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Minutes of Executive Board Meeting 90/154

3:00 p.m., October 26, 1990

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

Executive Directors	Alternate Executive Directors
	Z. Iqbal, Temporary
G. K. Arora	
C. S. Clark	G. C. Noonan
	Shao Z., Temporary
T. C. Dawson	S. B. Creane, Temporary
	M. E. Hansen, Temporary
J. de Groote	H. S. Binay, Temporary
	L. B. Monyake
	J. O. Aderibigbe, Temporary
E. A. Evans	
	M. Hepp, Temporary
	R. Marino, Temporary
R. Filosa	N. Kyriazidis
M. Finaish	M. B. Chatah, Temporary
M. Fogelholm	I. H. Thorláksson
	S. Rouai, Temporary
G. Grosche	
J. E. Ismael	
	F. A. Quirós, Temporary
J.-P. Landau	J.-F. Cirelli
Mawakani Samba	C. V. Santos
	P. Wright
	G. P. J. Hogeweg
K. Yamazaki	K. Ichikawa, Temporary

C. Brachet, Acting Secretary
J. W. Lang, Jr., Acting Secretary
C. P. Clarke, Assistant

Also Present

IBRD: G. Zanini, Africa Regional Office. African Department: E. L. Bornemann, Deputy Director; E. A. Calamitsis, Deputy Director; G. E. Gondwe, Deputy Director; P. A. Acquah, D. T. S. Ballali, N. Calika, P. S. Heller, A. Jbili, E. K. Martey. Asian Department: P. R. Narvekar, Director; E. J. Bell, D. J. Goldsbrough, E. A. Milne, R. S. Teja, W. M. Tilakaratna. Exchange and Trade Relations Department: J. T. Boorman, Director; T. Leddy, Deputy Director, A. Basu, G. R. Kincaid. External Relations Department: V. R. Khanna. Fiscal Affairs Department: M. Z. Yucelik, H. H. Zee. Legal Department: H. Elizalde, P. L. Francotte, R. B. Leckow. Secretary's Department: K. S. Friedman, B. R. Hughes, M. J. Papin, S. L. Yeager. Treasurer's Department: G. Laske, Treasurer; M. P. Blackwell, W. J. Byrne, W. L. Coats, Z. Farhadian-Lorie, G. Wittich. Personal Assistant to the Managing Director: B. P. A. Andrews. Advisors to Executive Directors: P. O. Montórfano, A. Napky, A. Raza, B. Sarr, S. P. Shrestha, N. Toé. Assistants to Executive Directors: T. S. Allouba, C. Björklund, B. Bossone, B. A. Christiansen, T. T. Do, A. Fanna, S. K. Fayyad, J. Gold, S. Gurumurthi, A. Hashim, K. Kpetigo, R. Meron, M. Mrakovcic, M. Nakagawa, J. K. Orleans-Lindsay, S. Rouai, G. Serre, D. Sparkes, S. von Stenglin.

1. VIET NAM - 1990 ARTICLE IV CONSULTATION; AND OVERDUE FINANCIAL OBLIGATIONS - REVIEW FOLLOWING DECLARATION OF INELIGIBILITY

The Executive Directors considered the staff report for the 1990 Article IV consultation with Viet Nam (SM/90/186, 9/24/90), together with a staff paper on the further review of Viet Nam's overdue financial obligations to the Fund following the declaration of its ineligibility to use the general resources of the Fund, effective January 15, 1985 (EBS/90/183, 10/22/90). They also had before them a background paper on recent economic developments in Viet Nam (SM/90/194, 10/12/90).

The Deputy Managing Director was in the chair.

Mr. Ismael made the following statement:

Viet Nam has continued to achieve impressive progress in its comprehensive economic reforms over the past year. Key elements in the shift to a market-oriented economy have been put in place, including price liberalization, measures to increase domestic and foreign competition, and the elimination of rationing and subsidies.

In the countryside, where more than 80 percent of the population lives, collectivized agriculture has been dismantled under a system in which the land is leased to peasant families. After having to import over 400,000 tons of rice a year through most of the 1980s, Viet Nam last year became the world's third largest rice exporter. Another good harvest is expected this year, despite badly delayed fertilizer shipments from trading partners in the Council for Mutual Economic Assistance (CMEA).

In the industrial sector too, the scope for private sector activity has been greatly expanded with the lifting of restrictions on the number of workers that a private company can employ. In addition, since July, wholly private Vietnamese companies have been allowed to form joint ventures with foreign investors. Most important, state enterprises have been compelled to operate on a commercial basis and have been given the necessary autonomy to enable them to do so. Sharp price realignments and financial stringency have given rise to severe difficulties among state enterprises: at least 200,000 workers--equal to about 7 percent of state enterprise employment--had been laid off by mid-1990. Together with the pressures arising from the ongoing demobilization of troops, the social costs of adjustment have proved to be high.

To advance the economic reform efforts, it has been recognized that the legal system needs to be improved. Two important decree-laws have come into effect this month: one governing the role of the State Bank, which, for the first time, is given the formal legal powers of a central bank; and another governing the restructuring of the commercial banking sector. Currently being drafted for introduction during 1991 is the country's first comprehensive law on companies, which would provide a strong legal framework for private ownership and foreign investment. The Government also plans to introduce a law on progressive personal income taxes. Meanwhile, new tax laws, which seek to eliminate variable and ad hoc tax bargaining with state enterprises, have recently been passed by the National Assembly.

Among the more imminent changes is an overhaul of Viet Nam's 1980 Constitution. It is felt that substantial changes to the Constitution are mandated by the shift from a centrally planned economy to a free market system. The new charter will be drafted over the next several months for discussion at the Party's seventh congress, scheduled for May 1991.

Unfortunately, some slippages have emerged as well during the past year, particularly in the financial area. They stemmed partly from the halving of Soviet aid, resulting in a loss amounting to roughly 4 percent of GDP during 1989-90. In addition, the unanticipated need to finance rice stockpiling, owing to successful rice production last year, made it necessary for the authorities to resort to more financing from the State Bank than had been initially envisaged. Last, but not least, government expenditures increased because government procurements now have to be paid at market prices. As a result, the rate of inflation, which was 7-8 percent a month during the first quarter of 1989 and had disappeared between March and September, picked up again to about 2.5 percent a month during the last quarter of the year and averaged 2.9 percent a month during the first half of 1990.

Reflecting these trends, the differential between the official and parallel market exchange rates for the dong has widened from less than 10 percent to about 20 percent in mid-1990. In an effort to keep the differential within a 10 percent range, the currency was adjusted to D 6,200 per $1 on September 28, 1990, compared with a parallel market rate of D 6,500 per $1. The authorities are now looking into the specifics of shortly introducing two foreign exchange trading floors that will marginalize the distinction between official and parallel market exchange rates.

Looking to the challenges ahead, severe difficulties will be faced by further cutbacks in Soviet aid in 1991, when the current five-year plan ends; Viet Nam will also be required to service its substantial debt to the U.S.S.R. Moreover, from the beginning of 1991, all trade between Viet Nam and the U.S.S.R. will have to be paid for in dollars and be based on international prices. The negative terms of trade impact of the latter will further strain the balance of payments and the fiscal position.

Despite the daunting problems that have to be faced, Viet Nam remains committed to continuing its economic adjustment efforts and to that end is prepared to undertake stronger and more comprehensive policies. My authorities have now prepared, in conjunction with the Fund staff, a comprehensive program of technical assistance in the area of macroeconomic management to be financed by the UNDP.

Viet Nam needs international assistance to successfully complete its economic reform, solve its arrears problems, and normalize its relations with the international financial community. No country is in a position to self-finance such an endeavor; the Fund even insists on the availability of adequate external financing in cases of Fund-supported adjustment programs.

Viet Nam has been making extraordinary efforts to normalize its relations with the Fund, despite its tight international reserves, which are now equal to only four weeks of imports. Payments falling due amounting to SDR 17.5 million were made in 1989, and payments of SDR 12.1 million have been made so far in 1990 to keep outstanding arrears with the Fund at the end-1988 level. Viet Nam remains committed to meeting payments of about SDR 6.3 million coming due during the remaining period of this year. At the moment, a payment amounting to SDR 3.5 million that was due on September 28, 1990 is still outstanding; this delay reflects administrative problems, and my authorities intend to make the payment in the near future.

By resolutely pursuing further adjustment measures and staying current with the Fund for obligations falling due beyond end-1988, Viet Nam has fully cooperated with the Fund under the intensified collaborative approach. There is, therefore, no reason for support to be denied under this approach. Unfortunately, so far the necessary international support required for the consummation of the intensified collaborative approach could not be mobilized.

Therefore, it is imperative that the process of normalizing Viet Nam's relations with the Fund be expedited, so as to facilitate economic stability and advance economic growth over the medium term.

Extending his remarks, Mr. Ismael said that it was also imperative that the process of normalizing Viet Nam's relations with the Fund be expedited in order to advance political change. Furthermore, as Viet Nam's situation had changed very little since the previous review, there was no reason to adopt a different decision than had been adopted at that time; accordingly, he could support the proposed decision.

Mr. Cirelli made the following statement:

> For more than two years, the Vietnamese authorities have undertaken a set of bold reforms aimed at changing Viet Nam's economy from a centrally planned one to a market-based one. The adjustment programs in Eastern Europe have clearly demonstrated the manifold difficulties of such a task, which further underscores the impressive initial results in the transformation of the Vietnamese economy.
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> My authorities highly commend the Vietnamese authorities for having maintained the momentum of reforms this year, especially as Viet Nam is one of the poorest countries in East Asia, and the substantial results of their economic policy have been achieved with little external assistance and in the context of declining assistance from the nonconvertible area.
>
> The staff report and Mr. Ismael's statement allow us to draw two main conclusions. First, although the task has not been achieved, it is encouraging to note the pursuit of the structural transformation of the economy; indeed, this constitutes an essential element of the success in creating a market-based economy. Second, the pursuit of sound financial policies is indispensable for the resumption of sustainable growth of the economy.
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> There is no doubt that the significant results obtained so far are directly linked, first, to the conjunction of tight financial policies adopted last year and, second, to the fact that the key measures required to make the transition have been taken. Among them, the liberalization of prices from administrative control, the reform of the public sector, and the liberalization of trade have been crucial. These policies have been very successful in dramatically reducing hyperinflation and in modifying economic agents' expectations.
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> Two different features characterize last month's developments: one, which is of some concern, is a sign of weakening in the domain of financial policies; and the other, which is very positive, is the strengthening of structural reforms.

The slippages that have emerged in the financial area must certainly be addressed before they jeopardize the major success obtained so far, namely, the sharp decrease in inflation. The main problem facing the authorities is the budget deficit. Owing to a lack of savings and external financial assistance, the monetary financing of the budget has been unavoidable. This is regrettable, as such a process could fuel inflation again. At the same time, the reduction of budget expenditures appears very limited, given the large amount of investment needed, particularly in the infrastructure sector. Thus, the authorities must rely mainly on revenue increases, which could only come from the maintenance of a general economic framework that was propitious for growth. Several elements, however, are encouraging. First, the primary fiscal deficit should be halved in 1990 to 5 percent of GDP, compared with 11.4 percent in 1989, and I would like to welcome in particular the prudent wage policy adopted by the authorities. Could the staff confirm this figure of 5 percent and give us some idea of the budgetary impact of the recent oil prices. Second, reforms are under way to develop nonmonetary financing of the budget, notably through the creation of a public bond market. Finally, a wide reform of the tax system has been adopted, which provides a legal basis for uniform tax treatment and will improve revenue collection. With this prospect, the forecast creation of an income tax is a welcome step.

To provide a solid ground for growth and to foster savings--which are currently at a very low level, despite a welcome boost last year--a monetary policy aimed at price stability and positive real interest rates is of the utmost importance. The increase in savings, if channelled to productive investments, will greatly contribute to reducing the economic bottlenecks facing Viet Nam and will therefore foster growth. Creating the conditions for better monetary control is important, and I welcome the reform of the Central Bank. In this context, the distorted interest rate structure has to be corrected as soon as possible. An immediate objective should be to avoid exchange rate differentials between official and parallel rates, which risk creating a process of spiralling devaluation that would be detrimental to the stabilization of the economy. The unification of the exchange rates is still an objective the authorities must pursue, and I welcome the establishment of trading floors, which will improve the functioning of the exchange market.

