

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 89/142

10:00 a.m., November 8, 1989

M. Camdessus, Chairman

Executive Directors

C. B. Clark

E. A. Evans

E. V. Feldman

M. Fogelholm

M. R. Ghasimi

J. E. Ismael

A. Kafka

J.-P. Landau

Alternate Executive Directors

C. Enoch

G. C. Noonan

Zhang Z.

Di W., Temporary

A. Rieffel, Temporary

J. Prader

S. M. Hassan, Temporary

R. Marino, Temporary

G. Montiel, Temporary

C. Schioppa, Temporary

N. Morshed, Temporary

O. Kabbaj

B. Goos

K.-H. Kleine, Temporary

L. E. N. Fernando

C. V. Santos

A. R. Ismael, Temporary

M. Al-Jasser

G. P. J. Hogeweg

S. Yoshikuni

L. Van Houtven, Secretary and Counsellor

L. Collier, Assistant

1. Chile - 1989 Article IV Consultation, Stand-By
Arrangement, and Exchange System Page 3
2. Ghana - 1989 Article IV Consultation; and Enhanced
Structural Adjustment Facility - Request for Second
Annual Arrangement Page 40

Also Present

IBRD: S. Bery, Latin America and the Caribbean Regional Office; V. Nehru, Africa Regional Office. African Department: M. Touré, Counsellor and Director; E. A. Calamitsis, Deputy Director; G. E. Gondwe, Deputy Director; P. Dhonte, M. T. Hadjimichael, I. Kapur, R. L. Sharer, R. H. van Til. Central Banking Department: M. Swinburne. Exchange and Trade Relations Department: T. Leddy, Deputy Director; A. Basu, E. Brau, P. D. Brenner, A. Chopra, P. J. P. Szimczak. External Relations Department: H. P. Puentes. Fiscal Affairs Department: S. K. Chand, N. Erbas, D. P. Hewitt, A. Ize, C. Liuksila. IMF Institute: P. R. Rado; A. Ahiable, L. Nketiah, Participants. Legal Department: H. Elizalde, J. K. Oh. Secretary's Department: C. Brachet, Deputy Secretary; A. Tahari. Western Hemisphere Department: L. H. Duran-Downing, J. P. Guzmán, M. E. Hardy, J. E. Leimone, E. Mendoza, S. C. de Sosa. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: J.-L. Menda, D. Powell, R. Wenzel. Assistants to Executive Directors: H. S. Binay, C. Björklund, B. A. Christiansen, H. E. Codrington, S. K. Fayyad, M. A. Hammoudi, M. Hepp, J. Heywood, K. Ichikawa, L. I. Jácome, P. Kapetanovic, C. Y. Legg, D. Saha, G. Serre, M. J. Shaffrey.

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

The Executive Directors considered the staff report for the 1989 Article IV consultation with Chile and Chile's request for a 12-month stand-by arrangement in an amount equivalent to SDR 64 million (EBS/89/193, 10/12/89). They also had before them a background paper on recent economic developments in Chile (SM/89/209, 10/18/89).

Mr. Feldman made the following statement:

Chile has just completed a four-year extended arrangement with the Fund. During the period of the program, Chile achieved a substantial decline in the rate of inflation, while growth resumed strongly and the country's external position improved considerably. This successful period represents an important first step during which the country, which had emerged from the debt crisis with one of the heaviest per capita debt burdens in Latin America, was able to carry out a deep and lasting fiscal adjustment combined with wide-ranging structural reforms. Such policies resulted in a strong recovery of domestic savings and private investment and in a significant expansion of nontraditional exports.

The Chilean economy grew quickly and imbalances were reduced significantly during the extended arrangement. Real GDP grew by over 5 percent annually, saving and investment to GDP ratios increased significantly, inflation decelerated from average rates of 30 percent in 1985 to 15 percent in 1988, and the unemployment rate declined from 12 percent at the end of 1985 to 6.3 percent at the end of 1988.

