps somewhat too rapid; after all, in 1988, 75 percent of prices were controlled, compared with only about

10 percent at present, including prices that were controlled in many other countries. In the circumstances, the authorities probably had had no other choice. Some price adjustments--for example, energy prices--had been particularly substantial and needed.

As to overall policy with respect to energy prices, the Director remarked, the Polish authorities' letter of intent clearly stated that their aim was to move domestic prices for all energy products closer to prices on world markets over time. The staff agreed with the authorities that the price adjustment could not be made in a single step. Moving energy prices merely from where they were to a level at which production of coal would become profitable implied 500-600 percent price increases, which had been the main cause of the inflation in January 1990. Hence, moving prices farther than that in a single step would have put the program in danger, thus outweighing any gains from that move, particularly after the devaluation of the currency.

The staff was not certain of the current precise inflation rate, the Director said. Reports from Poland indicated that prices at January 15 had increased from December 15 in excess of 60 percent, compared with the staff's price profile for January of 45-50 percent. Apparently some prices had fallen in the last two weeks of January, but the rate of inflation at the end of January would not be known until mid-February. The significant margin for error in the area of inflation estimates was reflected in the fact that the authorities had initially indicated, during the staff's visit to Poland in mid-December, that the rate of inflation for that month was about 30 percent, had changed the estimate to 20 percent during the mission's visit, and had indicated another estimate, 28 percent, in early January. The final figure for the month was now 18 percent. While the staff could not say for certain what the rate of inflation was at present, it was clear that, in the first half of January, prices, particularly food prices, other than those that had been adjusted by design, had increased more than expected because of food supply and distribution problems and because of the lags in the acceptance by pro-ducers, particularly in the agricultural sphere, of the idea that the rate of inflation would fall, and that it was worth holding zlotys rather than stocks of goods and grain. The staff hoped that price performance in the second half of January would be much better. Notwithstanding the information on the price performance in the first half of January, the Government had informed the staff that it was sticking with the incomes policies that had been adopted--that was clearly a sign of the Government's determination to deal decisively with inflation.

It was important for the exchange rate to be the second anchor of the system, and the effectiveness of that anchor naturally would depend very much on the ability to maintain the first anchor, incomes policy, the Director commented. Since the pressure in the free market on the zloty had decreased in the last quarter of 1989--in fact, the zloty had appreciated in that market after a very sharp depreciation in the third quarter--the staff felt that it was possible to unify the exchange rate at an appropriate level and subsequently to defend it successfully. To that end, the authorities had sought a bridge loan from the BIS, and several friendly countries had set up the Stabilization Fund to support any needed exchange market intervention. The staff and the authorities had assumed that intervention could well be needed in January, when it was likely that the exchange rate would be tested, but that had not in fact proved necessary. There had been a switch, particularly by enterprises, from foreign currency to zloty deposits, and there had been some sales of dollars by the household sector through the "kantor" market. In fact, the exchange rate in the latter market, which was reserved to households, was just below the official rate.

Another important element in the program was interest rate policy, the Director remarked. Interest rates in the first months of the program had been set very high--with a 36 percent per month central bank refinance rate, leading to rates of up to 50 percent per month on lending to enterprises, and 35 percent for time deposits of one year or longer. In the absence of a financial market, it was difficult to fine-tune interest rate policy to respond immediately to the exchange rate. That was why a backstop of foreign exchange reserves was needed for intervention. There was of course a choice in Poland between holding zlotys--and particularly zloty time deposits--and dollars, but, at present, holding zlotys was the better financial bet. The staff hoped that that bet would be confirmed and lasting, but that would depend on maintaining the current policy stance. Indeed, one of the problems at present was that the financial market could not quickly absorb shocks, and it was for that reason that much of the Fund's technical assistance, particularly from the Central Banking Department, was concentrated in the financial market area. The staff was especially looking at the possibility of establishing a money market, with a view to gathering information to permit a timely response on the interest rate side to avoid undue pressure on the exchange rate. Those efforts would take time.

Exchange convertibility was somewhat limited, in the sense that not all current transactions by individuals were free, the Director continued. For instance, individuals were still not free to receive foreign currency at the official exchange rate for tourist purposes. But they were certainly free now to obtain foreign exchange for imports and enterprises and could obtain it for imports and bona fide transactions related to, e.g., royalties as well as debt or other payments for services.

There was already a kind of capital account convertibility in Poland that some countries in Europe aimed to achieve only by July 1, 1990, the Director commented, namely, the ability to hold foreign currency deposits by residents in the country. That practice was the result of past policies that had tried to attract foreign exchange by allowing Polish citizens to maintain deposits in foreign exchange. As a result of that practice, reserves that had been so acquired had been largely spent, and at present those deposits had only a fractional coverage in foreign exchange. Eliminating that privilege might have created a run on those deposits, with serious consequences. For that reason, households continued to have the right to maintain those deposits and to add to or withdraw from them. It was through interest rate policy that the staff and the authorities hoped that the desired gradual switch into zlotys would occur.

The surrender requirement of exporters was indeed a restriction, but one that many countries with fully convertible currencies had maintained for some time, the Director said. In the particular circumstances of Poland, the net effect of dispensing with such a requirement would not necessarily have been positive. Previously, because of the scarcity of foreign exchange, exporting enterprises had had the right to maintain a portion of their foreign exchange earnings in particular accounts, and they had been able to sell such foreign exchange at auction. Those arrangements were a reflection of the fact that enterprises had known that they could not always obtain foreign exchange from the authorities at the official exchange rate for their bona fide payments. An important advancement as a result of the changes introduced on January 1 was that enterprises could now obtain foreign exchange for zlotys from the central bank at the official rate without any preconditions for import purposes, thereby obviating the need for the previous exchange retention arrangements. The new availability of foreign exchange to the enterprises was a sign of confidence, and the arrangements applied to all enterprises equally.

Another important question was why the same wage policy that had failed in the past should be expected to succeed now, the Director said. There was no precise technical answer, but it was important to remember that the present Government had shown that it could enforce such a policy and--unlike previous administrations--was prepared to enforce the tax payments that were necessary to complement that policy. However, while the authorities had had no option but to introduce the incomes policy to combat inflation, that policy clearly could not be maintained for very long. The authorities were giving thought as to how the future wage system should develop and, in that connection, they clearly continued to attach importance to promoting social justice. The wage policy applied effectively only to the socialized sector; there was more de facto wage flexibility in the private sector. Hence, a scheme was in place that was, in fact, similar to the one Mr. de Groote had favored, under which wages in the socialized sector were subject to government policy while the nonsocialized sector was free to set its own wages. In that connection, the obvious problem in Poland was that the so-called socialized sector accounted for more than 95 percent of the economy; hence, in effect, the Government's incomes policy was being extended to virtually the entire economy. The limit under that policy was on the wage bill. Therefore, if enterprises rationalized themselves, their productivity would increase because of the improved performance of production and because of a reduction in hidden unemployment; some scope for wage differentiation should then be possible.

The contingency measures for fiscal policy were described in the staff report, the Director noted. They included expenditure and revenue measures.

A particular concern was the pressure that was expected on the budget in the first quarter, which was partly seasonal and partly a reflection of the fact that inflation had a very negative effect on the government's accounts. The rate of inflation was expected to be very high in the first three months of the program period and was expected to decline in the following months. A program objective was to reduce the initial deficit considerably, since in those crucial initial three months excessive liquidity generated by the government should be avoided. Measures toward that end, which were described in the staff report, included limitations on monthly budget authorizations, and requiring that expenditure out of the reserve funds by ministries be approved by the Ministry of Finance. A long list of contingency revenue possibilities, in addition, had been identified jointly by the Fund staff and officials.