As for structural policy, the momentum and consistency of the reforms, which are geared toward transforming the economy, are quite remarkable. Mr. Ismael's statement has rightly detailed the scope of the reforms undertaken. One must acknowledge that the authorities are working in the right direction to address the main issues facing this transition toward a market economy. Among them, let me stress the importance of the proposals planned for next year to provide a legal framework for private ownership and a bankruptcy law, which is indispensable for the cleaning up of loss-making public enterprises. I welcome the fact that the financial sector reform prohibits the State Bank from directly extending credit to local banks, thus providing the right framework to ensure that the elimination of subsidies achieved last year will not be replaced by the creation of new indirect subsidies through bank credit. This underscores the need to maintain strict credit control at the central level. Finally, the equality of treatment between the private and the public sectors, introduced by the new law, will eliminate the distorted competition experienced so far.

All in all, the prospects for the Vietnamese economy look very encouraging. The medium-term scenario considered by the staff indicates that substantial progress toward a viable external payments position is feasible in the years to come. Such a positive outcome calls for the continued commitment of the authorities to maintain the right policies and to protect the gains already achieved in stabilizing the economy. But this also calls for more external assistance to back and secure the whole transformation process that the authorities have embarked upon.

On the one hand, one can be reassured by the Vietnamese authorities' willingness to solve the problem of their arrears vis-à-vis the Fund, and to normalize their relations with the international community. In comparison with many other arrears cases, Viet Nam has an impressive track record and has been able to stabilize its arrears for almost three years. At present, new steps have to be envisaged. I am glad that last week the EC decided to lift previous restrictions against Viet Nam. As far as my authorities are concerned, this chair has expressed--at the previous Board review--our willingness to sponsor a group of friends of Viet Nam, aimed at accelerating the process of normalization with the financial community. Some countries have already responded favorably. We hope that we will soon attain the critical mass of countries expressing their willingness to make a contribution toward Viet Nam's financial needs, in order to put Viet Nam in the position of fully benefiting from the collaborative approach, and so that a meeting of the group could be held in the near future.

On the other hand, the Fund should deepen its involvement by playing a leading role in the resolution of the arrears problem, and by helping the authorities design and put in place a strong adjustment program to address the present macroeconomic imbalances. In this regard, the establishment of a policy framework paper with the authorities should be undertaken rapidly. At this time, the Vietnamese authorities must receive a clear signal that their efforts to rejoin the international financial community are understood and supported; I hope this meeting will provide a useful opportunity. I wish the Vietnamese authorities well in their endeavors, and can support the proposed decisions as drafted.

Mr. Fogelholm made the following statement:

The staff reports provide an excellent account of Viet Nam's achievements over the past 18 months. The transformation from a centrally planned economic system to a market-oriented one has been quite remarkable and equals, or perhaps even surpasses in specific areas--notably, enterprise and price reforms--the speed of such changes in Eastern Europe. These achievements are much more impressive when one takes into account the fact that this was managed with very little external support. However, despite significant progress, the structural reform process is far from complete. Further advances in macroeconomic stabilization are also required; this implies that financial policies will have to be strengthened considerably.

In the area of monetary policy, I share the staff's concern about the recent increase in liquidity resulting mainly from the monetary financing of the budget. Although the reasons for this are understandable, a change in policy direction is necessary if inflation is to be curbed. In this context, it is most important that the State Bank's enhanced authority--provided under the new central banking law--be given credibility through strict enforcement of existing credit and monetary control mechanisms. Moreover, containment of bank credit to the Government and the public enterprise sector requires a thorough consolidation of the public sector and improvements in the efficiency and performance of public enterprises. The importance of such measures is further underscored by the destabilizing budgetary impact of the substantial decline in Soviet commodity aid.

A more market-oriented approach to interest rate policy is also essential, and this implies prompt establishment of positive real interest rates--a need that particularly relates to the current lending rate structure. While acknowledging the authorities' concerns regarding the potentially negative impact of higher lending rates on the financially strained public enterprises, I believe that gains in efficiency in the medium term will largely depend on correct relative prices. A market-based interest rate structure is, of course, also necessary to improve the functioning of the financial sector and, more generally, the allocation of capital throughout the economy. Thus, I urge the authorities not to postpone any change of interest rate policy by linking it to future financial gains of public enterprises.

On fiscal policy, I concur with the view that there is a need to improve the present tax system and strengthen tax collecting procedures, and I support the thrust of the staff's recommendations in this area. However, it is not fully clear to me why the staff recommends that the authorities raise further the average effective import duty rate. Does the staff mean that, at this juncture, revenue enhancing measures should take precedence over trade liberalization efforts?

I will limit my comments on the economic policy situation to these remarks, which is easily done as I am in full accord with the staff's appraisal. Please allow me, however, to make some general observations on the overdues situation.

I believe that there can be no doubt that Viet Nam has actively cooperated with the Fund, both in terms of payments to the Fund and implementation of economic policies. Nevertheless, it is extremely important that Viet Nam stay on course in terms of reforms and continue to make payments to the Fund at least to the extent that the amount of arrears does not increase from its present level. More would of course be preferable.

It is also crucial that the authorities clearly express their commitment to further policy reforms in order to erase any doubts--both domestically and internationally--that may exist with regard to their intentions. However, in the absence of external assistance, their ability to intensify these efforts could be seriously undermined. This chair believes that, in order to support the economic reform process in Viet Nam, the Executive Board should acknowledge that the authorities need and deserve the Fund's assistance in formulating and implementing a Fund-supported comprehensive economic adjustment program.

It is also the view of the Nordic countries that, in order for the Fund to support Viet Nam in its efforts to clear the arrears to this institution, member countries that until now have blocked such settlement must show more flexibility. As equal treatment of member countries is a central element in the Fund's enhanced arrears strategy, and as our Governors have agreed to amend the Articles of Agreement to render this strategy more efficient, it is of the utmost importance that we show the world that the strategy works in practice.

In conclusion, I would suggest that the next Fund mission to Viet Nam be given a mandate to work out a strong adjustment program with the authorities, thereby improving our preparedness to support the country swiftly, once the political obstacles to the clearance of the arrears have abated.

With these remarks, I support the proposed decisions.

Mr. Grosche made the following statement:

We share the staff's view that the authorities' comprehensive economic reform is on the right track and that it deserves the support of the international community. Improvements in the political environment in the region should help to create better prospects for international support. In order to obtain full support, however, the authorities need to do their share as well. They need to demonstrate their commitment to reforms through continued adjustment in the framework of a consistent program.

We consider the direction and speed of reform over the past year to be broadly satisfactory, but policies can and should be further improved. Viet Nam has the advantage of vast human and natural resources and, with the correct system in place, its economy has the potential of approaching those of the other very successful countries in the region. Obviously, its starting position is not the best: a distorted system and low income levels make fast progress difficult. Before becoming another of the small tigers, the country has to live through further periods of adjustment and reform. Already, two useful lessons can be drawn from the short experience of reform in Viet Nam. First, severe external financing constraints need not constrain reform. Reform measures like the ones in the agricultural sector, for example, can yield quick results even without external financing. Second, the country's success in reducing inflation mainly through high real interest rates can serve as strong encouragement to other countries with protracted difficulties in keeping prices down. However, as the staff and Mr. Ismael inform us, some slippages have emerged. It is of particular concern to us that the rate of inflation has picked up again. I endorse the staff's recommendation to enforce higher reserve requirements. At the same time, I would also fully support their advice to quickly raise lending rates and to submit a timetable for an early removal of the distorted structure of interest rates, which could cause substantial losses for the banking system.

Fiscal policy could be confronted with the difficult task of making up for the cuts in Soviet aid through greater savings and revenues. Clearly, bank financing of the already high deficit needs to be contained. In the short run, expenditure control is of the essence, but investment outlays should be spared as much as possible. The restoration of the country's rundown infrastructure is one of the key elements of the authorities' economic strategy. I would be interested to learn from the World Bank representative about the potential of the World Bank in assisting the authorities in establishing an investment program with clear priorities so that scarce financing can be put to best use.

On the revenue side of the budget, a broadening of the tax base and further reforms in tax administration should not be delayed. Over the medium term, higher oil revenues should also help to better balance the budget. Like the staff, we question the large imports of gold--obviously needed to pay the farmers for their excess rice production. To me, this demonstrates the lack of confidence in the country's currency and the clear need for continued credible anti-inflationary policies.

We are deeply concerned about the expectation of rising arrears, as well as the large balance of payments gap, the financing of which is not yet assured. I am less optimistic than the staff about the possibility of an early achievement of balance of payments viability, especially as the calculations of future flows are heavily burdened by uncertainties about obligations vis-à-vis the CMEA countries. In any case, increased assistance from the convertible area should not be used to finance net resource transfers to the U.S.S.R.

I have nothing to add on the staff's advice on exchange rate policies, except to endorse their recommendation for firm monetary control to prevent a vicious circle of inflation and exchange rate depreciation.

Finally, a few words on structural matters. Viet Nam has the big advantage that the structure of farming has been left largely untouched by the old system, and that it can build on a small-scale manufacturing sector. The rest of the economy, however, remains heavily burdened by inefficient state-owned enterprises. Much needs to be done in this area, particularly in leaving it to the market to set prices, in reforming the financial structure of enterprises, and in addressing the endemic overstaffing, as the staff calls it.

With these remarks, I can support the proposed decision concluding the Article XIV consultation. I support the draft decision on arrears in the expectation that at least the outstanding payment that was due on September 21, 1990 will be made very soon.

Mr. Evans said that the period since the 1989 Article IV consultation had done much to confirm the perseverance and commitment of the Vietnamese authorities to their program of macroeconomic and structural adjustment. The authorities had not only made significant and impressive gains in the introduction of market-oriented economic reforms, but also had been able to sustain that momentum despite the lack of external financial support and a deteriorating external environment, including a larger than anticipated decline in CMEA aid. The economic results in 1990 were less impressive than in 1989, although Viet Nam was possibly one of the very few cases about which one could say that the outcome largely reflected external developments. Most disturbing in 1990 was the re-emergence of inflation and exchange rate instability, the immediate source of which could be readily traced to the loss of domestic financial control in the face of inadequate external financing.

Neither the staff report nor the staff appraisal gave a clear view of how those crucial issues might develop; indeed, there were no forecasts for 1991, Mr. Evans observed. However, even without quantitative forecasts, the policy requirements were clear enough, and the staff and the authorities appeared to be in broad agreement. While much remained to be done, he supported the staff appraisal and urged the authorities to pursue the required policies with vigor. On the basis of past performance, he expected that the authorities would do so, provided their efforts were not further frustrated by the international community. External financing remained extremely difficult, and it was crucial that Fund members not continue to deny Viet Nam the opportunity to fully participate in the collaborative approach for dealing with arrears. Accordingly, he supported the proposed decisions.

Mr. Iqbal said that he supported the draft decisions.

The staff representative from the Asian Department confirmed that, as noted by Mr. Cirelli, the 1990 fiscal deficit was expected to fall to 5 percent of GDP. The staff's most recent estimate of the budgetary impact of the oil price increase was that revenues would increase in 1990 by about one half of 1 percent of GDP beyond the estimate contained in the staff report.

Some concern about the staff's recommendation for increasing import tariffs had been expressed by Mr. Fogelholm, as that recommendation might be construed as favoring protection, the staff representative recalled. One had to recognize that there was a major shift taking place in the external orientation of policies--from quantitative controls to pricing mechanisms--which would clearly involve a shift toward tariffs. As quantitative controls had been lifted prior to the establishment of a comprehensive tariff system, the average level of import taxes was currently only 4 percent. Moreover, some imported goods were not being taxed at all at present, in contrast with equivalent domestic goods. It was in that context that the staff had made its recommendations to raise tariff rates and--equally important--to strengthen tariff collection.

The staff representative from the World Bank remarked that the World Bank was involved in the authorities' investment program in three ways. First, in conjunction with the Ministry of Planning and the Korean Development Institution, the World Bank was in the process of designing a project to strengthen the expertise of the Ministry of Planning in managing the new situation, whereby the economy would be run by a mixture of incentives and other measures, rather than by fiat. Second, the staff continued to conduct its own economic analyses of the economic situation in general, and, planning issues and the financial sector in particular. Third, the staff produced a number of sector reports--on transportation and agriculture, for example--which attempted to prioritize the authorities' actions in the investment area.