There has been a recovery in the living standards of the population, reflected in a 12 percent increase in per capita consumption in real terms between 1985 and 1988, and an additional increase of 4.5 percent is expected for 1989. Despite these increases, consumption per capita in 1989 will be about 5 percent lower than the 1981 peak level.

During the past four years, Chile has implemented significant structural reforms with the aim of improving both the efficiency of resource allocation and the living conditions of the population. Fiscal adjustment has been a key component of the economic program, and this will be reflected in an almost overall public sector equilibrium for 1989 and 1990 at the long-term trend price of copper. At the center of Chile's fiscal discipline is a dramatic cut in public expenditures. A reduction in expenditures of more than 8 percentage points of GDP between 1985 and 1988--with a further decline of 1.2 percentage points projected for 1989--has permitted sizable tax reductions, making room for the expansion of private investment. While expenditure cuts have included various government outlays, the

privatization of public enterprises has played a central role in the process of withdrawal of the state from activities that could be undertaken by the private sector. From a total of 18 public entities selected for privatization at the end of 1985, the state remains as only a minor shareholder in three of them and as a major shareholder in one enterprise.

Reforms implemented in the financial sector have allowed its recapitalization: after experiencing very heavy losses associated with the sharp crisis of the early 1980s, the banking sector has recovered its soundness and profitability and is now subject to more efficient supervision. A new constitutional law assuring the autonomy of the Central Bank in some fields of macroeconomic policy implementation was approved in October 1989. A number of reforms implemented during these years have been oriented toward the liberalization of the exchange and trade system, including, for instance, the establishment of a uniform external tariff of 15 percent. Other complementary reforms have positively affected the functioning of labor markets and the social security system. Finally, reforms in the fields of education and health have been oriented toward providing better social benefits and services to the population.

On the external front, a dramatic increase in exports, owing partly to favorable copper prices but basically associated with the strong growth rate in noncopper exports--volumes increasing over 10 percent each year since 1985--has resulted in a reduction of the external current account deficit from about 8 percent of GDP in 1985 to 0.8 percent in 1988. In the meantime, different debt conversion and debt reduction mechanisms have led to a reduction in the external debt from 120 percent of GDP at the end of 1985 to 80 percent at the end of 1988, and a further decline to 65 percent of GDP is projected by the end of 1989. During 1989, economic activity has accelerated, led by a strong increase in investment, a buildup of inventories, and buoyant consumer demand. Real GDP expanded by 10.4 percent in the first semester of 1989, compared with the same period of 1988, and it is expected to slow down to a growth rate of 8.5 percent for the whole year. Imports, and to a lesser extent exports, are expanding rapidly, while inflation has shown some acceleration.

To moderate domestic demand and to return to a growth path that is sustainable in the medium term, the authorities adopted a series of measures in recent months. Since late 1988, the Central Bank's interest rates have been raised progressively, and measures adopted during June and July resulted in a real depreciation of the peso of about 7 percent. Furthermore, fiscal policy has been adjusted to maintain current expenditures in real terms at 1988 levels, while no further tax reductions are now foreseen. The authorities believe that current policies

are appropriate to achieve the objectives of the program, and-- as on previous occasions--they remain committed to adopting further measures, if needed.

Presidential elections will be held in Chile in mid-December 1989. At the same time, a new Congress will be elected. The new Government is expected to take office in March 1990, for a period of four years. All candidates have indicated their intentions to maintain--without major modifications--the broad lines of the economic strategy currently being implemented in Chile.

The maintenance of the present course of policies should allow a real GDP growth rate of about 4-5 percent in 1990 and in subsequent years, which would be consistent with domestic stability. In 1990, the nonfinancial public sector, at the trend price of copper, is projected to register a deficit of 0.4 percent of GDP and inflation is expected to decline to 12 percent. At the same time, and with the support of the international community, Chile should be able to finance the projected external gaps and to manage its still large debt service.