In the fiscal area, the relevant performance criterion was the core central government, rather than some other measure of the government position, because of the limited availability of monthly data in Poland, the Director explained. Data on the whole government sector were available only at the end of the year, which of course would not permit adequate monitoring by the Fund. As the private sector increased in the future, a subceiling on credit to the socialized enterprise sector as well as the government might eventually be worth considering. But one would obviously need to have a very clear understanding of which enterprises should be covered, and why, as well as an ability to collect adequate information on their accounts--which was not the case at present.

With the undeveloped state of Poland's financial market, the authorities inevitably had to use both price and quantitative constraints to implement monetary policy, the Director said. This approach was certainly not the preferred one, but the only reasonable one in the circumstances. The authorities were fully aware that it would take time for the newly independent banks to assume full autonomy, and they were trying to encourage, through technical assistance from abroad, foreign banks eventually to participate in the local banks. Also, the establishment of private banks in Poland was now permitted, and it was the staff's understanding that one Polish private bank was going to be set up, and that there was interest by foreign banks in participating in joint bank ventures. That development was certainly welcome, as competition in the banking system was crucial.

The wide spread between borrowing and lending rates in January 1990 had aggravated the already high cost of borrowing for enterprises, the Director observed. Measures had been taken to reduce that spread in February. At which level to set interest rates was a difficult decision, and the authorities had finally settled on a positive rate based on forward-looking inflation. All the information in the financial market in January indicated that it was possible to lower interest rates, and they had in fact been lowered by the central bank and would apply for the whole month of February. Accounting rigidities apparently deviated against more frequent than monthly changes in interest rates.

With respect to the external debt policy, the staff had stressed to the authorities the importance of comparability of treatment of creditors, and the authorities fully recognized that principle, the Director commented. The staff expected that an agreement with the Paris Club would be reached as soon as the coming week, and there was every indication that the agreement would be generous--perhaps more generous than was implicitly assumed in the current balance of payments forecast. That outcome would of course be welcome; the staff was not wed to its balance of payments projection, given the uncertainties of the current situation. There was obviously a possibility that exports might decline rather than remain unchanged in volume terms, and that imports might increase by more than had been forecast. The authorities had agreed that if, on the other hand, the debt relief was greater than what was implicit in the balance of payments forecast, then half of that gain would accrue to reserves to strengthen farther the reserve position of Poland, and only half would be available to ease the adjustment on the import side.

The letter of intent did not provide for any accumulation of funds for the payment of the notional 15 percent to the banks, but there was an understanding between the staff and the authorities that they would accumulate such funds, the Director explained. A formal agreement to set aside resources for that purpose could have created problems vis-à-vis official creditors who were asking the banks to provide Poland with the same treatment that the official creditors were prepared to give to Poland. Once the agreement with the official creditors was reached--probably in the coming days--conclusions for the discussion with the commercial banks could be drawn.

Institutional reforms were very important, the Director stated. They were already being implemented, and they would continue to be implemented, or at least designed, during the coming year. One of the many important tasks of the resident representative and staff missions, together with the World Bank and other international institutions, such as the OECD and the EC Commission, would be to help the authorities in the area of institutional reform.

The staff had asked the authorities for a timetable on privatization, the Director noted. The authorities had promised to make the timetable available by the time of the next review.

Direct foreign investment had been taken into account in a very notional way, the Director explained. Both for 1990 and in the medium-term scenario figures were identified in the projections. Depending on the success of the authorities, the credibility of the future program, and the progress on privatization, there was large scope for such investment; but there was no way that the staff, or the authorities, could offer other than notional figures at present.

Responding to Mr. Kafka's question, the Director said that the staff had no breakdown on interest arrears by country.

As to the economy's supply response to the program, the Director observed that the depreciation of the exchange rate should make the export sector more profitable and should provide for employment opportunities in that sector. Private sector activity should also prosper. In that context, the credit ceiling provided for an increase in credit to the nongovernment sector in real terms, particularly in the second half of 1990, precisely to provide for financing to new enterprises, and particularly private ones. In addition, there was to be an attempt to break down monopolies, particularly in the distribution sector, and therefore reduce the incentive for cutting production rather than stabilizing output.

The staff did not expect developing country exports to be adversely affected by the anticipated increase in Polish exports, the Director commented. The weight of Poland in total exports was so small that the world economy could accommodate both Polish and developing country exports. At the same time, the stimulus that Poland would feel in competing with other exporting countries would be very important for Poland. In that connection, it would be crucial that markets--particularly markets in Europe--that were now closed or somewhat closed to Polish exports should be open.

In response to Mr. de Groote's question, the Director noted that, at current prices, the Marshall Plan would be equivalent to $68 billion in grants. That would imply that, on a per capita basis, Poland should receive some $15 billion in grants over five years. That kind and volume of assistance was not expected.

A question had been raised about what was being done to encourage investment, the Director recalled. In the case of Poland, the issue was not so much the level of investment, but its efficiency. In Poland, investment was still 22 percent of GDP, which was a high figure. The main questions to ask were where the investment went, how efficient it was, and what it implied in terms of additions to capital stock. If the reform measures succeeded in pushing the flow of investment toward the productive sector, even with a lower level of investment there should be productivity and output increases in Poland--indeed, that was the objective of the systemic reform in Poland.

At present, there were many hindrances, in addition to wages, to labor mobility, the Director said. Hence, making wage differentiation sufficiently large would not necessarily increase labor mobility. There were housing problems; indeed, housing was a crucial issue in Poland. Housing was often provided by the enterprises. It was not easy for persons who worked in an enterprise that closed down to abandon their housing and move to another area, because they were not likely to find housing available immediately. The labor code had been modified, and employers, both in the socialized and private sectors, were able to fire people if they thought that such a step was desirable, and the hiring process too had been considerably eased. As a result, some improvement in the situation with respect to labor mobility was expected. The present wage policy should not be a major deterrent to labor mobility given its temporary character.

As to the issue of the amount of access being proposed, Poland had adopted what everyone would agree was a very strong program, the Director of the European Department commented. In addition, there was considerable uncertainty about the balance of payments, and there was a crucial need to increase reserves in order to reinforce the credibility of the exchange rate. The proposed arrangement did not provide for the use of the Stabilization Fund to finance the balance of payments in 1990. In addition, Poland had no indebtedness to the Fund. In those circumstances, the proposed access seemed fully appropriate.

The Chairman commented that one option might have been to reduce the amount of proposed access in response to the inadequate amount of the Fund's total resources. The issue of the amount of access to propose had still been unresolved at the time of his visit to Poland. After his full discussions with the authorities and other leaders in Poland, he had decided to recommend access that might appear at first glance to be on the high side. But Poland's program was clearly of unique significance in the history of the Fund, and it was well balanced, strong, and enjoyed the very strong commitment of the Government. In view of the political risks that the Government was ready to take in support of the program, he believed that the Fund had no alternative but to provide its own adequate support to help protect the program. Of course, the success of the program would depend on a number of different factors in addition to the proposed amount of access, which always involved an element of judgment. In that connection, it was important to bear in mind the level of commitment of the authorities and other political leaders to the new program. He had stressed to the authorities that, given the exceptional nature of the program and the political risk involved, management needed to have a good indication of the authorities' commitment before it could present the program to the Executive Board. With the exception of the former official unions, the leadership of Poland--including officials in the church and Solidarity, as well as political leaders--had given their unqualified support to the program. Hence, the Fund had all the assurances that could reasonably be expected that the Government and public opinion were behind the program.