Ms. Creane made the following statement:

We welcome the continuing efforts made to restructure the Vietnamese economy into a more market-oriented system. In the past year and a half, the authorities have taken key structural reform steps that, with the additional measures planned, should go far in improving Viet Nam's economic adjustment prospects. The package of tight financial policies that accompanied the structural reforms in 1989 had the positive result of shrinking the government deficit and sharply cutting back the inflation rate. Unfortunately, as many today have already observed, while structural reforms continued into 1990, tight financial policies did not, and the authorities now risk reversing the progress accomplished last year in reducing inflation.

Like the staff, we believe that the authorities' main focus should be on a tightening of financial policies. It is now clear that the decline in the primary source of inflationary pressure--bank financing of the public sector--will not be sufficient to reduce the rate of inflation, or even to stem its renewed acceleration. Lacking any alternative means to finance the deficit, the only solution is a further narrowing of the deficit. The Vietnamese authorities have already taken important steps, such as prioritizing capital expenditures and cutting subsidies. But it seems that much of the improvement might be ephemeral--such as cuts in much-needed capital expenditures or shifting much of the subsidy cuts onto the wage bill--rather than rooting out less essential outlays, such as defense and the unexplained expenditures included under the "other" category.

The need to find alternative sources of revenue is obvious, in view of the likely transient nature of some of this year's expenditure cuts and the significant remaining budget deficit. We strongly recommend that the authorities supplement the tax reform measures already taken with additional taxes and enhanced collection efforts.

Although structural measures are being taken to avoid the bank financing source of inflation in the future, neither the staff report nor Mr. Ismael's statement indicate that the authorities are implementing an effective short-term response to the current monetary buildup. Credit to the public enterprises and government continues to expand at excessively high levels--if lower than in previous years--leaving less than 7 percent of domestic credit to be extended to the nonstate sector. The increase in the reserve requirement is a positive, but not sufficient, tool. The lowering of lending interest rates in the first half of this year, at the same time that inflation was reaccelerating, makes one wonder whether the authorities had so quickly forgotten the experience of the previous year. As a result, we support the staff's recommendation for an urgent tightening of monetary policies, in particular by raising lending rates.

On structural reform, Viet Nam continues to move in the right direction by introducing measures that should establish a firm basis for a market-oriented economic system. Recent measures of particular importance include legislation introducing the legal framework for the central bank, and the restructuring of the commercial banking system. We strongly advocate the acceleration of those steps planned but not yet taken, such as the introduction of bankruptcy laws, a clear and broad legal framework for private sector activity, and well-defined property rights for banks. We also strongly recommend, as an essential complementary step, the freeing of administered interest rates and the dismantling of the redeposit system at a much more rapid pace than currently contemplated. The combination of these measures would allow the authorities to employ indirect methods of monetary policy control. By dissolving the structural and credibility rigidities that currently hamper this solution, they should also establish the environment necessary to allow nonbank financing of the deficit through successful bond issuance. These measures should also further encourage the nonstate sector--which already accounts for the major part of output, despite operating under considerable constraint.

We welcome the decision on the recent devaluation of the dong--as explained in Mr. Ismael's statement--as well as the decision to open the two foreign exchange trading floors, which should effectively unite the parallel and official rates. At the same time, we caution the authorities that this increases the need to further tighten financial policies. Viet Nam has made commendable progress in moving toward an outward-oriented trade policy and in reducing its current account deficit. Against this background, we join others in questioning why the authorities allowed scarce resources to be diverted to gold imports, and in recommending the policy prescription of tight financial policies as the cure for calming market fears.

We were disappointed that Viet Nam has not yet been able to meet its most recent obligation to the Fund. Measured by its record of generally following through on payments within a few weeks of its due date, the payment could have been made by today's discussion and avoided the unfortunate symbolism.

With the implementation of the structural reforms planned and further tightening of financial policies, Viet Nam is on a track that may well lead to a normalization of relations with creditors. For these reasons, we agree to the proposed decisions.

Mr. Wright made the following statement:

I have only a little to add to the lucid and thorough analysis contained in the staff reports. Like other speakers, I commend the authorities on the impressive pace at which they are transforming Viet Nam to a market economy, despite the severe curtailment of aid from the U.S.S.R. They have grasped the importance of making the transition as comprehensive as possible, as well as getting right the precise sequencing of structural reforms, and it is gratifying that positive results are emerging so soon.

I have only brief comments to make on the monetary situation and on Viet Nam's relations with the external financial community. As the experience of other countries attempting similar liberalization has shown, a sound financial framework is essential if inflation is not to undermine the process of reform. In Viet Nam's case, impressive progress has been made in bringing inflation down, but further reductions will prove difficult if not impossible in the absence of a credible monetary policy and a proper framework in which it can operate. It is therefore particularly disappointing that the authorities have still not set medium-term fiscal and monetary targets; further delay will only reinforce the doubts that have already emerged in Viet Nam about the authorities' resolve to bear down on inflation. I agree with the staff's comments on the excessive rate of monetary growth, the unsustainable structure of interest rates, and the need to take more decisive steps to eliminate bank financing of the budget deficit.

It is particularly important that the monetary and fiscal measures that the staff have recommended proceed in tandem with structural reforms in the financial sector, which remains the economy's weakest link; perhaps the staff could tell me when they expect the results of the World Bank study of this sector to be available.

Overall, I strongly agree with Mr. Grosche that, in reading the staff paper, it is hard to avoid the conclusion--perhaps not a very surprising one--that confidence in the financial system is still sadly lacking. This is reflected in the large-scale and entirely regrettable purchases of gold for transactions purposes, and the apparent inability of the authorities to finance their deficit in a nonmonetary form through the sale of bonds. The re-establishment of confidence will take time, and the authorities should begin the process without delay. The highest priority should be given to developing indirect techniques of monetary control. Steps also need to be taken to strengthen confidence in the fragile banking system, and here I would suggest that greater participation by foreign banks may have a role to play.

Turning to Viet Nam's relations with the international financial community, the medium-term scenarios in the staff paper clearly show how Viet Nam would benefit from a normalization of relations with foreign creditors and renewed access to external finance. It might have focussed our minds still more to know how Viet Nam would cope without rescheduling and new lending next year. Perhaps the staff could elaborate on exactly how precarious Viet Nam's position would be on less optimistic assumptions.

Turning finally to Viet Nam's overdue obligations, I am content with the draft decision as it stands, which is essentially the same as those adopted at each of the last three reviews. In view of the authorities' established track record of cooperation and the serious difficulties which they face next year, I hope that the Fund--and, in due course, the World Bank too--will soon be in a position to play a more active role to ensure that Viet Nam's economic reforms are sustained and its arrears are finally cleared.

Mr. Binay made the following statement:

During the past two years, the Vietnamese authorities managed to match, through serious adjustment and reform efforts, the unprecedented challenge of major changes in their external environment. Progress has been most obvious in agriculture and in the interest shown by foreign direct investment. Without much improvement in production techniques or the use of fertilizers--only one half of the developing countries' average--Viet Nam's position among the world's rice exporters continues to improve. Foreign direct investment gained substantial momentum, as reflected by this year's investment license applications. The challenge is how to support and accelerate this momentum, not only with adequate macroeconomic policies, but also with innovative schemes that could be devised with a view to reducing the massive debt-service obligations of the country.

As rightly noted by Mr. Ismael and the staff, the difficulties in the near future will result from the fact that foreseeable conditions for 1991 require Viet Nam to adapt to the new realities if the process of reform is to become self-sustaining. Anticipated cuts in Soviet aid and expected terms of trade losses due to changes in the trading base--if not compensated--will threaten not only the stability of macroeconomic balance, but also the momentum of institutional reform efforts. According to the staff estimates, the financing gap, taking into account the necessary debt rescheduling during the next three years, stands at $400 million a year. While the staff's analysis of the medium term rightly highlights the balance of payments concerns, the importance of sufficient financing for domestic reasons should not be neglected. There is an obvious need to transform industries, by modernizing technology, and to support the private sector in order to assist employment with favorable external relative prices. But improvements in two other areas, namely, fiscal policy and the financial sector, have equal priority for future prospects.

On fiscal policy, the need to establish a market-based tax system becomes most important, as the private sector has now a much larger share. Although I welcome the authorities' efforts to streamline the system during the previous months, I wonder whether it would not be desirable to introduce a general value-added tax system instead of more administratively complex taxes--such as turnover and profit taxes, and the special consumption tax. The transparency provided by the value-added tax system, in terms of accounting and identification of the links between various levels of production, would also be a preferable method to broaden the tax base. On the expenditures side and on state enterprises, courageous steps have been taken in the right direction to correct the burden of overstaffing. But future success depends as much on the persistence of realistic wage policies as on the private sector's capacity for job creation.

On the current status of the financial sector--which is far from satisfying the needs of the private sector--vast problems of disintermediation and the lack of confidence are reflected in the increased use of gold as an exchange and savings instrument, parallel to the expansion of an informal sector. Accelerating institutional reform, as well as promoting the private sector and the entry of foreign banks, would have the effect of boosting confidence in the functioning of the domestic markets. On the regulatory framework and on surveillance, I hope that the authorities' expectations for World Bank assistance can soon be met.

Regarding Viet Nam's arrears to the Fund, I am of the view that this country deserves to be regarded as a good candidate for successful implementation of our collaborative approach. The resilience of the Vietnamese economy--once appropriate policies start to be implemented--allows us to be hopeful for the future, providing the country succeeds in reopening its access to external sources of financing, which is the purpose of the Fund's collaborative strategy.

I support the proposed decisions.

Mr. Yamazaki made the following statement:

I welcome the decisive policy reforms being implemented with the strong commitment of the Vietnamese authorities. Indeed, the wide-ranging policy measures taken by the authorities since early 1989 are impressive, and demonstrate the authorities' willingness to proceed with the policy reforms. It is especially encouraging that the Vietnamese economy has been making steady and rapid progress toward a more market-oriented economy.

The State Bank will, beginning this October, be given the formal legal powers of a central bank. Financial sector reforms will be a key element in fostering greater competition in the economy. It is also auspicious that the legislation governing the commercial banks will come into effect, which will abolish restrictions that limit the banks' business to specified economic sectors and to allow the entry of new banks. At the same time, an interbank money market will be formed. I am sure these reforms in the financial sector will greatly help to introduce a more market-oriented element into the banking system and will lead to the correction of distortions that have existed in the interest rate structure. Changes are taking place in private business, as well as in the financial sector. As Mr. Ismael mentioned in his statement, the country's first comprehensive law on companies is planned to be introduced next year. This will provide a strong legal framework for private ownership and foreign investment. State enterprises have already been given the right to operate on a commercial basis with full autonomy.

All these reforms are encouraging, and bear witness to the authorities' strong commitment to a more market-oriented economy, in line with the economies that maintain convertible currencies. These outward-looking structural reforms have led to the projections that the capital account in 1990 will be balanced, owing to the strong flow of direct investment into Viet Nam. The Vietnamese economy is now heading in the right direction, and I hope that the Government will keep the same course of continued reforms.

Notwithstanding the progress made in the structural areas and some important positive results produced by that progress, the adjustment process still has far to go. In particular, I would support the staff's view that the battle against inflation is not yet won, and that the road to return to a sustainable balance of payments position is still long and winding. In this regard, I would continue to urge the authorities to pursue tighter monetary control. Strong restraint on the State Bank financing of the budget deficit is required, especially in light of the foreseeable difficulties owing to further cutbacks in Soviet aid.

In order to meet these objectives, the staff correctly recommends further strengthening of budget revenue, and further savings on the expenditure side. Measures for the former should include a vigorous restructuring of the state enterprise sector; this will promote tax contributions to the budget. Additional measures will be needed, such as increased import duties and the elimination of exemptions on capital equipment and raw materials.

On the external side, although I regret the continued existence of Viet Nam's arrears to the Fund, I welcome the fact that since the last review Viet Nam has made payments to the Fund that are equal to its obligations falling due, though with some delay. Together with the authorities' determination to pursue comprehensive adjustment policies with Fund monitoring, the authorities' intention to remain current in their forthcoming obligations to the Fund is encouraging and will strengthen their collaboration with the Fund under the intensified collaborative approach. In this light, I agree with the staff that no remedial measures are necessary at this stage.