Despite its successful economic performance, Chile's economy is still vulnerable to external shocks, particularly to changes in oil and copper prices and in international interest rates. Strong efforts have been carried out to diversify and develop noncopper projects and exports; nevertheless, copper exports still represent between 40 percent and 50 percent of total exports. Copper prices for 1989 are expected to be above the trend price, but the sharp expansion in world supply that is expected in the near future will increase the likelihood of a fall in copper prices. Furthermore, interest payments on external debt represent more than 7 percent of GDP, reflecting not only the high burden of external debt but also the vulnerability of the economy to abrupt changes in international financial conditions. Also, during the coming years, significant amounts of external payments will become due, including net repayments to the Fund, while amortization to commercial banks on financial packages agreed in 1983-85 will fall due from 1991 onward. Although it is expected that these obligations can be refinanced, they represent a sizable part of the financing gap for the coming years.

Chile has followed an active policy in the management of external debt and has achieved a sizable reduction in its debt burden. The most recent information available shows that from 1985, when the country started its program of debt conversions, until September 1989, over US\$8 billion of external debt, representing 56 percent of the external debt outstanding with the banks at the end of 1985, has been converted. Different

items on the menu of debt operations have been utilized, in particular debt-equity swaps, representing 64 percent of debt reduction operations.

A debt buy-back operation was completed in September 1988, when US\$168 million of reserves was used to convert obligations amounting to approximately US\$300 million, resulting in an average purchase price of 56.3 percent. This operation was the first step of a program agreed with commercial banks whereby up to US\$500 million of reserves could be used for official buy-backs. The authorities intend to complete a second buy-back operation before the end of the year, and commercial banks gave the necessary consent on October 27.

Chile's multiyear financial agreements with commercial banks envisage the country having either enhanced surveillance or a stand-by or extended arrangement with the Fund. In this connection, and given the economic and political circumstances of the country during this period of transition, the authorities are requesting the continuation of the Fund's support through a stand-by arrangement in the first credit tranche in the amount of SDR 64 million. This stand-by arrangement would represent continued support for Chile's economic program and facilitate external debt management, particularly by increasing gross reserves while the country continues to undertake debt reduction operations. The Fund's outstanding credit to Chile, including the disbursement of the requested stand-by arrangement in the first credit tranche, would decline from about 220 percent of quota at the end of 1989 to about 120 percent of quota at the end of 1992. This represents a significant flow of net repayments to the Fund, with amortization equivalent to 100 percent of quota and charges and interest payments of about 50 percent of quota.

The Chilean economy is smoothly undergoing a period of political transition, and there are reassuring signals that the favorable results achieved with the efforts of the population in recent years will be preserved. The consolidation of these achievements will also require the renewed support of the entire international community.

Mr. Kafka made the following statement:

Our discussion on Chile last February (EBM/89/17, 2/15/89) dealt with the current economic situation, which has continued to be very satisfactory as described by the staff and Mr. Feldman. Today, I would like to concentrate on a longer-term perspective.

Under a four-year extended arrangement with the Fund, Chile's economic policies have been marked by the pursuit of two related objectives that are standard in many developing countries: increased domestic saving and price stability. Distinguishing the Chilean case is the use of a consistent set of prudent demand policies to keep inflation down, on a scale and with a continuity perhaps unique in high-inflation countries, plus the simultaneous use of courageous structural policies.

What is particularly unusual in the Chilean experience is that demand policies have been implemented through a reduction in both total revenue and total expenditure of the consolidated nonfinancial public sector. This combination reflected not only a decline in the presence of the state in the economy but an improvement in the overall public sector balance by almost 6 percentage points of GDP between 1985 and 1989. The authorities believed during that period that only with some reduction in total public revenue would society accept a major reduction in public expenditure.

The imaginative approach of the Chilean foreign debt conversion program has attracted favorable comments. We agree that there are important lessons to be drawn from this experience, though not all may suggest imitation. But for us the key ingredient of Chile's success has been the improvement in the fiscal accounts. Fiscal action brought about the improvement in national savings, both public and private. Also, the authorities understood that emphasis on increasing domestic savings would attract investment-related private capital inflows even though substantial increases in direct investment failed to materialize.