Mr. Filosa said that he wished to comment on the political acceptance and economic feasibility of the program. In the case of Poland, the causal relationship was as follows: the economic prospects under the program led to political acceptance of the program. He had mentioned in his opening statement that there had been some discussion in Poland of the question whether the proper path of adjustment consisted of a strong program to sharply reduce inflation and quickly re-establish macroeconomic balances, or a gradual approach to inflation reduction through a gradual implementation of the program. He had noted that the political support for a strong program had grown over time because of the consideration that had been given to the negative effects of alternative solutions. Hence, his conclusion was that the political acceptance of the program was based on the fact that the program addressed all the relevant issues of economic policy and promised success. In fact, the genesis of the present shape of the program was precisely the wish for a strong program that would promise a sharp deceleration of inflation and exchange rate stability after a long period of exchange rate instability and distortion. The program was also designed to provide a strong safety net, as that was the third important political factor with respect to earning support for the program in Poland. In fact, the program had been built on the hypothesis that the program should, to the extent possible, reduce the hardship to the population while addressing quickly and almost simultaneously all the policy problems that Poland previously had not been able to face. In some previous cases, programs had been politically acceptable because they were weak and did not seem likely to produce hardship.

He certainly welcomed the unanimous and strong support that Executive Directors had given to Poland's bold and comprehensive program, Mr. Filosa commented. Two themes of Directors' comments stood out. First, they had stressed that the authorities were to be commended for their vision in shaping the program. Second, they had stated not only that with their program, the authorities were brave and innovative in dealing with the challenges facing Poland, but also that the program was historic for the Fund itself. Those statements would give the authorities a good sense of the widespread support of Executive Directors for the courageous program and served as a reminder of what was at stake, namely, not only the economic well-being of Poland but also the role that the Fund was expected to play in the future in Poland and other similar cases involving present and potential members. The program for Poland was so well designed, it was capable of setting the standard for future arrangements in similar cases.

He welcomed the consideration that Executive Directors had given to the problem of the financing of the program in 1990 and beyond, Mr. Filosa continued. It was particularly important to have the support of the Board and the Paris Club in a way that was commensurate with the strength of the program. His authorities would be pleased to learn that the Executive Directors expected the Paris Club's support to be more generous than usual in consideration of the particular efforts by the Polish authorities in designing their program.

He agreed with the comments by the Chairman and the Director of the European Department on the issue of access, Mr. Filosa stated. It was of course important to be prudent in judging access, but, at the same time, the Board had to be prepared to provide access that was adequate in relation to the balance of payments need of the country and the strength of the program. He hoped that the Fund would soon be endowed with enough resources to give the institution the chance to participate in a substantial way in financing of innovative and far-reaching programs by governments that wished to make a break with the past.

Mr. Kafka commented that, at the previous meeting, he had mentioned that a Fund-supported program should be both politically and economically acceptable. He had certainly not meant to suggest that, in order to ensure political acceptance, a program should be weak.

Mr. Filosa commented that Mr. Kafka's point was well taken and reflected the present situation in Poland, where the program was economically acceptable and enjoyed strong political support. He had meant to stress that the experience in Poland suggested that only a good program could be expected to lead to political support for that program.

The Chairman then made the following summing up:

> On the occasion of this Article IV consultation, the Executive Directors also approved Poland's request for a stand-by arrangement. Directors unanimously expressed their admiration of the Polish authorities for their courage, imagination, and determination in introducing an unprecedented program of radical transformation of the economy. Endorsing wholeheartedly the priorities and pace of the program, Directors stressed in particular that, despite the obvious considerable risks, they saw no viable alternative to the approach of swift and decisive head-on treatment adopted by the authorities. The vigorous efforts begun by the Polish Government in the fourth quarter of 1989 toward stabilizing the economy had prepared the ground for the far-reaching program of stabilization and reform that had been introduced on January 1, 1990.
>
> Directors agreed that the program rightly stressed, as the first priority, a rapid and decisive fall in the rate of inflation and the elimination of shortages. At the same time, they welcomed the intention to transform the economic system by progressively moving to market mechanisms. Many of the elements of the Government's program were seen as particularly bold, including the sharp reduction in the number of administered prices and substantial increases in other administered prices, the liberalization of most other prices, and a tax-based wage policy designed to limit the growth of wages to a rate significantly below the rate of growth of prices and to serve as an important nominal anchor against inflation. The decision effectively to merge the various exchange markets and fix the official exchange rate as a second nominal anchor from the outset was seen as innovative and as most important for stabilization and structural reform. At the same time, Directors welcomed the fact that most current transactions are now being channeled through the principal exchange market at this official rate and that quantitative restrictions on imports have been eliminated.

Directors also welcomed the objective of the authorities to reduce the deficit of the general government from about 8 percent of GDP in 1989 to virtual balance in 1990, and to pursue a credit policy aimed at limiting the rate of monetary expansion and ensuring the early emergence of positive real interest rates so as to restore the attractiveness of the zloty as a store of value. In this latter connection, however, many Directors expressed concern about the adequacy of the monetary instruments at the disposal of the authorities and the flexibility of the financial system as a whole during the difficult transitional period as inflation was being brought under control. They noted, though, that this was well recognized by the authorities, who were striving to remedy matters. The decision of the authorities to establish the National Bank of Poland as a fully independent central bank was warmly endorsed together with the decision that in 1990 the Government would not borrow--directly or indirectly--from the central bank. The hope was expressed that the latter decision would continue to prevail beyond 1990, since nonbank financing of the public sector was seen as essential for the restoration of price stability and sustainable economic growth.

Directors expressed concern over the recent decline in output and stressed the importance of implementing, as soon as possible, a range of additional reforms intended to enhance the supply response of the economy. In this connection, they urged rapid action on a number of legislative and other initiatives included in the Government's program, including the transformation of state enterprises, with particular emphasis on privatization and expanding the autonomy of those enterprises remaining subject to public ownership; the breaking up of monopolies in key sectors; expeditious bankruptcy proceedings for unprofitable enterprises; modernization of the banking system; and preparation for a fundamental overhaul of the tax system in 1991-92. The need, in cooperation with the World Bank, to develop an adequate accounting system also deserved mention.

At the same time, Directors generally saw the provision of a protective shield for the neediest groups of the population and of retraining and unemployment benefits for workers rendered redundant, as essential to ensure the continued political and social acceptability of the reform program.

Many Directors observed that the unusually bold program being implemented by the authorities carried considerable risks. The most immediate questions concerned the ability to hold to the nominal wage and exchange rate anchors, the effective bite of credit restraint, and the supply response of the economy for essential goods. Equally important and difficult to gauge was the correct sequencing and sustainability of the institutional reforms. Indeed, the scope and rapidity of the institutional change envisioned by the program were in many respects unprecedented, and the Government could be expected to come under significant pressures to relent on its policies during a difficult transitional period in which inflation had to be drastically reduced and output and employment effects were difficult to predict. Perseverance and a steady hand would be essential to maintain policy credibility and to change expectations. Close and continued monitoring of the program by the Fund was thus particularly called for, Directors observed. However, with continued understanding on the part of the Polish population, deft implementation of further reforms, and the full support of the international community, Directors considered that the program could succeed.