I support the proposed decisions and I trust that the authorities will continue to make significant progress in their adjustment efforts.

Mr. Kyriazidis made the following statement:

Viet Nam is at a very critical and delicate stage in its transition toward a market-based economy. Major liberalization measures and structural changes have been successfully implemented, while others appear to be imminent. The staff report and Mr. Ismael's statement give us a broad description and evaluation of these important achievements, for which the Vietnamese authorities should be highly commended.

However, notwithstanding the impressive results of the anti-inflationary stabilization measures introduced in March 1989, the macroeconomic structure of the economy continues to exhibit fundamental weaknesses that could easily lead to strong new destabilizing pressures, unless comprehensive and credible restrictive measures are rapidly implemented. Indeed, macroeconomic stability is, at this stage, the necessary requirement to proceed successfully along the road of institutional and structural reforms, foster investment activity and growth, and return to a sustainable balance of payments position. I fully share the staff's concerns and proposals in this regard, and I would like to comment briefly on some aspects of the necessary macroeconomic adjustments. I will then present our views on Viet Nam's overdue financial obligations to the Fund.

The large fiscal deficit and its high degree of monetary financing were at the roots of the near hyperinflationary economic scenario that characterized Viet Nam's economy before the adoption of the stabilization package of March 1989. The sharp increase in interest rates to highly positive levels in real terms, together with the devaluation of the exchange rate to a realistic level, very effectively increased the demand for dong-denominated assets. Impressively, inflation and inflationary expectations were stopped. This was, however, a short-run stabilization attempt, which lacked a comprehensive restrictive macroeconomic package to be implemented in the medium run. Not surprisingly, slippages in fiscal policy resulted in a sharp increase in money creation, inevitably leading to re-emerging inflationary pressures.

Notwithstanding the correct general thrust of policies that the Vietnamese authorities intend to implement for the 1990-93 period, this fundamental macroeconomic instability, which has its origin in the fiscal problem, continues to generate a high degree of uncertainty about the future path of the adjustment process. Indeed, the risk of destabilizing inflationary pressures is still high and the cost of stabilizing inflation could always be higher, carrying with it the risk of backtracking in the structural reform process that has been highly successful so far.

An effective, stronger fiscal consolidation, both with regard to the budget and the state enterprise sector, is therefore essential at this stage. While I certainly welcome the significant steps achieved thus far to reduce the primary budget deficit in 1990--notwithstanding the relevant shortfall in total foreign financing--it is a source of great concern and uncertainty that the Vietnamese authorities have not yet determined the fiscal targets for 1991, when, among other factors, the shift of trade to world market prices with the CMEA area is likely to increase the burden on the budget.

On the monetary front, important measures are planned, among which is a sharp increase in effective reserve requirements. These measures alone, however, though establishing the ground for an effective future policy of indirect monetary control, cannot be successful beyond the short term in containing the excessive monetary expansion linked to the financing of the fiscal deficit. To this end, an efficient market for public debt instruments should be established. This would require, as a first step, moving quickly toward a market-oriented interest rate structure, in line with the envisaged reforms of the State Bank and of the commercial banking sector.

These financial weaknesses of the Vietnamese economy are certainly a source of concern, but they can and should be overcome through the technical and financial assistance of the international community. Viet Nam has great economic potential, in terms of both human and natural resources. All the endeavors and the successful results so far achieved should not be slowed or arrested because of a lack of international support.

The solution of the problem of the arrears, both with the Fund and with other creditors, is clearly strictly linked to the aforementioned considerations. I am glad to note from Mr. Ismael's statement that Viet Nam continues to make extraordinary efforts to normalize its relations with the Fund, actively pursuing the collaborative procedures envisaged under the cooperative strategy. It is always our position that this institution cannot condone the continuation of outstanding arrears; however, in light of the above considerations, we strongly believe that it is appropriate to persist in the efforts to assist Viet Nam in normalizing its relations with the Fund within the framework of the intensified collaborative approach. I can support the proposed decisions.

Mr. Arora made the following statement:

One may recall that just 6 months earlier, Executive Directors had--almost with one voice--commended the authorities for implementing a comprehensive and wide-ranging program of macroeconomic and structural adjustment. It is to the credit of the country that, despite problems and difficulties, it has gone ahead with the reforms at great cost and without much outside help.

The results have been encouraging. Thus, responding to the price and other incentives, agricultural production increased so much that, far from being an importer of rice, in 1989 the country emerged as the third largest exporter of rice; crop estimates for 1990 are equally encouraging. Significantly, much of the increase was on account of higher yields. In the industrial field, too, after an initial set back, production is projected to increase handsomely in 1990. Small-scale industries and trade also recorded large gains. Overall, though GDP rose by only an estimated 2.7 percent in 1989, the rate is projected to more than double to 6 percent in 1990; the staff contends that these rates may well have been underestimated. Inflation at the end of 1989 was no doubt high, but it must not be forgotten that, at 35 percent, it was less than one-tenth of the level of a year ago; the staff considers the success in this regard to be dramatic.

On the fiscal front, tax reforms boosted tax receipts in relation to GDP. Though expenditure also increased, it was largely on the capital account--investment in industry, construction, irrigation, transport, and communication. The increase in other items of current expenditure was almost completely offset by elimination of all current budgetary subsidies. During 1990, while tax and other revenue receipts are projected to go up further in relation to GDP, the authorities intend to freeze current expenditure, including wages, in nominal terms.

In the area of money and finance, bank credit to state enterprises in relation to GDP grew by 1.5 percentage points to 10.4 percent in 1989; the authorities intend to slash it to

4.7 percent in 1990. The rate of increase in dong liquidity and domestic credit was cut down sharply--the former, to one fourth, and the latter to much under one half. Interest rates on deposits, though still administered, were made positive in real terms. In the external sector, adoption of a pragmatic exchange rate policy led to a quantum jump in exports--mainly petroleum and rice--to the convertible currency area. As a result, there was substantial improvement in the external position.

These are no mean achievements, considering the sharp decline in external assistance and the very short span of time. In fact, their performance is much more impressive and credible when compared with that of other countries transforming from a centralized to an open, market-oriented economy. The evidence is thus strong of Viet Nam's determination to take corrective measures and its unwavering commitment to strong adjustment policies. It is time the international community accepts the evidence.

There is, of course, evidence of some recent policy slippages, particularly in the area of fiscal policy, as reflected in increases in expenditure, on the one hand, and large increases in bank financing of state enterprises--causing sharp increase in reserve money and dong liquidity, and a consequent buildup of inflationary pressure--on the other. However, to the extent that the increase in public expenditure was on account of stockpiling of rice and the increased monetization of the budgetary deficit--on account of the large drop in external assistance and the inability of the authorities to sell government securities to nonbanks--these can hardly be taken to indicate loosening of control; the problem may, in the main, be attributed to factors beyond the control of the authorities. While on this point, I am surprised that the staff does not consider the planned reduction in bank financing of the deficit, from 10 percent in 1989 to 4.5 percent in 1990, consistent with a strong anti-inflation program. The staff may like to comment on this point.

The staff is right in emphasizing the need for a substantially higher rate of investment, especially to restore the rundown infrastructure and that, in the main, this will have to be financed by a turnaround in savings generated by government, surpluses of state enterprises, and larger mobilization of public savings. However, as the authorities rightly emphasize, resumption of capital flows from the convertible currency area would be equally important. It will be unfortunate if, in spite of all that Viet Nam has done on its own, its technology renovation program is held up--or considerably slowed down--for want of adequate flows of external assistance.

As I see it, there are two basic issues which the authorities need to firmly tackle, and on a priority basis: one relates to the contents of monetary policy, and the other to the functioning of state enterprises.

Regarding monetary policy, I would like to make three points. First, in their anxiety to make bank deposits attractive, the authorities set the interest rates on household deposits high enough to ensure real positive returns to households. However, the lending rates have been reduced sharply across the board, so much so that the average rate of return to banks on deployment of resources is considerably less than the average cost of resources. This is hardly conducive to the healthy growth of the banking system. Thus, while I do appreciate the authorities' contention to go slow on liberalization of the interest rate structure, the situation needs to be rationalized, not only to provide some real positive return to banks, but also, and more importantly, to ensure better allocation of resources. Second, while the authorities do not believe that they could reduce bank financing of the budget deficit in 1990 below the budgeted level, they intend to tighten bank liquidity; the key measure they are considering is a sharp increase in effective reserve requirements. I am of the view that, with no control on bank financing of the budget deficit, any increase in the reserve requirement will only reduce the flow of bank credit to the private/productive sector and would not, therefore, be consistent with the objectives of an open and market-oriented economy. Perhaps a better course of action would be for the State Bank to liberalize the interest rate structure, develop new money market instruments, and pursue active open market operations. Mr. Ismael or the staff may like to comment on this. Third, it seems that banks are holding their excess balances in higher interest redeposit accounts at the State Bank. To the extent that interest paid by the State Bank adds to reserve money, I doubt whether the existence of the interest redeposit window at the State Bank really helps to sterilize even a part of the excess bank liquidity, as asserted by the staff. In fact, in my view, the scheme may actually dilute the effectiveness of other instruments of monetary control. I would welcome staff comment on this point.

The second issue that the authorities need to tackle relates to financing of state enterprises. Though direct budgetary subsidies have been eliminated and criteria for bank lending considerably tightened, their reliance on bank finance remains a major factor in the large level of domestic credit and, therefore, liquidity expansion. Apart from ensuring access to easy and very cheap credit, which has created a sense of complacency, the banking system's near exclusive exposure to government and state enterprises will limit its ability to finance the growing private sector and is again, therefore, not compatible with a market-oriented economy. State enterprises must be made to generate internal resources and be more self-reliant; they may also be encouraged to raise resources from the market. This will, however, require sharp improvement in their efficiency and, therefore, performance. Moreover, as the staff has rightly pointed out, this way state enterprises would also be in a position to make a significant contribution to the budgetary resources. It is in this context that I welcome the move to subject these enterprises to a capital user fee, to ensure inclusion of the opportunity cost of capital in production and pricing decisions.

In the sphere of foreign trade, I am intrigued by the policy of imports of nonmonetary gold on a large scale for use by trading companies to purchase rice surpluses and marine products for exports. I do not see the logic of the scheme. In my view, this is an ill-conceived scheme, which the country can hardly afford. On the exports front, although the staff expects the total volume of rice exports in 1990 to exceed the record level of 1989, the result in dollar terms is projected to decline by some 18 percent. Does the staff expect the price of rice to crash in the international market? I would like to know the assumptions made by the staff in this regard.

I welcome the dismantling of the monolithic banking structure, and the two new decree laws, which, I hope, will help establish a well-regulated, competitive, and market-oriented banking system.

Viet Nam has remained current with the Fund and is committed to clear its arrears expeditiously. It has also initiated, at great cost, measures to move toward an outward- and market-oriented economy. The staff and the Executive Board are of the view that economic reforms are on the right track. Viet Nam is also committed to going ahead with the strong adjustment program. However, there is only so much a poor country can do on its own, without outside support. It is time the international community also committed itself to helping Viet Nam move further in the desired direction. The requirements are not large.

With a combination of a strong adjustment program, and a restructuring of arrears and new debt-service obligations, the residual financing gap is estimated at about $400 million a year during the next three years. Such a package can be assembled by multilateral institutions and a few interested bilateral donors, and it is time they do so. The illustrative medium-term balance of payments scenario sketched by the staff indicates that

Viet Nam's external position would remain fragile and sensitive to external shocks. In fact, the staff has noted that Viet Nam would not be in a position to meet its payments in full during the early years of the next decade, even with a substantial drawdown of international reserves and a halt in the growth of imports. Therefore, Viet Nam needs--and deserves--the full support of the international community if it is not to slide back to square one.

I am surprised that the staff has not cared to even mention--let alone discuss--the serious unemployment problem facing the country. The problem, accentuated by the implementation of the strong structural adjustment program, has been further exacerbated by the crisis in the Middle East and economic/political transformation in Central and Eastern Europe, including the U.S.S.R. So far, the authorities have remained brave about the problem; but it is an issue that needs to be resolved before it explodes. The crisis may also affect the ability of the authorities to expeditiously clear Viet Nam's. I would welcome staff comment on this.