Another key aspect of the Chilean experience was the early elimination of wage indexation so that private wages were determined by market forces and collective bargaining, while minimum wages were kept low. Interest rates were decontrolled after the 1982 financial crisis, and new financial instruments were issued to stimulate financial savings. After two sharp devaluations in 1985, the peso was kept depreciated until recently so as to stimulate noncopper exports. And, despite all the difficulties, the authorities maintained public investment at basically the same relatively high level after 1984; at the same time, private investment increased, boosted by the availability of savings and by confidence in the economy.

In our view, despite the strong adjustments already achieved, the Chilean authorities were well advised to request a first credit tranche stand-by arrangement, and the Fund staff was correct in recommending approval of that stand-by arrangement. This will help the authorities to consolidate their

efforts and to reap the benefit of their past endeavors; in addition, this support is necessary at this time of political transition.

Although Chile started its program under the recent extended arrangement with a substantial gap below capacity output, it should not be complacent about the recent extraordinary growth in domestic demand, which cannot continue in the medium term. I agree with the staff that further tightening in demand policies should be on the revenue side, since further reductions in expenditure could impair the quality of essential public services.

We would also like to repeat from last February's discussion our word of caution to the authorities about one aspect of the debt profile, namely, that short-term debt vis-à-vis total debt has increased continuously from 1985 to 1988, even though total debt has declined for the second consecutive year. The medium-term outlook is not entirely optimistic. Even with a very high projected noncopper export volume growth of 12 1/2 percent a year and with copper prices at the estimated trend price, debt service payments would have declined in 1994 by only 4 percentage points of exports and nonfactor services compared with 1989, and external debt would still represent 121 percent of exports. The high sensitivity of the medium-term outlook for interest rates and petroleum and copper prices should be noted in this connection. We warmly support Chile's request for a stand-by arrangement.

Mr. Marino made the following statement:

The Article IV consultation with Chile and the member's request for a stand-by arrangement provide us with an excellent opportunity to reflect on the elements of Chile's successful performance under its recently completed four-year extended arrangement, to consider its economic program for 1990 and to assess the challenges that the authorities will face over the medium term.

From 1985 to 1989, Chile has managed to grow at an average annual rate of over 5 percent despite interest payments on external debt of about 10 percent of GDP; increase gross domestic investment by 5 percentage points of GDP; lower inflation from 30 percent to 15 percent; decrease the balance of payments deficit by more than 5 percentage points of GDP; reduce unemployment from 12 percent to 6 percent; and increase gross national savings by 10 percentage points of GDP. This is an impressive record by any standard.

Significant policy actions have supported this economic performance. A tight fiscal policy, which included a cut in public sector expenditures of close to 10 percentage points of GDP, transformed the overall deficit of the public sector in 1985 into a sizable surplus in 1988. The peso was devalued in real effective terms by close to 35 percent. A number of structural measures were implemented, including the privatization of public enterprises, the reforms implemented in the financial sector, the liberalization of the exchange and trade system, and, very importantly, the reforms undertaken to improve the functioning of the labor market. Additionally, the Chilean authorities wisely used the windfall gains provided by the boom in copper export prices in 1988-89 to boost reserves and to effect debt buy-backs.

In spite of Chile's adjustment efforts, wide-ranging structural reforms, and considerable reduction of its debt burden, both the staff and Mr. Feldman agree that its external position is still fragile. The fears are centered on a fall in copper prices--even though the program projections already include a 25 percent reduction in world copper prices--on increases in international interest rates, and on rises in the price of oil. Additionally, there is uncertainty regarding the refinancing of amortization payments to commercial banks falling due in the early 1990s, which coincide with scheduled repurchases of Fund resources. This situation attests to the magnitude of the effort required to restore external viability to an economy which, at its turning point, had an external debt of 120 percent of GDP, and it highlights the importance of debt reduction and, accordingly, the Brady initiative.