Directors underscored the crucial role for external assistance in various forms, in particular the provision of timely and generous exceptional financing in 1990. In this context, Directors noted that the G-24 countries, under the coordination of the Commission of the European Communities, had provided significant financial support in full cooperation with the Fund. Directors emphasized the importance of the forthcoming discussions between Poland and the Paris Club creditors in mid-February and of a successful conclusion of the discussions which the authorities had begun with commercial banks and others. Many Directors stressed the need for very generous rescheduling of outstanding arrears and debt service obligations falling due and many Directors also emphasized the importance of comparable treatment by Poland of different creditor groups. Directors urged that the authorities, with the assistance of their creditors, resolve all debt service arrears as quickly as possible. In advocating outright approval of Poland's request for a stand-by arrangement, several Directors observed that external arrears would have to be tolerated for the time being.

The medium-term outlook for the balance of payments was viewed by Directors as raising a number of difficult issues. It was noted that the staff's baseline scenario would still leave Poland with a current account deficit in 1995 at about the same level as in 1989. In this context, a number of Directors observed that a less vulnerable and more sustained medium-term adjustment path would depend not only on successful implementation of far-reaching market-oriented reform but possibly also on a significant amount of debt and debt-service reduction. It was noted that the scope and specific modalities of the needed approach to debt would only become clear in time, but Directors expressed confidence that ways would be found to mobilize the exceptional finance needed to support the adjustment and reform effort beyond 1990.

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

The Executive Board then approved the following decisions:

Decision Concluding Article XIV Consultation

1. The Fund takes this decision relating to Poland's exchange practices subject to Article VIII, Sections 2(a) and 3, and in concluding the 1989 Article XIV consultation with Poland, in the light of the 1989 Article IV consultation with Poland conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. Poland's exchange restrictions and multiple currency practices are maintained under Article XIV, Section 2, except that the multiple currency practices listed below, as well as restrictions on certain payments and transfers by enterprises are subject to approval under Article VIII, Section 2(a). The multiple currency practices that arise from the operation of the parallel exchange market, the convertible foreign exchange coupon scheme, and the currency-specific surcharges on foreign exchange sales for travel to CMEA countries that are members of the Fund are subject to approval under Article VIII, Section 3. The latter practice constitutes a discriminatory multiple currency practice, which the Fund urges Poland to eliminate. The Fund also encourages Poland to take the necessary steps to avoid the emergence of broken cross rates. The Fund welcomes the Government's intention to reduce reliance on the other restrictions subject to Article VIII and on bilateral payments arrangements and hopes that early progress can be made in this respect. In the meantime, the Fund grants approval of the multiple currency practices that arise from the operation of the parallel market and from the convertible foreign exchange coupon scheme until May 15, 1990.

Decision No. 9358-(90/15), adopted
February 5, 1990

Stand-By Arrangement

1. The Government of Poland has requested a stand-by arrangement for the 13-month period beginning February 5, 1990 in an amount equivalent to SDR 545 million.

2. The Fund approves the stand-by arrangement as set forth in EBS/90/11, Supplement 1.

Decision No. 9359-(90/15), adopted
February 5, 1990

2. LESOTHO - 1989 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1989 Article IV consultation with Lesotho (SM/89/282, 12/29/89; and Cor. 1, 1/26/90). They also had before them a background paper on recent economic developments in Lesotho (SM/90/11, 1/17/90).

Mr. Monyake made the following statement:

My Lesotho authorities concur with the thrust of the staff appraisal and greatly appreciate the analysis and policy recommendations. Directors will notice that the economy has started benefiting from the structural adjustment policies pursued over the past two years. Economic management now appears to have reached a watershed, characterized in 1989/90 by significant improvement in fiscal, monetary, and production performance.

Directors will recall that Lesotho's main weakness in the past was in fiscal management, an area of performance that the staff describes as showing "dramatic improvement." Looking at the fiscal position since the inception of the program in 1987/88, the adjustment progress accomplished is represented by the reduction in the budget deficit from 10.6 percent of GNP to 3.9 percent estimated for 1989/90, which is beyond the program target. Under the Committee on Structural Adjustment and Public Expenditure, established in November-December 1988, a series of institutional strengthening and expenditure monitoring measures have been put in place, leading to effective control of expenditure. These measures, which have been explained in the staff report, have been aimed at containing the wage bill and strengthening budgetary discipline.

On the revenue side, the sharp increase in non-South African Customs Union (SACU) receipts in 1989/90 resulted primarily from the broadening of the tax base through the extension of company taxation to parastatals and from increased sales tax rates. In fact, the full impact of these measures has yet to be translated into higher tax yields. Not surprisingly, therefore, the brunt of the fiscal adjustment in 1989/90 fell more on the expenditure than on the revenue side. The authorities believe, however, that, with the enhanced elasticity of the tax system, a more even fiscal adjustment should soon emerge. They contend that, for the time being, taxation measures are adequate. What is required is improvement of their collection mechanism. Therefore, they request assistance in putting together a more efficient strategy of tax collection, rather than increase the already heavy tax burden on those who get caught in the net.

They are also aware of their limitations on further tax rate increases relative to those prevailing in the Republic of South

Africa in view of their membership in the common market and the porous nature of their borders with South Africa. They have pointed out that an increase in the general sales tax rate in Lesotho relative to the corresponding rates in South Africa would lead to smuggling across borders. This contributes toward restraining Lesotho's progress in reducing the relative significance of SACU receipts in total revenue, over which the authorities have no control. These receipts account for 60 percent of total revenue, and the present medium-term projections still place them at the same level by 1994/95.

Despite satisfactory program implementation in the field of money and credit, the structural weakness of this sector has yet to be tackled. The quantitative benchmarks for total domestic credit and credit to the Government were observed. Nevertheless, the long-standing problem of the banking system's failure to channel savings into productive enterprises persists. The liquidity ratio, for example, has been around 80 percent, for lack of acceptable domestic projects to finance. The authorities are now poised to undertake some reforms in this sector following a study completed by the World Bank staff and presented to the Government. It is expected that some of the recommendations will be incorporated in the 1990/91 program. In the meantime, the Government has made appreciable progress in facilitating credit absorption for agricultural exports and manufacturing activities as described in the staff report. With regard to interest rates, the Government has progressively adjusted them upward since the inception of the program, when the rate payable on savings deposits stood at 6 percent to 14.5 percent in September 1989. They are now moderately positive in real terms.

On the production front, the authorities' policy measures and accomplishments in agriculture, industry, and the early phase of the Lesotho Highlands Water Project (LHWP) are reflected in a stepped-up rate of investment to 44 percent of GDP and a GDP growth rate of 5.5 percent in 1989/90. These are a source of encouragement to my authorities.

In connection with this rising tempo of economic activity, I would like to draw Directors' attention to the accelerating rural development work involving the expansion of irrigated land area, the development of commercial livestock and export crops, and the essential transportation network in the difficult mountainous terrain. As an integral part of this rural transformation, the Government has placed high priority on the social component through improvement of health and environmental conservation. It considers that, since the bulk of the population resides in the rural areas, this part of the structural program should be the focus of the country's adjustment effort. While the authorities have already formulated the necessary medium-term policies in this area, the critical constraint now is financial resources. They are, there-fore, working closely with donor agencies and bilateral sources to identify appropriate finance for rural development and infrastructure.