Though the Vietnamese economy is dominated by agriculture, it has abundant skilled labor, reasonable infrastructure, and other facilities--albeit in need of upgrading--for rapid industrialization. In fact, it has the potential and wherewithal to become the next Asian boom country. The catalyst to bring this about is international finance. Should the Fund not act as the catalytic agent?

The Vietnamese authorities have cooperated and continue cooperating with the Fund in implementing a comprehensive program of macroeconomic and structural adjustment. The Fund, for its part, has promised and continues promising to assist Viet Nam in "any appropriate way." It is high time that the Fund translates its intentions into concrete and specific actions. To begin with, it can at least ensure formation of a support group.

The Fund, and other multilateral institutions, swear by the efficiency of the market. The data indicate substantial inflows of direct foreign investment in Viet Nam. The staff estimates those inflows to be $220 million in the two years ending 1990; the East-West Center in Hawaii has estimated them at over $500 million in the past two years. The market has thus shown its confidence in the performance and program of Viet Nam. Should the multilateral institutions lag behind?

With these remarks, I support the two proposed decisions.

Extending his remarks, Mr. Arora said that the Vietnamese adjustment program was a successful example of the Fund's collaborative approach, and the management and staff were entitled to take some pride in having assisted Viet Nam in engineering the remarkable transformation of its economy. Indeed, in the history of stabilization policy in the region, there were few examples of the consistency and perseverance with which the Vietnamese authorities had implemented their own strong adjustment policies. It was noteworthy that those efforts had been made in the context of an extremely unfavorable external environment: assistance from the CMEA countries had dropped precipitously--to the equivalent of about 4 percent of GDP--and there had been little assistance from the convertible currency area. The supply response had been truly impressive, suggesting that the phrase "growth-oriented adjustment" had become a reality, rather than merely an aspiration. While it was true that there had been some slippages, what had been accomplished in the face of mounting unemployment and social distress deserved unqualified support. Moreover, the difficult challenges ahead could only be met with the Fund's encouragement and support.

The time had come for the international community to make good on its pledge to help those who were committed to meaningful adjustment and reform, Mr. Arora continued. Several countries that faced similar problems were being helped, and there did not appear to be any reason why assistance should be withheld from Viet Nam. A great deal was at stake. The credibility of the Fund's model of reform depended crucially on whether the Fund aided in normalizing Viet Nam's relations with the international financial community.

While he shared the staff's assessment and supported its policy advice, a degree of caution with respect to the recommendation on lending rates was appropriate, Mr. Arora remarked. Implementation of the reforms had exposed serious weaknesses in the state enterprise system--the structure of interest rates was a case in point. Clearly, further reform was required; however, as a practical matter, the crucial issue was the timing of that reform. It could be argued that lending rates should be raised immediately, forcing many large enterprises to go into liquidation, which would dramatically increase unemployment. In his view, however, it would be wiser to allow some consolidation of the gains from economic growth before administering interest rate reforms, as premature implementation of the necessary reforms might aggravate unemployment too much and thereby jeopardize the entire reform effort.

Mr. Hogeweg considered that the authorities' stated need for a Fund-supported adjustment program--to provide a framework for resolving the remaining policy issues--was as much a call for assistance as it was a plea for guidance in the completion of the enormous task that they had undertaken. Moreover, they had clearly identified the key issues and had established a clear set of priorities for the future. Nevertheless, the attainment of some targets remained vulnerable to policy lapses, as was borne out by recent slippages in fiscal and monetary policies. In that context, it was reassuring that fundamental reform of the financial system was under way, including the introduction of a new law on the role of the State Bank. Such structural reforms might lessen the risk of future slippages.

The widening gap between the official and the parallel exchange rates was worrying, Mr. Hogeweg went on, as it indicated a rise in inflationary expectations. It was also a sign of the still precarious condition of the economy, and of the ease with which it might revert to its former state. Accordingly, it was absolutely vital that the authorities persevere in their endeavors.

Viet Nam fully deserved the cooperation of the Fund and its membership in the implementation of the collaborative approach, Mr. Hogeweg stated. Therefore, he agreed with the draft decision on overdue financial obligations and, in particular, with the reference in that decision to the call for the membership to fully cooperate in the implementation of the collaborative approach. It was regrettable that no progress had been achieved on that issue since adoption of the previous decision, which contained similar language, and he hoped that further repetition of that language could be avoided.

Mr. Chatah said that he was in agreement with both the staff appraisal and the remarks made by Directors regarding the policy priorities for the period ahead. It was important to ensure that the deterioration in certain aspects of Viet Nam's external environment did not cause a further weakening of the economy, as the impressive gains on the structural front should be preserved and strengthened. In that respect, he welcomed the increased emphasis on accelerating the establishment of the legal and institutional framework for the transformation of the economy.

The Vietnamese people had a history of perseverance, and he had confidence that they would succeed in their current endeavors to restructure their economy and reintegrate it into the world economy, Mr. Chatah continued. He fully shared the remarks made by Mr. Fogelholm, Mr. Evans, and others on the arrears question. It was fair to say that the international community's response to Viet Nam's efforts over the previous two years was long overdue. He supported the proposed decisions.

Mr. Noonan made the following statement:

> Like other speakers, we generally concur with the staff report and, therefore, I have little to add to the comments of my colleagues.
>
> Progress made in Viet Nam in stabilizing the macroeconomic environment and in implementing major structural reforms is very

impressive, particularly in light of the fact that Viet Nam has suffered a major decline in external assistance, in contrast to the increase in assistance enjoyed by other countries undergoing a similar transition. It would appear that Viet Nam is the most successful example to date of a transformation from a centrally planned economy to a market economy. The success is evidenced by a number of factors: the relatively strong economic growth in 1989 and the forecast for 1990--GDP increased by 2.7 percent in 1989 and is projected to increase by 6 percent this year; the significant reduction in the inflation rate, despite a recent acceleration; the virtual disappearance of the spread between the parallel and official exchange rates, although recently there has been some reversal; and their record of payment to the Fund, despite the major decline in external assistance.

There are special circumstance that would seem to have contributed to the better success of Viet Nam when compared with the experience of some of the other centrally planned economies. Foremost among these is the fact that Viet Nam is primarily an agriculture-based economy, and it seems that the process of privatization is considerably less complex in the agricultural sector than in the industrial sector. Moreover, the agricultural sector has substantially faster supply-side responses to price liberalization than the industrial sector.

At the same time, it is clear that the major gains made would not have been possible without the sweeping reforms introduced by the authorities, which included the depreciation of the currency by 500 percent, and the lay-off of close to 25 percent of employees in the public sector--18 percent in government and 7 percent in the public sector.

However, there have been some setbacks recently--mainly an acceleration in the inflation rate, and a new spread between the official and parallel exchange rates--primarily the result of slippages in credit policy. We concur with the staff on the policy measures required to address these problems, and we urge the authorities to quickly proceed in this direction.

I can support the proposed decisions. In our view, there is no doubt that Viet Nam is fully cooperating with the Fund in terms of both its payment record and in implementing economic policies, which is the only way it will improve its long-term payment capacity. We hope that Viet Nam will soon be in a position to benefit from not only the Fund's policy expertise, but also its financing facilities.

The staff representative from the Asian Department stated that several technical assistance missions had examined the possibility of introducing a value-added tax system as a means of securing additional revenue. However, Viet Nam's institutional structure and its accounting system were judged to be insufficiently strong for the proper implementation of such a system; in time, further consideration would be given to that issue.

In response to a question by Mr. Wright, the staff representative said that a World Bank financial sector mission had recently returned from Viet Nam, and that its draft report was in preparation. It was his understanding that the report would be considered by the Vietnamese Government in January 1991, and would be issued shortly thereafter.

As to Viet Nam's prospects in the event that its relations with the financial community were not normalized, the staff representative said that it was difficult to provide an immediate quantitative prediction, but it was important to emphasize that the reforms would continue, as the Government was committed to a path of reform from which it had already derived substantial benefits. Obviously, without a normalization of relations, it would be much more difficult to open up the economy and increase its orientation toward the world market, arrears would inevitably continue to accumulate and import growth and, therefore, output growth in the economy would necessarily be slower. Although it was difficult to be precise about the magnitude of those effects, it was clear that they would be enormous.

The staff was well aware that the weaknesses of the state enterprises implied enormous social problems that had to be dealt with, and in that respect he fully agreed with Mr. Arora, the staff representative from the Asian Department commented. The Government was trying alleviate some of those social problems through its Social Impact Fund, providing retraining and a small cushion of financial support for those who were laid off. However, the staff recommended that such support should not be provided in a general manner, through the maintenance of negative real interest rates on lending to those enterprises, as Mr. Arora had suggested. If such lending did continue, there would be an opportunity cost: someone somewhere in the system would not have access to the credit that was being directed to state enterprises. Inevitably, it would be the non-state sector that would have to bear those costs; however, that sector was clearly the most dynamic part of the economy and was the most likely source for new employment opportunities. It was in that context that the staff had made its recommendations on interest rate restructuring.

Mr. Ismael said that he agreed with most Directors' comments, which included constructive advice. Undoubtedly, Viet Nam had provided ample proof that its reform efforts had not been dependent on such assistance. Nevertheless, the availability of international assistance would help in providing additional incentives for Viet Nam to further its reform efforts. In that regard, he would draw attention to the Fund's own policy, which he had cited in his opening statement, concerning the availability of adequate external financing in cases of Fund-supported adjustment programs. It was encouraging to hear several Directors state that a positive and concrete response from the international community to provide external financial assistance was long overdue.

The Acting Chairman made the following summing up:

Directors were unanimous in their praise of the wide-ranging economic and structural reforms now under way in Viet Nam, and in general supported the appraisal of the staff on Viet Nam's current policies and prospects. They were concerned, however, by recent weaknesses in financial policies and urged the authorities to take early action to preserve the impressive gains achieved in reducing inflation. They observed that the process of reform needed to be deepened in order to strengthen the outward-looking orientation that had been imparted to the economy, and pave the way toward Viet Nam catching up with other countries in the region. Directors welcomed Viet Nam's efforts to cooperate with the Fund in resolving the problem of overdue financial obligations. They noted that Viet Nam had made substantial payments to the Fund in an effort to stabilize arrears at the end-1988 level, while observing, however, that some payments had been delayed. They urged the Vietnamese authorities to continue their efforts to clear arrears to the Fund and called on the membership at large to support Viet Nam's efforts to do so in the context of the intensified collaborative approach.

The supply response to the economic reforms has been strong, and considerable progress has been made toward the establishment of a market-based economy. Directors expressed satisfaction over the pace of reforms in 1990, particularly in the areas of taxation and financial sector reform. In the former area, Directors agreed that a substantial broadening of the tax base was needed in view of the central role that fiscal deficits have played in Viet Nam's economic difficulties, and also welcomed the authorities' ongoing efforts to introduce new taxes and strengthen tax administration. Several Directors also noted that while the new banking laws set the basis for a more efficient and market-oriented financial system, the task of restructuring the financial system would require significant and sustained efforts, particularly in light of the need to improve the balance sheets of banks that were burdened with nonperforming loans, as well as to strengthen the authority of the newly established Central Bank.

With regard to the next phase of institutional reform, Directors strongly supported the authorities' emphasis on formulating commercial and property laws so as to provide a clear legal framework for the private sector. Directors urged the authorities to maximize the scope of activities that would be open to the private sector. Directors generally agreed that the broader reforms within the CMEA, particularly the move to trade in convertible currencies and at world market prices, while resulting in a considerable initial terms of trade loss for Viet Nam, would greatly increase the potential for economic efficiency.

The key concern of virtually all Directors was the reemergence of inflation during 1990 and the threat that macroeconomic instability posed to the reform effort. In the past, the heart of this problem had been in the area of fiscal policy. While recognizing that external factors--most notably the sharp decline in Soviet aid--had complicated the task of fiscal retrenchment, Directors regretted that insufficient action had been taken thus far to limit State Bank financing of the budget deficit. A number of Directors expressed the view that the level and composition of spending, especially on defense and certain investments, should be reassessed. Directors in general urged the authorities to implement revenue and expenditure measures in line with the staff's recommendations, establish as early as possible a strong fiscal target for 1991, and develop a path for fiscal adjustment within a medium-term context.