Under these conditions of vulnerability to exogenous external shocks, we consider it appropriate for Chile to maintain an ongoing active relationship with the Fund. It would be unfortunate if an external shock of a temporary nature led to a reversal of any of the policy measures implemented by Chile during the past four years, or if a bunching of amortization payments destabilized the exchange markets.

Chile's external vulnerability derives in some measure from its reliance on copper exports. Therefore, it is encouraging to note the significant effort to diversify the export base. This action, coupled with the use of the Copper Stabilization Fund, should gradually reduce the fragility of the country's external accounts.

An important factor behind the growth of noncopper exports has been the exchange rate and wage policies followed by the authorities over the past four years. Thus, great care should be taken to maintain the competitiveness of Chilean exports. In this regard, the recent widening of the spread between the

parallel and official exchange markets is a cause for concern. Accordingly, we urge the authorities to monitor closely developments in this area.

With regard to the most recent developments in Chile's economy, we welcome the actions taken by the authorities to contain demand pressures manifested in the pronounced rise in imports, greater inflationary pressures, and buoyant private consumption.

Chile's economic performance over the past four years has been impressive; however, the benefits from this expansion have barely allowed consumption per capita to reach 1981 levels. Therefore, the momentum of growth must continue for the population to attain adequate living standards. This can be achieved with continued fiscal and monetary discipline and with the support of the Fund and the international community. We support the proposed decisions.

Mr. Hogeweg made the following statement:

It is evident that the economic policy implemented by Chile over the past few years has been very successful. I understand that the stand-by arrangement requested by Chile is designed to continue the medium-term policy framework underlying the extended arrangement that expired in August. Looking at Chile's external position in the next few years, I see no great problems if, as the staff assumes, commercial banks agree on the refinancing of amortization payments falling due in the early 1990s. From this perspective, and recognizing that good policies are also possible in the absence of a program supported by Fund resources, one may wonder why there is a Fund-supported program at all, as this chair did last year when the extended arrangement was lengthened (EBM/88/124, 8/5/88). The answer seems to be that, in its multiyear rescheduling agreement with commercial banks, Chile undertook to have either enhanced surveillance or a stand-by or extended arrangement with the Fund through the end of 1991.

Although the Fund is not bound by an agreement between a member country and its creditors, it will, of course, try to accommodate a member's request in a way that is consistent with Fund policies. From Chile's present situation, I gather that the member is not really in need of Fund resources and that important progress has been made in its adjustment effort. Hence, I wonder why enhanced surveillance has not been chosen at this juncture. I realize that the present stand-by arrangement request envisages only one modest drawing, upon approval, from the first credit tranche. Would it be correct, in interpreting this proposal, to split it analytically into a stand-by

arrangement without resources on the one hand, and a first credit tranche drawing on the other? Looked at in this fashion, are we not somehow implicitly going in the direction of creating a new type of stand-by arrangement, which would fit countries that do not need our resources but do need a Fund arrangement in their relations with their creditors? Under such a stand-by arrangement, a member would not accumulate drawing rights but would be entitled to draw if, while complying with performance criteria, circumstances would change in such a way that the balance of payments would no longer be sustainable. Another year remains after expiration of the current stand-by arrangement and end-1991. Is there a reason to follow a different policy next year?

The staff notes that the medium-term projection is highly sensitive to assumptions with regard to interest rates and oil and copper prices. As to copper, the expansion of world production in the early 1990s, which may well affect prices, originates primarily in Chile, as indicated in the recent staff report on Zambia. Such price movements therefore would not be beyond the control of Chile. Also, I would expect the Copper Stabilization Fund to present at least a partial cushion in this respect.

Finally, I was struck by compensating amendments in Chile's exchange rate policy. I understand that an attempt at end-1988 to use the exchange rate to help restrain imports and inflationary pressures failed because domestic financial policies were not sufficiently tight. The staff comments that the compensating real effective depreciation since May has improved the consistency of policies for the longer term, although obviously it will not help in restraining prices. I would conclude that Chile should be more ambitious in bringing down inflation. An inflation rate of 12 percent by the end of 1990, as programmed, will represent a return to the 1988 level after the disappointing performance in 1989. However, at these levels, a decisive step toward price stability should be possible and would be highly desirable.