The authorities expect the private sector to mobilize finance for manufacturing activities. Most of the large-scale investment that is taking place has been undertaken by South African and Asian firms, but the Government believes that, with an improving economic environment, there will be more direct investment from a broader spectrum of external sources. During this month of February, the Government will discuss with the World Bank staff its recommendations for a comprehensive package of investment incentives contained in a study that has just been completed.

In the medium term, the increasing pace of economic activity associated with LHWP should foster production diversification and employment creation, while lessening the vulnerability of the balance of payments to exogenous factors beyond the authorities' control. They fully recognize that, given the large number of school leavers and the large proportion of labor force that now works in South Africa, it will take considerable economic diversification before the employment situation in Lesotho is under control.

The balance of payments situation, as reported in the staff paper, has recently improved, owing to government policies to promote exports. Nevertheless, the Government realizes that workers' remittances, which were five times more than exports of goods in 1989/90, will continue playing a critical role in the medium term, as they will still be more than three times the value of other exports by 1994/95. Their main hope of strengthening the balance of payments lies in the LHWP. They agree with the staff that, in order to attain the position indicated in the staff's medium-term projections, the LHWP should be implemented on schedule, while the quality of macroeconomic management recently attained is consolidated and further strengthened. Concurrently, external official and private capital inflows should be timely and adequate, along the lines assumed in the medium-term projections.

The authorities have asked me to assure the Board that they are fully committed to the implementation of the structural adjustment program.

Continuing, Mr. Monyake commented that it was always helpful to look behind the data in staff reports to examine the environment in which they had been generated and the people in that environment. After all, economics was far from being an exact science, and considerable judgment in assessing a country's situation was clearly required. In addition, in conducting consultations with a country implementing an adjustment program, it was essential to have sets of options that could be discussed with the authorities, as any particular desired outcome could usually be achieved through a variety of measures, rather than just one specific set of measures, depending on the overall environment in the country concerned.

Mr. Enoch made the following statement:

> At the time of the previous Board discussion of Lesotho, Directors expressed serious concerns about the country's performance under its first-year structural adjustment arrangement. In the six months since then, performance appears to have improved significantly.
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> Given the constraints under which the Lesotho economy operates, fiscal policy must be central in any adjustment strategy. Last summer's Board discussion was very critical of Lesotho's performance in this area. The authorities seem to have taken note of this. Control of current expenditure has improved markedly, and levels of current expenditure were well within the program target.
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> On the other hand, control of capital spending has been less impressive, as a result of a number of unbudgeted purchases, while financing from concessional foreign borrowing has declined markedly. The persistence of such overshooting reinforces concern about budgetary control. I would be interested in any comments the staff could make on measures the staff or the World Bank have in mind to ensure that, in the future, actual performance is in line with the program.
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> Revenue developments seem on the whole to be more satisfactory, although delays in implementing certain measures again indicate the limited administrative capacity of Lesotho. It is, however, somewhat disturbing that the buoyancy of customs duty and personal income tax receipts was below unity for the past decade. The staff's references to streamlining the system seem appropriate, especially if such rationalization can be achieved swiftly with technical assistance. I would be interested to hear whether such streamlining is intended to be revenue neutral. There seems also to be an urgent need for the authorities to raise revenue.
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> As the staff notes, there has been a welcome shift toward credit to businesses since 1987, although Table 15 in the background paper also shows an increase in credit to statutory bodies. I can find no market-related reason for these developments, although they seem to represent a shift back toward the distribution of credit seen before 1985. Further comments on this would be welcome.

The authorities have taken action to raise interest rates, but there are questions as to whether this is sufficient. The paper notes a difference of view between the staff and the authorities on the effectiveness of interest rate policy, with the authorities arguing that remittances are deterred from Lesotho by the relative inconvenience and poor service of the local banking system, and the staff arguing that this reinforces the case for higher interest rates.

While I endorse the staff's emphasis on ensuring that positive real rates are achieved and maintained, especially given the need to compensate for the likely decline in employment in South Africa, the nature of the financial sector in Lesotho is clearly important. The forthcoming World Bank financial sector report may well indicate a need for significant reforms. Table 16 in the background paper shows how extraordinarily high the liquidity ratios are. I would be interested in staff comments on the reason for this high liquidity, what return this offers the banks, and whether it reflects a lack of viable investment opportunities in the country.

Lesotho's performance with regard to the structural aspects of the structural adjustment arrangement has been rather patchy, as revealed by the list of slippages with regard to the structural benchmarks on page 20 of the main staff paper. Perhaps the most disappointing aspects have been with regard to land reform. I hope that agreement can rapidly be reached on extending grazing fees to the remaining areas, and that means of financing leasing arrangements can be successfully arranged. The highly liquid banking system would seem to be an obvious source of the required funds.

Outside agriculture, the continuing growth in investment is encouraging. The high level of unemployment and the heavy dependence on remittances from South Africa make it essential that domestic production continue to grow beyond the impact of the Highlands water project. This is demonstrated in the staff's medium-term scenario, even making the relatively optimistic assumption that there is no decline in remittances: not only does the economy remain in a highly vulnerable position, but also unemployment stays distressingly high. Nevertheless, the authorities need to be cautious in seeking to stimulate activity through artificial investment incentives. The World Bank's input is likely to be valuable in this area too.

The staff paper notes that Lesotho now has no exchange restrictions on the making of payments and transfers for current international transactions. I wonder whether the staff discussed with the authorities the possibility of moving to Article VIII status and, if so, what was the response of the authorities.

Mr. Saha made the following statement:

The Lesotho authorities have made considerable progress in implementing structural reform and demand-management measures that have significantly improved their economic and financial situation. Preliminary data indicate that, despite the impact of unfavorable weather conditions on the agricultural sector, real GDP growth is estimated to have grown by 5.5 percent in 1989/90 compared with a target of 6.3 percent, reflecting strong activity in manufacturing and construction. The overall fiscal deficit is expected to be significantly reduced, and with the prospects of a significant reduction in the external current account deficit and a surplus of about SDR 10.7 million in the overall balance of payments, the external sector outlook is encouraging.

Despite this commendable performance, Lesotho still faces a string of challenges that require continued determined efforts by the authorities, as recommended by the staff. I broadly share the staff's views and will make a few comments for emphasis.

In the agricultural sector, we welcome the authorities' efforts to expand and diversify production through land irrigation and management. However, the slow progress in land reform is a cause for concern, as the existing lease arrangements do not provide collateral to farmers who wish to secure loans from commercial banks. To this end, we encourage the authorities to speed up the adoption of the commission's report on changes in the Land Act of 1979. This could certainly help to secure credits to farmers and contribute to the creation of more employment opportunities.

As is indicated in the staff report, the authorities have made considerable progress in curbing the overall fiscal deficit. Moreover, from Mr. Monyake's statement, I note the authorities' intention to take additional measures and I encourage them to consider, apart from the strengthening of tax collection, other measures aimed at consolidating the budgetary operations. Reduction of the lag in the provision of data would also help to achieve better fiscal management.

In the monetary sector, the high liquidity in the banking system associated with the low absorption of credits for viable projects is a cause for concern, particularly as this could fuel inflationary pressure in the economy. In this connection, I welcome the completion of a survey on the financial sector with the assistance from the World Bank and the authorities' intention to start implementing the Bank's recommendations in the context of the 1990/91 program. Regarding the interest rate, as the miners' remittances will continue to be a major source of income for Lesotho, it appears crucial for the authorities to keep an active interest rate policy in order to attract remittances and improve the gross national saving performance. However, the high liquidity in the banking system makes this policy difficult. Therefore, the authorities should closely monitor interest rate developments.