Directors strongly emphasized the need for tighter monetary policies, including curtailment of credit to state enterprises, rigorous enforcement of the new higher reserve requirements, and the open-market-type operations to tighten bank liquidity. There was also agreement that distortion in the interest rate structure, involving lending rates set below the household deposit rate, should be quickly removed. Several Directors stressed the importance of containing credit to state enterprises.

Most Directors welcomed the authorities' recent efforts to keep the official exchange rate close to market-determined levels and to achieve exchange rate unification, and emphasized the importance of sound monetary and budget policies as an essential underpinning to the proposed introduction of foreign exchange trading floors.

Looking to the medium term, Directors agreed that the prospects for renewed growth had been greatly improved as a result of the structural reform effort. Given Viet Nam's substantial investment needs, it was clear that an early normalization of trade and financing links with the rest of the world was essential. At the same time, uncertainties regarding the pace and timing of renewed inflows of foreign capital meant that considerable attention would have to be paid to increasing domestic savings, particularly public savings, and to tailoring public investment to the available resources. In this respect, Directors encouraged work on the formulation of a core investment program.

While some Directors thought the financing gaps envisaged in the staff's projections were large, but nevertheless of a manageable size, it was pointed out that the return to medium-term balance of payments viability remained highly uncertain, not least because of the pace of cutbacks in Soviet aid and the treatment of past Soviet debt. Directors were unanimous in urging prompt settlement of arrears to the Fund as a critical step toward normalization of financial relations with the international community.

Most Directors expressed the view that, despite some recent slippages in financial policies, Viet Nam had amply demonstrated its willingness to cooperate with the Fund under the intensified collaborative approach, and looked forward to an early preparation of Fund support for an adjustment program, and also broader international support for assisting Viet Nam in re-establishing financial relations with multilateral institutions under the collaborative approach. In their view, the authorities' recent policy initiatives toward a market system were impressive and the progress toward the normalization of relations should be maintained.

The next Article IV consultation will be held on the standard 12-month cycle.

Mr. Fogelholm asked about the state of preparedness of the Fund to negotiate a program with the Vietnamese authorities and the speed with which a program could be worked out.

The staff representative from the Asian Department replied that it was impossible to say how quickly that could be done, because it was a two-way process. As Directors had remarked, there were still many policies that had yet to be put in place, particularly those concerning the medium-term fiscal position and the structure of interest rates. Nevertheless, technically and analytically, the staff was ready to proceed; it had already held many discussions with the authorities about the content of a possible medium-term policy framework paper.

The Executive Board then took the following decisions:

Decision Concluding Article XIV Consultation

1. The Fund takes this decision relating to Viet Nam's exchange measures subject to Article VIII, Sections 2(a) and 3, and in concluding the 1990 Article XIV consultation with Viet Nam, in the light of the 1990 Article IV consultation with Viet Nam conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. Viet Nam continues to maintain restrictions on the making of payments and transfers for current international transactions in accordance with Article XIV. In addition, the multiple currency practice that arises from the setting by the Bank of Foreign Trade and the provincial governments of exchange rates that differ from the official exchange rate by more than 2 percent is subject to approval under Article VIII, Section 3, and the exchange restrictions that give rise to external payments arrears and those that arise under bilateral payments agreements with Fund members are subject to approval under Article VIII, Section 2(a). In the circumstances of Viet Nam, the Fund approves the multiple currency practice until December 31, 1990 and urges Viet Nam to remove the exchange restrictions subject to approval. The Fund also encourages Viet Nam to liberalize the exchange measures maintained under Article XIV as soon as possible.

Decision No. 9573-(90/154), adopted
October 26, 199o

Overdue Financial Obligations - Review Following Declaration of Ineligibility

1. The Fund has reviewed further the matter of Viet Nam's overdue financial obligations to the Fund in the light of the facts and developments described in EBS/90/183 (10/22/90).

2. The Fund welcomes the continuing cooperation of the Vietnamese authorities in working toward the elaboration and implementation of a comprehensive program of macroeconomic and structural adjustment. The Fund also welcomes the fact that the comprehensive economic policies put in place by Viet Nam have already resulted in considerable benefits to the economy, but urges the Vietnamese authorities to strengthen further their macroeconomic and structural policies. The Fund also welcomes the authorities' determination to pursue comprehensive adjustment policies with Fund monitoring aimed at sustained economic

growth, financial stability, and balance of payments viability. The Fund intends to continue to collaborate actively with Viet Nam and continues to stand ready to assist Viet Nam in any appropriate way.

3. The Fund regrets the continued existence of Viet Nam's arrears to the Fund, which places a financial burden upon other members and reduces Fund resources needed to help others. The Fund welcomes the fact that during 1990 Viet Nam has made payments to the Fund equivalent to its obligations falling due, albeit with delays. The Fund stresses that full settlement of Viet Nam's arrears should be given the highest priority, urges Viet Nam to effect their prompt settlement, and notes the authorities' continuing efforts toward settlement. In this context, the Fund calls on the membership to cooperate fully in the implementation of the collaborative approach so as to achieve a speedy and successful clearance of Viet Nam's overdue obligations to the Fund.

4. The Fund will review again the matter of Viet Nam's overdue financial obligations to the Fund within six months from the date of this decision, in the light of actions taken by Viet Nam in the meantime to settle its arrears to the Fund and to implement a comprehensive adjustment program.

Decision No. 9574-(90/154), adopted
October 26, 1990

2. SOMALIA - OVERDUE FINANCIAL OBLIGATIONS - REVIEW FOLLOWING DECLARATION OF INELIGIBILITY

The Executive Directors considered a staff paper on the further review of Somalia's overdue financial obligations to the Fund following the declaration of its ineligibility to use the general resources of the Fund, effective May 6, 1988 (EBS/90/176, 10/16/90; Cor. 1, 10/18/90; and Sup. 1, 10/25/90).

The staff representative from the Treasurer's Department said that since issuance of the staff paper, Somalia had paid $500,000 to the Fund. Since the previous review, Somalia had made three payments, totaling $1.35 million, or a little under SDR 1 million. Somalia's arrears currently amounted to SDR 114.7 million.

Mr. Finaish made the following statement:

The Board today is being asked to make a judgment about Somalia's record of cooperation with the Fund in accordance with the criteria set out in the strengthened arrears strategy. But underlying this specific issue is a broader and more fundamental question, namely, how the Fund can best help Somalia move closer to the ultimate objective of clearing its arrears and resuming normal relations with the Fund.

A solution to Somalia's arrears problem and, indeed, to most of the protracted arrears cases, requires three basic conditions: a commitment by the authorities to put their domestic economic house in order; the ability to implement the needed policy and reform measures; and the availability of external financial assistance, not only to support adjustment and reform, but also to help in the settlement of arrears.

There can be no doubt that the Somali authorities are committed to economic adjustment and reform. They have been working closely with the Fund staff in formulating policies and adopting specific measures. But the commitment of the authorities can be ascertained not only from their positive and cooperative attitude in their discussions with the management and staff, but also from what they have actually done and are doing. This is particularly clear when one looks at areas of policy where governments usually find it most difficult to act, such as the exchange rate, public expenditures, and pricing policies. A few brief illustrations are in order.

First, since early August 1990, the Somali shilling has come under severe pressure as a result of the sharp decline in foreign exchange receipts. Nevertheless, the authorities moved quickly to adjust the official rate and were therefore able to achieve the target ratio of official to parallel rates of 83 percent. Second, expenditures continued to be tightly restrained, with the share of spending on defense and security relative to total ordinary outlays being kept at 19 percent, compared with the original target of 26 percent. Given the security needs of Somalia, this is not a small accomplishment. Third, during the first half of 1990, revenues also exceeded the target, with the ratio of domestic revenue to ordinary expenditure reaching 35 percent, compared with a budget target of about 30 percent.

As far as pricing policy is concerned, as mentioned in the staff paper, the authorities have moved decisively to adjust various administered prices. To give an example, the price of gasoline, which was So. Sh. 150 per liter in January 1990, was gradually raised to So. Sh. 510 in August 1990. Following recent developments in the oil market, the price was further raised to So. Sh. 663 per liter. Electricity rates were raised by 500 percent.

The purpose of saying all this is not to paint a rosy picture of Somalia's economic performance. Obviously, the economic situation remains extremely difficult, and there are still serious problems that need to be dealt with urgently and decisively. But a great deal has been done, and the authorities are working hard to tackle the remaining weaknesses in the system, including the financial sector and the revenue structure. The point I want to stress is that the positive policy discussions and the close cooperation between the authorities and the staff are being translated into substantial policy action, and this spirit of cooperation needs to be preserved and strengthened.

The Fund can also contribute to the kind of progress we all want to see in Somalia's economic performance by continuing to provide the needed technical assistance. This is a crucial element for a successful implementation of economic policies and reform in Somalia. The staff paper correctly emphasizes the administrative impediments that have obstructed implementation in a number of areas, including reform of the financial sector and tax administration. It is unfortunate that the technical assistance mission on tax administration could not proceed to Somalia as planned, presumably due to security considerations. It is, of course, the prerogative of management to make a judgment as to whether it is safe for the staff to travel to Somalia, but I note that the World Bank's resident representative is back in Mogadiscio. It is the authorities' strong hope that the technical assistance mission will be able to go to Somalia soon.

As far as donor support is concerned, we are all too aware of the fact that the attitude of some donors has been shaped by views and perceptions about the domestic political situation in Somalia. Obviously, the Fund is not the proper forum to discuss these issues, and certainly one cannot tell donor governments how to conduct their foreign policies. But it is only fair to point out the serious efforts that have been made recently, which are mentioned in the staff paper, to address the domestic political situation and to move along the path of national reconciliation. The authorities are fully aware that an improvement in the domestic political environment is not only important for the achievement of economic progress, but also for the much-needed external support.

In the staff paper, the staff have looked at Somalia's record in terms of policies and payments and have concluded that actions in these two areas have not been sufficient to meet the two criteria for cooperation. The proposed decision reflects this conclusion.

I do not want to debate the interpretation of the guidelines or criteria for cooperation. But I do not feel it would be justified or useful at this stage to brand Somalia noncooperative. Somalia has been making monthly payments to the Fund, and those amounts have already been increased twice this year. In fact, in a communication that I received a few days ago--which was circulated yesterday as the supplement to the staff paper--the Minister of Finance and Revenue has indicated that the amount will be increased again, starting this month, to $500,000. This increase comes at a time when Somalia is being hit hard by the crisis in the Middle East, which has led to a decline in Somalia's exports to countries in the Middle East region and in remittances from Somalis working in those countries, and to increases in the prices of its oil imports. Table 1 of the staff paper demonstrates the extremely tight foreign exchange position of Somalia. With foreign exchange receipts from exports and official capital flows falling sharply, imports in 1990 are projected to be one-third lower than in 1989. While $500,000 a month may appear to some as a small amount, given the extreme shortage of foreign exchange in the country it represents a substantial effort on the part of the authorities.

I have already touched on the other criterion for cooperation, namely, the adoption of corrective economic policies. If there are problems of implementation in certain areas, it is not because the authorities are reluctant to accept the Fund's advice. On the contrary, the authorities have been eagerly seeking the advice and technical expertise of the staff and are doing their best to overcome the institutional and administrative impediments that hinder implementation of the necessary measures.

In these circumstances, it would be unfortunate if the Fund were to send a message to the authorities that told them that they are noncooperative. I am afraid that is the only way they will interpret the proposed decision. I may propose some amendments to the decision at the end of the discussion.

Mr. Filosa made the following statement:

On the occasion of the last review of Somalia's overdue financial obligations to the Fund, I noted with a sense of encouragement that the Somali authorities had agreed with the Fund on a policy package that represented a significant effort toward the necessary restructuring of the economy. Moreover, the package, although it did not match the standards of upper credit tranche conditionality, seemed nonetheless to signify a decisive departure from the previous policy stance. I also noted on that occasion that Somalia's cooperation with the Fund had intensified somewhat relative to previous reviews. It was evident, however, that much more was still required of the authorities--in terms of both corrective policy measures and efforts to fulfill financial obligations to the Fund--for them to re-establish a sound track record. More generally, it was recognized that Somalia had to create the conditions that would encourage donors and creditors to augment the flow of financial support.