Mr. Fernando made the following statement:

Chile's request for a Fund-supported economic program was foreshadowed in the Board meetings of August 1988 and February 1989, which encouraged the Chilean authorities in this direction. This is the seventh straight year of economic adjustment designed in collaboration with the Fund, and Chile's policies and economic performance have indeed been commendable. Consistent with a general reduction in the role of government, underlying fiscal conditions have been brought into near balance, with spending ratios to GDP declining significantly. This

development has provided a strong impetus to stabilize macro-economic conditions in a manner that would facilitate structural reform. Further, it has also helped to provide positive incentives for private sector activity through reduced taxes on production and exports as well as through privatization. In particular, the authorities should be commended for their sound track record of program implementation, general overperformance in respect of the financial program, and achievement of structural policy targets: these attainments occurred notwithstanding the temptations normally associated with a commodity boom, such as the situation for copper which Chile experienced.

Program implementation has been associated with strong growth. Inflation has been brought down to levels not merely low in the historical context but low in relation to South American standards. Even in respect of the external current account deficit, the underlying improvement is clear.

Yet, Chile's balance of payments viability is fragile. The terms of trade situation and the continuing need for further progress in export diversification are obvious factors bearing on the current account of the balance of payments. But more important, the vulnerability of the overall balance of payments derives from the present stock of external debt, particularly that owed to private market sources. Servicing of this level of debt, which calls for an even sharper export bias and the pursuit of a growth orientation sufficient to maintain public confidence in adjustment policies, places enormous burdens on the authorities and on the economy.

We recognize the significant progress Chile has made in reducing debt as well as in improving the maturity profile of the debt stock. Chile's policies are strong and growth promoting, and it has a good track record of program implementation. The country has maintained close links with creditors, has carried out many debt reducing operations of a voluntary and market-based nature, has a reserves buildup such as to facilitate further operations including the guarantee of debt-service payments, and has an increasingly healthy climate for foreign investment and for the reversal of capital outflows.

With this background, it is logical to ask the question, can and should Chile be included in the strengthened debt strategy? Financing gaps appear in Chile's medium-term balance of payments from 1991 onward as previous reschedulings expire. Closing the financing gaps--and yet protecting the adjustment momentum--points to the need for further rescheduling.

Table 8 of the staff report projects the external debt picture through 1994. According to this table, total external debt as a ratio of GDP, which at end-1988 amounted to

80 percent, could decline to 52 percent only in 1994 while the debt-service burden is envisaged to decline over the same period from 31 percent to 23 percent. We wonder whether the authorities or the staff have an optimum level of debt as a target to work toward. Market sources, of course, should continue to participate in Chile's economy at an appropriate level, but we would like further insight into what such a level should be. From 1985 to mid-1989, we have seen a sharp reduction of the medium- and long-term debt of private financial institutions; but after this point, the debt seems to stabilize at this level. Given the strengthening of the debt strategy, in particular the acceptance of debt reduction as an essential element since mid-1989, one would naturally look for a faster pace of activity in this area in cases such as that of Chile, but this is not apparent.

We encourage both Chile and the Fund to collaborate more closely in this area. With increasing experience, the Fund should provide support through analysis of and advice on medium-term economic and financial prospects, as well as assess the case for incorporating faster debt reduction as part of the adjustment program. This could also catalyze further external support for debt reduction operations. In this context, we can support the present request for Fund credit to support Chile's gross reserves while it proceeds with debt reduction. We would, however, wish to learn from the staff the considerations underlying the access limit of 15 percent of quota for the stand-by arrangement, which is expected to support reserves during the process of debt reduction.