Although the medium-term prospects are influenced largely by the political situation in the region, there is room for continued improvement of Lesotho's economy during the years ahead. Mr. Monyake has rightly pointed out the key conditions for this improvement in his statement and I agree with him. I welcome the authorities' continued commitment to the structural adjustment program and hope that the international community will continue to provide them with the necessary financial support.

Mrs. Hansen made the following statement:

We welcome the improvement in Lesotho's economic policies and performance since our discussion of the second-year structural adjustment arrangement request last June. The authorities seem to be moving in the right direction in several areas: the central government deficit as a share of GNP is expected to decline markedly in 1989/90; domestic credit has shifted away from consumption to production; and there has been an increase in merchandise exports, following a steady rise in private foreign investment. These are encouraging developments.

Although in some respects Lesotho's prospects seem relatively bright, the authorities still face a number of challenges, among which are the need to increase employment opportunities and strengthen the balance of payments. Achieving these objectives will require continued efforts to increase domestic savings and investment. As we are in broad agreement with the staff's analysis and policy recommendations, I will confine my remarks to a few points which we consider especially important in achieving these objectives.

First, we welcome the improvements that have been made in expenditure control, and we note that recurrent expenditure is expected to fall below the programmed level this year. Nevertheless, the extrabudgetary expenditure raises the concern that spending could get out of control in the future, undermining recent fiscal gains. Thus, we urge the authorities to make further improvements in the expenditure control system, especially at the authorization stage.

Second, we continue to have serious reservations about interest rate policy. Although interest rates have increased, we understand that rates on savings deposits are still negative in real terms. Given the need to increase domestic savings, and the fact that remittances from Basotho workers in South Africa are Lesotho's major source of foreign exchange, it is imperative to provide positive rates of return on savings. In fact, in view of the difficulty in attracting remittances from South Africa, it would probably be desirable to maintain interest rates at somewhat higher levels than those prevailing in South Africa.

We are concerned that the current arrangements concerning land tenure and land use are impeding agricultural development. One symptom of this appears to be the stagnation of agricultural credit, which, as we understand it, is due in part to farmers' inability to offer land as collateral. Another symptom is the problem of overgrazing. With agriculture providing income and employment for more than 60 percent of all households, establishing land tenure and land-use arrangements that encourage efficient resource use should be a high government priority.

With regard to the balance of payments outlook, the baseline scenario appears relatively promising for the medium term, in the sense that the overall balance is expected to be in growing surplus. However, we agree with the staff that these projections provide no grounds for complacency. Official reserves are low, and even the modest reserve growth projected will require foreign assistance. Moreover, as the sensitivity analysis shows, Lesotho's balance of payments position is vulnerable to developments in the South African mining sector. This points to the need to continue implementing strong demand- management and structural policies with a view to reducing this vulnerability over time.

In conclusion, we commend the authorities for their recent efforts to improve policy implementation and performance and hope to see this improvement sustained in the future.

Mr. Goos said that he broadly endorsed the staff's recommendations. He commended the authorities for the largely satisfactory performance under the current structural adjustment arrangement, which constituted a most welcome break from the worrying experience under the previous arrangement. Continued adherence to the program targets and policy undertakings for the current year was essential not only to build further on the adjustment progress made thus far but also to establish a credible track record that would allow favorable consideration of a request for a possible follow-up arrangement under the enhanced structural adjustment facility.

Notwithstanding the "dramatic improvement" in fiscal management, there was undoubtedly a need for further revenue enhancement, Mr. Goos continued. That conclusion was borne out by the substantial decline in the revenue/GDP ratio as well as by the indications that expenditure retrenchment was approaching its limits, at least in certain expenditure categories, as suggested by the emigration of nurses and physicians. While he generally agreed with the staff's emphasis on the need to improve tax collection and administration, he wondered whether the tax base could not be extended to the more affluent landowners and farmers as well as to industrial firms, all of which were, according to the staff report, largely exempt from income taxation. Moreover, it appeared that replacement of the sales tax exemption for basic food and other items by a targeted direct transfer system could also help improve fiscal savings and the efficiency of overall resource utilization. In addition, he joined the staff in urging the authorities to improve the timeliness of the collection and compilation of budget data and to discontinue the practice of extrabudgetary expenditures.

The staff could usefully elaborate on the World Bank's recommendations concerning the functioning of the banking system, Mr. Goos commented. In that context, he would also welcome staff comment on its advice that the authorities should "encourage the development of more creditworthy projects in order to channel some of the existing surplus liquidity in the commercial banks into productive investment." That advice sounded very interventionist, but he was sure that the staff had something different in mind.

He wondered whether the staff had already come to a conclusion on the issue of possible changes in the existing exchange rate arrangements referred to in the staff paper, Mr. Goos remarked. Given the close integration of Lesotho with South Africa's economy and Lesotho's relatively small size, he would have thought that, at least in the longer term, the benefits of the existing fixed-rate regime outweighed the potential pitfalls of an independent policy course.

He, like Mrs. Hansen, fully shared the staff's concern about the slow progress in land reform and land management, Mr. Goos said. The existing arrangements seemed to constitute a major obstacle to the full exploitation of Lesotho's growth potential.

Mr. Serre commented that he, too, was pleased to note the progress already achieved under the revised program supported by the second year of the structural adjustment arrangement, despite unfavorable weather conditions. He commended the authorities for having resumed strong macroeconomic policies that had led to a significant improvement of the fiscal and balance of payments positions.

He agreed with the thrust of the staff appraisal, Mr. Serre continued. With respect to macroeconomic policies, it was crucial to strengthen the momentum of present revenue-raising and expenditure-control policies, especially as there was clearly scope to do so. In particular, the staff rightly underlined the necessity to reinforce expenditure control and monitoring as well as the overall transparency of the budget. The authorities should clearly make further strides in that area if they wished to see the public finance adjustment process be established in a durable manner.

Monetary policy progress had been important in keeping developments in Lesotho on an even keel with those of Lesotho's main economic partner and in broadly coping with the needs of the productive sector, Mr. Serre considered. However, improving financial intermediation remained important, given the need to establish additional instruments for servicing monetary and interest rate policies. The ongoing study supported by the World Bank could usefully contribute to that effort.

In the external sector, he agreed with the staff that the medium-term prospects could remain encouraging only if the present adjustment stance was maintained and the diversification process of the economy was pursued, and, in particular, if the Highlands water project was implemented on schedule, Mr. Serre remarked. However, there was no room for complacency in the short term, despite the recent improvements in the current account deficit and the balance of payments. Therefore, like Mr. Enoch and other speakers, he urged the authorities to pay special attention to avoiding any policy that could jeopardize the progress that had already been achieved.

Lesotho had recently demonstrated a strong commitment to financial stabilization and structural reforms, Mr. Serre noted. The authorities' track record under the program represented a substantial effort to address the country's economic and financial difficulties so that sustainable economic growth and balance of payments viability could be achieved. In that connection, the authorities deserved the support of the international financial community in their future endeavors.

Mr. Ichikawa said that he, too, welcomed the favorable developments in the economy and commended the authorities for the improved performance. Nevertheless, in view of the past unsatisfactory performance under the first annual arrangement, the authorities should be encouraged to strengthen their adjustment efforts in the coming financial year in order to achieve the original objectives of the structural adjustment arrangement. In that connection, the staff's policy recommendations were broadly appropriate.