I am still confident that, notwithstanding the difficult political climate in which economic measures have been implemented in Somalia, as well as the slippages in the pace of reforms that have been observed during the last few months, the authorities have not lost their intention to cooperate with the Fund.

In this connection, one cannot fail to recognize that, in many respects, steps have been taken in a desirable direction and in compliance with the Fund's recommendations: a new commercial bank has been established, while the old one has ceased lending operations and is now recovering outstanding loans; circular checks have been totally demonetized; and initial actions have been implemented to restructure the Central Bank. Moreover, with respect to the short term, recent data show that monetary and credit aggregates have remained broadly in line with targets, the fiscal outlook for the first half of the year has been better than predicted, and the ratio of the official exchange rate to the open market rate reached its target in September 1990. Nor can one ignore the significant adjustments made in administered prices.

Major reasons for concern, however, have persisted and are today even stronger than before, as the pace of reforms seems to have slackened considerably since August 1990. Strong constraints seem to limit the administrative capacity of the government's operational bodies. As a result, the progress in financial reforms has been weaker than expected; at present, the commercial banking system is not functioning, and there seems to be some reluctance to get the new commercial bank to operate fully. The financial system remains in a condition of extreme fragility. Moreover, the Central Bank's supervision of the banking system is weak, many of its operations need to be streamlined and reframed within the context of the existing law, and its institutional capacity needs to be rebuilt.

Fiscal prospects, too, are now generating concern due to slippages observed in the second half of the year in the implementation of important measures, such as the establishment of an import verification system, the introduction of the rental income tax, and the implementation of the Fund's recommendations on tax administration.

On the occasion of my last visit to Mogadiscio, the Somali authorities agreed that the establishment of a new financial system and the full implementation of all fiscal measures included in the 1990 program would have represented a crucial test of their willingness and ability to correct the main imbalances in the economy. I am afraid that this test has not been passed.

The authorities' commitment to economic reform is clearly at stake, and the international community needs clear signals to be induced to extend support. The deterioration in the state of domestic security that has occurred since the time of the previous review has made an already gloomy picture worse, discouraging both the implementation of development projects and the initiatives of the Italian banking system for the provision of technical assistance to the new commercial bank.

I note the desire of Somalia to cooperate with the Fund and the World Bank and, in this context, the decision to increase monthly payments to the Fund to $500,000 starting this month. I hope that this decision will soon be complemented with appropriate concrete policy measures along the lines already discussed on several occasions. Should this happen, I am sure that all members of the Support Group will be ready to expeditiously resume the activity of the Support Group. At the same time, however, as Chairman of the Support Group, I would like to stress that the reactivation of the functioning of the Support Group now lies entirely in the hands of the Somali authorities. The new arrears strategy provides Somalia with a golden opportunity to facilitate the correction of the many distortions and deficiencies in the economy. If, however, Somalia fails again to substantiate its commitment to reform, the possibility of endorsement of a Fund-monitored program before the Spring 1991 deadline will be reduced to a minimum.

Mr. Monyake made the following statement:

Somalia is another case where security problems and an unstable political situation have proven to be major obstacles to the process of economic reform. The gains made during the first half of the year have been reversed, and the Middle East crisis has made an already critical situation worse. Evidently, unless some positive results are achieved in the current peace initiatives, the objectives of early economic recovery and a return to financial viability in Somalia might remain elusive.

Addressing the question of whether Somalia is cooperating with the Fund to find a solution to its protracted arrears problem, it would be difficult to come to a strictly negative conclusion. I think Mr. Finaish has gone to some trouble to explain to this Board the measure of cooperation that the Somali Government is endeavoring to embark upon. It is true that there have been slippages in the implementation of certain policies, and that the authorities have not been able to substantially augment payments to the Fund as promised. However, by themselves, these should not constitute an indictment of unwillingness to cooperate with the Fund at this stage. On the one hand, political constraints on the implementation of sound economic policies are a fact of life, even in societies with a long history of democracy. On the other hand, the country is suffering from an extreme shortage of foreign exchange, which is difficult to alleviate in the short run in the absence of stepped-up support from the donor community. As Mr. Filosa said, the donor community is sitting on the sidelines waiting for things to happen in Somalia. On the other hand, we are doubtful about the injection of that much-needed foreign assistance if the Somali people are not accumulating the foreign exchange they require. It becomes a chicken and egg situation.

I think we might postpone the question of the Managing Director's communication to all Governors of the Fund and the President of the African Development Bank at this time to see what might result from the recently announced political reforms and the newly formed cabinet. We should not lose sight of the fact that, of the several countries that have to deal with the problem of protracted arrears to the Fund, the African countries are the ones that have been the least able to untangle themselves. Somalia is coming close to being the third African country to be the subject of a declaration of noncooperation with the Fund. Having said that, I would urge the Somali authorities to explore all reasonable avenues of expeditiously resolving existing social and political problems in the country, and so create a conducive atmosphere for the implementation of a comprehensive adjustment program that would qualify for the Fund's endorsement under the intensified collaborative approach. At the same time, we hope that the international community will give Somalia all the financial support that it needs.

Extending his remarks, Mr. Monyake stated that, as the Executive Board was fully aware, his chair was deeply concerned about countries that fell into arrears, a problem that continually confronted the countries in his constituency. In that regard, one aspect of the exchange of communications between the Managing Director and the Minister of Finance and Revenue, which were contained in the supplement to the staff paper, was difficult to understand. The Minister of Finance and Revenue concluded his telex with an indication that the authorities were perplexed by the lack of appreciation among the Fund staff for the efforts that were being made, and that Somalia appeared to be on the threshold of being branded noncooperative. In his reply, the Managing Director observed that the staff paper did not in fact propose a declaration of noncooperation. The intention of that observation was unclear and required some clarification, because the Minister of Finance and Revenue had not suggested that the staff paper contained such a proposal; he merely indicated that Somalia appeared to be on the threshold of being declared noncooperative. Such language could only serve to discourage a well-meaning government, which, after attempting to put its house in order through all available means--including cooperation with the Fund--found itself on the brink of being the subject of a declaration of noncooperation. The authorities needed both assurance and assistance; therefore, he was not prepared to support the proposed decision, particularly paragraph 4.

Mr. Cirelli made the following statement:

Like other speakers, I deeply regret the absence of real progress since the June 1990 review of Somalia's overdue financial obligations to the Fund, despite the desire of Somalia to cooperate. Therefore, this desire should be transformed into real and concrete steps.

As regards stabilization policies, fiscal developments in the first half of 1990 indicate that tax revenue has been higher than expected. However, nontax revenue fell below the program target, owing notably to the disorganization of the public sector. Moreover, the impact of the high rate of inflation resulted in a further deterioration of the tax to GDP ratio. On the expenditure side, the weaknesses reflected in available data put serious strains on the sustainability of the modest progress registered so far. Finally, as underlined by the staff, fiscal performance in the second half of the year remains a cause for concern. Therefore, one can only urge the new Government to urgently implement the set of measures recommended by the Fund technical assistance mission. Such a decisive step will undoubtedly demonstrate the willingness of the authorities to move ahead.

Concerning structural reforms, we, like the staff, can only remark that it is unclear whether the authorities are fully committed to rigorously pursuing financial sector reform. Although monetary and credit policies were broadly on track during the first six months of the year, the government's position in relation to the Central Bank appears to have deteriorated markedly since July 1990. As regards the pricing system, the decision taken by the authorities to adjust administrative prices and those for petroleum products is an encouraging step. However, a further increase is needed in order to meet the fiscal revenue target from this source and to offset the consequences of the developments in the Middle East.

Turning now to the repayments of overdue financial obligations to the Fund, it is clear that payments made so far have not been sufficient to prevent the accumulation of new arrears. Therefore, in light of this consideration, I am afraid that I must conclude that Somalia has not been cooperative enough with the Fund in finding appropriate solutions to the deep-seated distortions that affect the economy, as well as in making sufficient repayments to the Fund.

The content of the draft decision adequately reflects the present situation, including the information provided by the authorities in their telex addressed to the Managing Director. In addition to the draft decision, which constitutes, in my view, a needed signal that more progress is expected, I also approve the maintenance of technical assistance, which will be essential to support the actions of the new Government. Finally, scheduling the next review of overdue financial obligations with the Article IV consultation will allow for a sufficient delay, during which strong stabilization measures may be implemented, and sufficient repayments made, so that one will be able to acknowledge the authorities' resumed active cooperation with the Fund. We urge the authorities to assess all the elements of the present situation in order to avoid the issuance of a declaration of noncooperation at the time of the next review.

We support the proposed decision.

Mr. Grosche stated that he supported the proposed decision, as it would send a signal to the authorities that the Fund was not satisfied with the steps taken thus far. Somalia had not implemented strong and comprehensive adjustment measures that could be regarded as sufficient for a Fund-monitored program. Moreover, the country's payments continued to fall substantially short of what would be necessary to at least stabilize the level of Somalia's arrears to the Fund. Therefore, the communication to all Governors of the Fund and the President of the African Development Bank was in order. Technical assistance should continue to be provided by the Fund, as it could be helpful in guiding the authorities along their very difficult path of adjustment. The Executive Board should consider discontinuing technical assistance only if the authorities did not cooperate with the Fund. A statement to that effect was not warranted at the present juncture, and he sincerely hoped that such a statement would not become necessary at the time of the next review.

Mr. Iqbal made the following statement:

> The policy package that was initiated in May 1990, although not comprehensive, had the potential for establishing a firm foundation for a sustained reversal of the deterioration of the economy. Unfortunately, the Somali authorities' efforts to grapple decisively with the serious economic crisis and to regularize their relations with the Fund have once again been hampered by security and other exogenous factors. Consequently, it has been difficult for Somalia to materially strengthen its payments performance, or to progress rapidly toward finding appropriate solutions to its economic and financial difficulties, including the settlement of its arrears to the Fund.
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> Nevertheless, some progress has been made toward containing monetary expansion, there have been steps toward correcting the official exchange rate, and administered prices have been raised in line with policy objectives. I believe that Somalia deserves more time and consideration, so that the authorities can move toward restoring the momentum of the policy package.
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> During this process, I wish to emphasize that the Fund should continue to play a constructive role in helping Somalia by providing technical assistance and, through the normal Article IV consultation channels, advice. We should recognize that perpetuation of the present impasse is beneficial for neither Somalia nor the Fund. Therefore, I consider the proposed five-month extension appropriate.
>
> I am hopeful that the authorities will use this time to do what is needed. I would call for tangible progress toward at least arresting the deterioration during this period. The authorities should strengthen the fiscal performance and consolidate financial sector reforms. It is essential that revenue measures planned for the second half of the year are actually implemented. There should also be no accumulation of payments arrears as a way of financing expenditures. At the same time, the authorities should be encouraged to move quickly toward restructuring the Central Bank and asserting control over the operation of the banking system. Regaining the credibility of monetary management and of the financial system is crucial for adjustment and for encouraging much-needed private sector initiative.

Finally, I support the proposed decision and wish to emphasize to the authorities that they should take full advantage of Fund support at this critical juncture in their efforts.

Ms. Hansen remarked that her authorities had been prepared to support a decision to implement remedial measures at the time of the previous review, believing that little was to be gained by delay. Unfortunately, it appeared that their skepticism about Somalia's cooperation with the Fund had been borne out by subsequent developments. Her authorities understood the difficulties caused by internal security problems, as well as the negative impact of the Middle East crisis. However, promised measures, which could have been taken in spite of those problems, had not been adopted, so that the resulting package was both insufficient and disappointing as an adjustment program.

On the positive side, the measures that were taken, such as the initial steps toward restructuring the banking system and the adjustment of administered prices, were welcome, as was Somalia's effort to increase its monthly payments to the Fund, Ms. Hansen continued. Unfortunately, that increase had not prevented a continued accumulation of arrears, and the reform effort--which had been inadequate in any event--had quickly faltered. The result had been a further deterioration in the credibility of Somalia's efforts to cooperate with the Fund.

As neither of the two criteria for determining a member's cooperation with the Fund had been fulfilled, Ms. Hansen remarked, she agreed with the provision in the proposed decision that the first remedial step in the arrears strategy should be taken. In view of the circumstances, she also agreed with the proposed delay in concluding the next review. In the meantime, the authorities should intensify their efforts to cooperate with the Fund.