On inflation--the area where the authorities were relatively less successful in meeting their objectives--we note the monetary policy actions already taken to restrain private sector credit expansion as well as complementary exchange rate action. In respect of the parallel exchange market, the staff report states that the Chilean authorities "reiterated their intention to follow policies that over time will result in a convergence of the rates in the two markets." Is this a reference to an ultimate objective of a unified foreign exchange market? It is worth noting that the parallel exchange market has played a useful role in absorbing shocks and facilitating debt-equity conversions and as a barometer for the direction of private capital movements. Circumstances in Chile, which are not, of course, limited to that country, would appear to vindicate the operation of such a market until assurances of long-term stability are more readily perceived by the markets. We would like to know more about the staff's ideas on this policy, bearing in mind that it constitutes a multiple currency practice.

Mr. Prader made the following statement:

Even though I would tend to share some of the questions put forward by Mr. Hogeweg concerning the need for a stand-by arrangement, I support the proposed decisions, particularly because I would like to show our appreciation for the strength of adjustment undertaken by the Chilean authorities. Like Mr. Hogeweg, I believe that, given its economic performance, Chile could have continued its adjustment path without recourse to financial assistance from the Fund. At the same time, the Fund should support and reward countries with an excellent economic track record and be flexible in the use of its arrangements when it comes to such countries.

I agree that limiting domestic demand pressures will be the principal policy task for the coming months. By now, signs of overheating have shown up in the recent increases in domestic inflation and import demand. To curb imports, the authorities have already reversed their previous exchange rate policy by seeking a small real depreciation of the peso, and the staff suggests that they keep additional rate depreciations under consideration should import demand remain stronger than desirable.

I am not entirely convinced that this course of action will improve the consistency of policies. The effect of an increase in import prices on the domestic price level might be quite significant, especially since inflationary expectations may already be taking shape and real wage increases and employment performance may both signal growing tensions in the labor market. Given these internal price pressures, there seem to be good reasons to take a cautious approach to any policy that might induce additional pressures.

Moreover, the effects of an additional currency depreciation on the current account do not seem at all assured. The reduction in imports may be short lived if the relationship between the domestic and foreign price levels were to be re-established at its previous level; nor is it certain that exports would have much to gain from an additional price incentive, given the rapid expansion that is already present. In sum, since the exchange rate does not appear to be the root of the current account deterioration, it cannot be stated a priori that a more active exchange rate policy would move the current account in the desired direction. Some additional comments from the staff on the rationale for its position would therefore be welcome.

A similar limitation also applies to the effectiveness of monetary policy at the present stage. By now, real interest rates have been increased to very high levels, and the staff

correctly notes that further increases would adversely affect investment. Not only would such an outcome damage Chile's development prospects, in the longer run it would probably also have a negative side effect on its price stabilization prospects, since the deceleration of investment would affect output capacity and thus the ability to meet demand pressures with an additional supply of domestically produced goods.

On the whole, the situation of Chile is not very different from that of a number of other developing countries that have achieved rapid and growth-oriented adjustment based on strong export expansion and private investment and have been rewarded with the recovery of the purchasing power of households. At some stage of their adjustment, these countries almost inevitably seem to be bound to face an increase in domestic demand and price pressures that cannot be easily corrected with conventional instruments.

In the case of Chile, the situation may be even more complicated, because by now the authorities have virtually exhausted all possibilities for further restraint on the public expenditure side. The staff observes that further cutbacks in spending would have adverse effects on the level and quality of essential public services, and therefore recommends revenue-enhancing measures if additional steps would become necessary to curb demand.

On this issue, the following questions come to mind. What is the experience to date with the far-reaching reduction in public sector functions that has already taken place, such as the privatization of the social security system? Do the authorities now plan a reorientation of public sector policies based on an expansion of revenues and public services? Given the expectations of a structural decline in the level of taxation created by the policy course of recent years, would such a policy be feasible?

Normally, one would expect structural policies to play a role in the improvement of a country's capacity to meet the recovery of demand at stable price conditions, but the staff report, surprisingly, does not address the issue of structural policies. Does this indicate that structural policies in Chile have reached a degree of progress at which no further significant contribution to internal stability or to the balance of payments can be expected? For instance, with respect to internal price stabilization, could the liberalization policies implemented under the previous programs be fully integrated into domestic production relationships, or are there still areas where further improvements in internal competition could result in more efficient production at lower prices?