The significant delay in the structural adjustment, particularly in land reform, was disappointing, Mr. Ichikawa commented. Land reform would not only improve the efficiency of the agricultural sector but also be the key to mobilizing Lesotho's financial and human resources for productive activities. While the fact that increased foreign investment was creating productive activities in Lesotho's economy was welcome, the authorities could also create vehicles for growth by actively mobilizing domestic resources. In that connection, he doubted whether it was appropriate to discuss the question of the surplus liquidity of the banking system merely in the framework of monetary policy. He basically agreed that, in order to attract workers' remittances, the authorities should raise interest rates and improve the efficiency of the financial system. At the same time, while those conditions were certainly necessary for growth-oriented adjustment, by themselves they were insufficient. Apparently the underlying problem was the absence of attractive investment opportunities in the productive sectors. While prudent macroeconomic policies were the most important elements of growth-oriented adjustment, they should be supported by rigorous structural adjustments.

The staff could usefully comment on Lesotho's development strategy in the real sector, and particularly which measures would be effective in promoting domestic entrepreneurship in the framework of adjustment, Mr. Ichikawa said.

Mr. Noonan made the following statement:

> The staff appraisal has highlighted the fact that Lesotho's performance during the second annual arrangement under the structural adjustment facility has been much better than under the first. Since June of last year, there has been steady GDP growth, a much improved fiscal situation, as well as positive developments in financial policy and the external sector, and, for this, the authorities should be commended. However, it is clear that the country is by no means out of the woods yet. During the Board discussion on the request for the second annual arrangement, this chair indicated that positive and timely action on several weaknesses in the fiscal and monetary areas was needed to put Lesotho on the path to economic viability. Regrettably, that observation still remains largely valid, although we recognize the improvements that have been made.
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> During the most recent completed fiscal year (1988/89), the public sector deficit, although down from the previous year, was still above program targets. There is more optimism about the likely performance in the current year. Most of the problem in 1988/89 was associated with overruns caused by unplanned military expenditure. It is unfortunate that this had to occur at a time when financial discipline is required, and it underscores the need to avoid extrabudgetary measures. In this context, we commend the action already taken to improve fiscal discipline, as outlined by Mr. Monyake, and we urge the authorities to make further improvement in their budgetary and expenditure control mechanisms. It is also in the interest of lower public spending to achieve early on realization of the benchmark for establishing a parastatal monitoring system.
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> Although the ratio of revenue to GDP is high, given the per capita income, there may still be some room for revenue enhancement through higher returns from the corporate tax. In the first place, corporate taxes as a percentage of total taxes seem to have weakened somewhat, on average, since 1984/85, compared with the period 1981/82 to 1983/84. More important, the background paper states that the yield of the tax is below its potential because of a lack of qualified personnel--a point Mr. Monyake agrees with, as I read the reference in his statement to the need for improvement in tax

collection as distinct from tax measures. The possibilities for increasing the tax take from other areas should also be examined in light of the extreme volatility and uncertainty associated with Southern African Customs Union receipts.

The control of inflation remains a key challenge on the monetary front. Strong GDP growth and interest rate liberalization, which attracted deposits from at home and abroad, were bound to give rise to demand and inflationary pressures. In the circumstances, it was crucial for the authorities to move swiftly to neutralize some of the buildup of liquidity in the banking system and thereby forestall the surge in domestic credit. Their failure to do so, leading to an undesirable surge of inflationary pressures, could have been avoided by prudent monetary policy, since, according to the background paper, the Central Bank again made no use of liquidity or cash reserve ratios. Without using these monetary tools, the authorities will be hard pressed to implement the staff's suggestion in the appraisal to tighten credit and channel commercial banks' surplus liquidity into productive activity.

The passive approach to monetary policy, which allowed uncontrolled consumption, also helped to depress the level of foreign reserves, and the import cover has fallen to a critical low level. In attempting to rebuild reserves, the authorities ought to be mindful of the significant contribution made by workers' remittances. In this regard, further structural reforms in the financial sector, particularly the realization of real positive interest rates, are needed to attract these flows. The political situation in the region makes the future of these remittances uncertain. In those circumstances, it is desirable to enhance all other sources of foreign exchange. To this end, the move toward greater diversification of the export base should continue.

The staff representative from the African Department commented that, with regard to improvements in the budgetary arrangements, the authorities had been implementing revenue measures. Some of those measures had not been as successful as the authorities had hoped; in other areas, they needed more time to study revenue measures more carefully before implementing them. One such measure that came to mind immediately was the narrowing of the bands on the personal income tax. At present, the authorities were conducting studies on some bands proposed by the previous mission. They would like to ensure that that measure would be, at least at the worst, revenue neutral; that was why they had not yet implemented the measure. However, during the negotiations on the next structural adjustment arrangement, the staff expected that that matter would have been studied sufficiently to enable the authorities to adopt the new bands.

Other revenue-raising measures had not been as successful as had been hoped, the staff representative continued. One of those was the increase in the sales tax on beer and luxury motor cars. There had been considerable evasion and smuggling, and the revenue outturn had not been as favorable as had been hoped.

With regard to the broadening of the revenue base, one of the measures contemplated by the staff was the extension of the income tax to migrant workers, the staff representative commented. The authorities had said that, while the flow of remittances was not within their control, they would still pursue the taxation option matter, although they were not optimistic about the possibility of implementing it in the very near future.

Much more success has been achieved in expenditure control, the staff representative said. The authorities were strengthening their expenditure control measures in the hope of recording even greater success in the future. To some extent, the authorities were not to blame for not having made even more progress thus far; the Fund and other donors had promised technical assistance in the area of expenditure control, but, owing to unfortunate circumstances, a fiscal expert had arrived in Lesotho 18 months after the authorities' request was made. The fiscal expert was now in Lesotho and was grappling with various issues, and the staff expected to see improvements in the very near future.

Excess liquidity plagued not only Lesotho but also other developing countries, the staff representative remarked. The problem was traceable to the need for suitable projects that commercial banks would consider appropriate. At the same time, it was important to bear in mind that there were attractive alternative investment avenues--government treasury bills and stocks that were relatively risk free--and the commercial banks were hesitant to extend themselves beyond those areas.

The World Bank had undertaken a study of the financial sector and had made some proposals, dealing mainly with the improvement of the financial instruments, the staff representative explained. The Bank had suggested that the authorities could develop for public trading money market instruments, principally treasury bills, bankers certificates, and bankers acceptances. The authorities planned to consider those suggestions. In addition, the Bank had proposed a restructuring of the financial institutions, primarily the Lesotho National Development Corporation and the Lesotho Agricultural Development Bank. The Bank's report on that area was being considered by the authorities, and the staff planned to discuss it with them during the next mission to Lesotho.

Possible changes in the exchange rate arrangement was a recurring issue in Lesotho and neighboring countries, the staff representative noted. With the sharp depreciation of the rand over the past few years, the rise in the rate of inflation in Lesotho together with the increase in debt service had led the authorities in Lesotho to look more closely at the exchange rate arrangement. But on balance, they had concluded that the arrangement was appropriate to their unique situation and that they would continue to maintain it. The staff broadly shared that view.