Mr. Wright recalled that since the previous review, which had provided a final opportunity for Somalia to improve significantly its track record, Somalia's record vis-à-vis the Fund had actually deteriorated. Furthermore, the proposed increase in monthly payments would not be sufficient to stabilize its arrears. Although the situation in the Middle East had not helped, it was clear that weak policy implementation was primarily to blame for the deterioration. Any further postponement of the remedial measures would weaken the Fund's credibility and would send the wrong signal to the authorities. Therefore, he supported the proposed decision.

The international financial community stood ready to help, provided that the authorities demonstrated their willingness to implement the necessary reforms, and that there was a parallel improvement in the human rights situation, Mr. Wright considered. Technical assistance should continue to be provided for the time being, and he hoped that the authorities would take the opportunity of the forthcoming Article IV consultation to open discussions on a comprehensive program that would start to reverse Somalia's economic difficulties.

Mr. Ichikawa said that he was in broad agreement with the staff appraisal. At the previous review, the Board had urged the authorities to strengthen substantially their cooperation with the Fund by means of full implementation and further strengthening of the economic reform plan, as well as by meaningful repayments to the Fund. It was regrettable that Somalia had failed to meet both of those criteria. With regard to policy implementation, although the authorities had initiated some important institutional reforms before the previous review, progress had slowed, and the objectives had not been pursued thoroughly. The weakening of the administrative capacity had intensified, and financial imbalances had widened. In the absence of effective adjustment measures, there was some concern that the economic situation would worsen in the period ahead. The deterioration of the economy had been due partly to adverse external shocks; however, the security situation had continued to play a critical role. In that respect, he regretted that progress toward reaching a peaceful settlement had been slower than expected.

With regard to their payments record, the authorities' efforts fell short of expectations, Mr. Ichikawa continued. Payments made since the previous review had been less than 10 percent of current obligations; furthermore, it was regrettable that repayments to the Fund in 1990 were projected to remain about one third of total debt repayments by the authorities. In view of the discouraging record of performance, there was no choice other than to proceed with the Managing Director's communication to all Governors. As to the provision of technical assistance, he fully associated himself with the view expressed by Mr. Grosche. Technical assistance would be instrumental in helping the authorities to improve their cooperation with the Fund; however, the availability of technical assistance would also depend on internal security conditions. The proposed decision and the draft letter appropriately reflected his disappointment, as well as his sincere hope that Somalia would resume active cooperation with the Fund in a timely manner. Accordingly, he supported the proposed decision.

Mr. Filosa stated that he had reserved his position on the decision in order to listen to the views of other Directors. He supported the proposed decision. He agreed with Mr. Finaish on the three principles that should guide Somalia: their commitment should be made evident; they had to demonstrate the ability to implement the necessary measures; and, having adhered to the first two principles, external funds should be made available. While he supported the proposed decision, he stressed that the Somali authorities should not interpret the decision as having branded them noncooperative. He agreed with Mr. Cirelli's observation that cooperation had not been sufficient; the reality of insufficient cooperation was evidenced by the fact that every time the authorities delayed the necessary measures, the situation became more difficult. The correct interpretation was, therefore, that there was very little time to act decisively to adopt the necessary measures, which had been discussed many times by the staff and the Executive Board. There were no new measures to be discovered; what was needed was the full implementation of the measures previously promised.

It was particularly worrisome that the financial system had collapsed, Mr. Filosa continued. That was something that Somalia could not afford if it wanted to normalize both the functioning of the economy and its relations with creditors. He understood that members of the Support Group were ready to resume cooperation, provided that Somalia's record in a number of areas--both economic and political--showed a decisive departure from past experience.

Mr. Finaish said that, in light of the discussion, it appeared that it would be difficult to persuade the Executive Board to amend the proposed decision. He had wanted to propose an amendment along the lines of Mr. Monyake's suggestion, namely, that paragraph 4 should be deleted and paragraph 5 amended, to delay action on a possible declaration of noncooperation until the next review. In light of the discussion, the Executive Board's preference seemed to be to adopt the decision as drafted. Nevertheless, there was one amendment that should be considered; paragraph 3 could begin with the following additional sentence: "The Fund notes that, notwithstanding the implementation of significant policy measures, particularly in the areas of the exchange rate, administered prices, and public expenditures, substantial weaknesses remain, especially in the financial sector and fiscal revenue." The proposed amendment was offered for two reasons, both of which were recognized by a number of speakers: first, the authorities should be given credit for what they had achieved in those areas, which was acknowledged in the staff paper; and second, rather than retaining a general statement on the need to embark on an adjustment program, the decision should be more specific in setting out the Executive Board's expectations in the areas of financial sector reform and fiscal revenue.

Mr. Filosa said that he supported the proposed amendment, with one caveat concerning the measures on administered prices. It was his understanding from Mr. Finaish's statement that there had been a further increase in the prices of petroleum products. Nevertheless, although it was difficult to be precise, it seemed that Somalia's commitment in that area required a much higher increase in prices. Furthermore, he had some misgivings concerning the suggestion in the proposed amendment that the measures already taken were significant. He certainly agreed with the main thrust of Mr. Finaish's proposal, which was aimed at providing a balanced picture of the content of the discussion. Some important measures had been taken, but significant weaknesses remained in the areas of the financial system and fiscal revenue. Accordingly, while he supported the proposal in principle, he would be more cautious concerning the prices of petroleum products.

The staff representative from the African Department remarked that the authorities had recently adjusted the administered prices for petroleum products; however, as Mr. Filosa had mentioned, that adjustment fell short of commitments made in June 1990. Prices were significantly below import parity levels and did not incorporate a customs duty, as had been anticipated. He doubted whether it would be appropriate to include price adjustments among the authorities' accomplishments; they had taken some actions, but in reality they had had no choice and, in any event, the measures taken fell short of what had been expected. He also doubted the appropriateness of recognizing actions taken in the area of credit. Although the data were incomplete, the figures for September 1990 suggested the possibility of a buildup of arrears in a number of areas. The authorities could be given credit for exchange rate actions and for some initial steps in the financial sector, although significant weaknesses still existed in that sector.

Mr. Wright commented that the message given to the authorities should be as unambiguous as possible, and, in that respect, there were two risks inherent in the formulation that had been suggested. One was that by referring to specific areas, the proposal would suggest that the progress that had been achieved in those areas was sufficient, and that no further progress would be needed; therefore, any such references should be captured in more general terms. The second risk was centered on the inference, which should be avoided, that the authorities had moved significantly toward meeting the conditions that were required for a declaration of noncooperation to be avoided; unfortunately, the proposed formulation appeared to give just that impression. The decision should be balanced by giving the authorities a certain amount of credit, but it should be made clear that the views expressed in the discussion were not finely balanced. Accordingly, he would be prepared to see some acknowledgment of the measures that had been taken, but the decision should be very clear that there was still a very long way to go before those measures could be regarded as anything other than insufficient.

Mr. Grosche remarked that he shared the views of Mr. Wright. While it might be appropriate to add something to paragraph 3, any amendment should be worded in such a way as to send a clear signal to the authorities that what had been accomplished was not sufficient and further action was necessary.

Mr. Finaish considered that it was appropriate to refer to the measures that had been adopted as being significant, as that view was reflected to some extent in the discussion and the staff paper. The proposed amendment also referred to substantial weaknesses, especially those in the financial sector and fiscal revenue, which implied that there were other weaknesses as well. Consequently, the proposed amended text correctly referred to both significant policy measures and substantial weakness. The main purpose of the amendment was to offer some recognition of certain difficult steps that had been taken, and to be more specific concerning the direction in which the authorities were expected to move in the future. As to the use of the words "significant" and "substantial," that was a matter of judgment, but there seemed to be agreement that there should be some recognition of the authorities' efforts.

Mr. Iqbal said that Mr. Finaish's suggestion had considerable merit. Both "significant" and "substantial" could be employed as proposed; their inclusion provided a fairly balanced view of certain conclusions in the staff paper. One could conceivably separate administered prices from the exchange rate and expenditure controls, but it also made sense to maintain the formulation proposed by Mr. Finaish.

Ms. Hansen stated that she agreed with Mr. Wright on the risks inherent in including the proposed wording. While appreciating the desire to strike a balance, she was somewhat concerned that the facts of the case might be obscured in the search for balance.

Mr. Ichikawa said that he supported Ms. Hansen's comments.

Mr. Aderibigbe commented that there was a considerable difference between "significant" and "adequate," and it was for the members of the Board to assess whether the measures taken were significant. To say that the measures were significant should not be construed as implying that they were adequate; if they had been adequate, the last part of the proposed sentence would not be necessary. The proposed sentence appeared to be well balanced and would send a clear signal to the authorities that they were on the right track, despite all the difficulties that they had encountered; without the proposed sentence, the decision had the appearance of discouraging the authorities.

Mr. Evans remarked that he agreed with Mr. Wright on the proposed amendment of the decision. The proposed decision already contained a reference to the need for Somalia to adopt a comprehensive set of measures, and it was preferable not to be specific about the particular measures that might be required. The Somali authorities already understood what was expected of them, and the Executive Board should not have to spell out the specific measures required at each review of a member's overdue financial obligations.

The Acting Chairman said that the summary of the discussion, which was to be sent to the Somali authorities, could include a reference to the Executive Board's recognition of the implementation of some difficult measures, and an indication that there was a need for further measures.

Mr. Finaish asked whether the reference to measures already implemented would be included in the letter to all Fund Governors and the President of the African Development Bank. If that were the case, he would not insist on amending the decision. In addition, the authorities had moved decisively to adjust various administered prices in line with their policy objectives, as had been explained in the staff paper.

The staff representative from the African Department suggested that the beginning of the fourth sentence in the third paragraph of the draft letter could be amended by inserting a phrase that would indicate that the authorities had taken a number of difficult policy measures.

The Acting Chairman said that such a reference could be included in the summary of the discussion that was to be sent to the authorities, as well as in the letter to all Fund Governors and the President of the African Development Bank. That reference could be in lieu of an amendment to the proposed decision.

Mr. Wright considered that including the proposed reference was a sensible alternative, as it would obviate the need for an amendment to the proposed decision; accordingly, he supported the Acting Chairman's proposal.

The Executive Board then took the following decision:

1. The Fund has reviewed further the matter of Somalia's continuing failure to fulfill its financial obligations to the Fund in the light of the facts and developments described in EBS/90/176 (10/16/90).

2. The Fund deeply regrets the continuing failure of Somalia to fulfill its financial obligations to the Fund, which places a financial burden upon other members and reduces Fund resources needed to help others. The Fund notes the increase in Somalia's most recent monthly payment to US$0.45 million and again urges Somalia to give the highest priority to increasing substantially its payments and to settling fully and promptly its overdue financial obligations to the Fund.

3. The Fund urges Somalia to adopt as a matter of urgency a comprehensive set of measures within the context of the intensified collaborative approach that would bring about necessary economic adjustment. The Fund continues to stand ready to assist the authorities in support of efforts to formulate and implement a comprehensive adjustment program.

4. In the absence of Somalia's active cooperation with the Fund in seeking a solution to the problem of its overdue financial obligations, the Fund decides that the Managing

Director of the Fund shall communicate with all Governors of the Fund and the President of the African Development Bank regarding Somalia's continued failure to fulfill its financial obligations to the Fund.

5. The Fund will review the matter of Somalia's overdue financial obligations to the Fund again at the time of the 1990 Article IV consultation or not later than five months from the date of this decision, whichever is earlier, in the light of actions taken by Somalia in the meantime regarding payments to the Fund and implementation of a comprehensive adjustment program. At the time of that review, in the event that Somalia has not resumed active cooperation with the Fund in seeking a solution to the problem of its overdue financial obligations to the Fund, the Fund may consider a declaration of noncooperation concerning Somalia.

Decision No. 9575-(90/154), adopted
October 26, 1990

The Managing Director then assumed the chair.

3. EXECUTIVE DIRECTORS

The Chairman bade farewell to Mr. Feldman and Mr. Mawakani upon the conclusion of their service as Executive Directors.

APPROVED: August 30, 1991

LEO VAN HOUTVEN
Secretary