With regard to Lesotho's development strategy, the authorities were emphasizing improvement in entrepreneurial and management skills, especially in the rural sector, the staff representative said. They were receiving technical assistance from several donors in that area. However, the main generator of growth in the next few years would be investment associated with the Lesotho Highlands Water Project; it was through that project that the authorities anticipated greater investment and foreign exchange earnings as well as some increase in employment.

During its latest mission to Lesotho, the staff had not discussed with the authorities a possible move to Article VIII status, the staff representative from the African Department remarked. That matter had been raised with the authorities several years previously, and at that time the authorities had said that they preferred to retain their Article XIV status. The staff would discuss that matter with the authorities again in the course of the next mission to Lesotho.

The staff representative from the Exchange and Trade Relations Department said that Lesotho's exchange system was basically free of exchange restrictions. As to current international transactions, the staff would explain to the authorities that there was no longer any benefit for them in keeping their Article XIV status rather than moving to Article VIII status.

There were solid advantages for Lesotho in continuing under the present exchange rate regime, the staff representative said, and the intention of the staff report clearly was not to neglect those advantages. The report described the trade and exchange regimes as being fairly liberal.

The past trends in, and the outlook for, the balance of payments seemed to suggest that Lesotho's debt service was fairly low compared with a broad spectrum of countries, the staff representative from the Exchange and Trade Relations Department remarked. Export growth in volume terms had been strong in the recent past and was expected to remain so in the future. Strong growth was also evident in workers' remittances in recent years, and direct investment was also on an upward trend. In sum, the present exchange regime seemed to inspire the confidence that one typically looked for from an exchange regime. At the same time, it was of course important to bear in mind the very close geographic and economic ties between Lesotho and South Africa. The rate of increase in consumer prices in South Africa in recent years had been only slightly greater than the rate in Lesotho. In general, the external environment was not creating significant problems for Lesotho's external position. If there was some concern about a possible weakening of the balance of payments, the policy response probably should center more on domestic than external policies. In that context, the staff agreed with Executive Directors' comments on possible reform of the financial system and strengthening of interest rate policy.

Mr. Monyake considered that it would not be useful to encourage the authorities to move to Article VIII status at the present stage. While it was true that the exchange system was free of exchange restrictions, that situation was due in large part to Lesotho's close relations with South Africa. If the political developments within the region were such that Lesotho had to break from the rand, no one could say what might happen with respect to the exchange rate system. It was best to wait until the political situation in the region stabilized before the staff took up possible Article VIII status with the Lesotho authorities.

The staff representative from the Exchange and Trade Relations Department said that should there be a need, in the authorities' judgment, to impose restrictions at some stage in the future, the Articles did not prohibit a member with Article VIII status from imposing restrictions, provided that there were underlying balance of payments reasons for imposing them and the restrictions were to be temporary.

After a further brief discussion, Mr. Monyake commented that the authorities were strongly committed to avoiding extrabudgetary expenditures. The ministerial subcommittee overseeing the implementation of the program had underscored the importance of adhering to the program benchmarks.

The question of making interest rates positive in real terms and the high liquidity of the banking system would undoubtedly be debated for some time yet, Mr. Monyake said. The banks would not wish to raise rates for depositors at a time when the banks could find few productive uses for those deposits. There was a need for not only positive real interest rates but also means for siphoning off all the excess liquidity. Thus far, the authorities had not been able to generate bankable projects. In that connection, one of the problems was the limited prospects for developing domestic entrepreneurship.

Land reform would not solve any of the problems that speakers had suggested it might, Mr. Monyake considered. Under current law, any farmer in Lesotho could borrow from the Agricultural Development Bank without using land as security. In addition, the land ownership system was not an obstacle to investment in and development of land; once someone had user rights with respect to land, he was in a position to use the land as he saw fit to do. The problem was that weather conditions made agriculture a very risky undertaking in Lesotho. Hence, land reform alone was unlikely to make a significant contribution to agricultural development. In any event, such reform was of course a very sensitive issue and would take considerable time to achieve.

He agreed with Executive Directors who had mentioned that the authorities should seek additional revenue-raising measures, Mr. Monyake said. However, it was important to note that the revenue base appeared to be very narrow, and that broadening it would be difficult. At present, the only measure that seemed available was to continue increasing the rates on existing taxes, although taxes in Lesotho were already the highest in the region. In seeking to broaden the tax base, the authorities would welcome the assistance of the World Bank and other sources of technical expertise. Increased investment in the country would help to generate more revenue.

In the light of the many positive comments by Executive Directors, he was somewhat surprised that only one of them had suggested possible eventual use by Lesotho of the resources of the enhanced structural adjustment facility, Mr. Monyake remarked.

The Chairman made the following summing up:

Directors expressed broad agreement with the thrust of the staff appraisal in the report for the 1989 Article IV consultation with Lesotho. Although economic growth would be less buoyant in 1989/90 than in the previous year, owing largely to the adverse weather conditions, Directors were encouraged by the favorable developments in the external and monetary sectors, and the improvement in the fiscal situation. They commended the authorities of Lesotho for the satisfactory performance under the current structural adjustment arrangement.

Directors emphasized the importance of diversifying Lesotho's economic base. While Lesotho's economic situation would benefit greatly from the successful implementation of the Lesotho Highlands Water Project, it would also be important to continue to implement appropriate structural adjustment policies. With respect to the agricultural sector, and while taking note of the remarks made by Mr. Monyake, Directors expressed regret that further progress has not been made toward implementing the proposed land reform. In this context, the issue of providing leasehold titles and more appropriate collateral for commercial banks needed to be resolved. To foster the development of the livestock sector, they stressed the importance of measures to improve range management, in particular by expanding the establishment of grazing associations and the introduction of grazing fees.

Directors noted that while the external current account and the overall balance of payments were expected to show significant improvements over the previous year, there remained a need to strengthen the foreign reserve position. Hence, policies should continue to be directed toward increasing production for exports and attracting direct foreign investment.

To achieve fiscal adjustment, the revenue-raising and expenditure control measures implemented thus far in 1989/90 have been important. However, Directors emphasized that revenue collection procedures need to be strengthened, streamlining of the personal income tax should be pursued more vigorously, and the yield from the corporate tax should be improved. Directors stressed that unbudgeted expenditures should be eliminated, and that budgetary monitoring and control mechanisms should be improved. In this respect, they urged the authorities to reduce the lag in reporting of government revenue, expenditure, and financing.

On the financial sector, Directors noted the high liquidity available to banks and stressed the need to create appropriate financial instruments and improved intermediation with a view to channeling resources into productive investments and economic activities. They felt that a further increase in interest rates to positive rates in real terms should be encouraged to stimulate savings and to attract migrant remittances.

Following the elimination of the last remaining restrictions on payments and transfers for current international transactions with those that arose from the Trilateral Monetary Agreement, Lesotho was encouraged to move to Article VIII status in the Fund.

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

3. ADMINISTRATIVE AND CAPITAL BUDGETS - MEDIUM-TERM OUTLOOK

The Executive Directors, meeting in restricted session, considered a memorandum from the Managing Director on the budgetary outlook in the medium term (EBAP/90/22, 1/26/90).

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/90/14 (2/5/90) and EBM/90/15 (2/5/90).

4. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to Executive Director as set forth in EBAP/90/29 (1/31/90).

Adopted February 5, 1990

5. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to Executive Director as set forth in EBAP/90/31 (2/1/90) and Correction 1 (2/2/90).

Adopted February 5, 1990

APPROVED: October 31, 1990

JOSEPH W. LANG, JR.
Acting Secretary