Regarding Chile's external payments policies, the staff correctly observes that Chile's use of debt reduction techniques has played a major role in lowering the debt burden well before debt reduction became a central component of the general debt strategy. This policy has been facilitated by the authorities' decision to sterilize windfall revenues from copper sales by accumulating them in the Copper Stabilization Fund and by using part of these accumulated resources for debt buy-backs. During our last conditionality review, this chair suggested that the establishment of such funds might also be considered useful for other countries whose stabilization efforts are compounded by their dependence on exports of one or a few commodities. In the Chilean case, the question arises whether the use of the resources accumulated in the Stabilization Fund for debt reduction purposes is still to be considered the best possible use of these resources or whether, given the degree of debt reduction that has already been achieved, these resources could be invested more efficiently as a contingency against future adverse shocks in the copper market.

Regarding Chile's use of special debt conversion arrangements to provide subsidies to specified sectors, the staff mentions that such mechanisms have been used to subsidize mortgage holders and fruit exporters. What is the impact of these operations on the country's general debt policy and on its domestic subsidization policy? I would welcome comments from the staff.

Mr. Al-Jasser made the following statement:

The Chilean authorities should be commended for the comprehensive and successful adjustment under the recently completed extended arrangement. In view of past experience and the general thrust of the new program, with which I agree, I have no hesitation in supporting approval of the proposed stand-by arrangement. The program objectives of reducing inflation through 1990 and consolidating external adjustment without a significant slowdown in economic growth are appropriate. Despite improvements in the external debt situation and a strengthened competitiveness, the external position remains fragile and, as Mr. Feldman indicated, highly sensitive to the vicissitudes of copper and oil prices. Therefore, I would have liked to see a tighter financial program with less ambivalence about the mix of fiscal and monetary policies, the exchange rate, and the additional structural measures needed to further insulate the economy from the effects of fluctuations in copper prices.

The recent expansion in domestic demand has been associated with a reduction in private sector savings which, combined with

the anticipated decline in public sector savings, can abort medium-term growth prospects. Under these circumstances, and like Mr. Prader, I believe that overdependence on high real interest rates over a considerable period, while containing demand pressures, could adversely affect private investment without correcting the lowered propensity to save. Therefore, fiscal policy should be accorded a greater role and made somewhat tighter, especially now that the demand pressures have been spurred, partly by the recent tax cuts. Thus, it would seem appropriate to re-evaluate the recent reductions in tax rates with the aim of revising tax policy in order to provide greater incentives to save and to control demand pressures. Imposition of the consumption tax could be considered as a means for this purpose. At the same time, prospects for further privatization and divestment of public sector activities should be explored.

I am in agreement with the general thrust of exchange rate policy as modified in mid-1989. However, given the recent upsurge in imports and the need to provide continuous support for export diversification away from copper, greater flexibility may be necessary. In this context, the authorities should also consider speedily unifying the exchange markets and standing ready to take additional steps to sustain the unification.

As to Chile's external debt situation, I am heartened to see the impressive progress made so far and the plans to further reduce the debt burden. Resolute steps in this direction are necessary in view of the volatility of export earnings. Chile's experience in using a wide range of market-related debt reduction techniques in alleviating the debt burden should be drawn upon by other highly indebted countries. However, I am mystified by the specification in the program of highly liberal quantitative benchmarks for external public debt. Similar criteria for the last year of the extended arrangement were underutilized by a very wide margin. Could the staff shed some light on establishing criteria that cannot, in principle, be viewed as binding?

With regard to Chile's access to the Fund's resources, while I have no difficulty in supporting this arrangement, once again we are encountering the issue of a floating first credit tranche in the context of extended arrangements. There is clearly a need to review this provision of the extended Fund facility without reducing members' access to Fund resources. Perhaps this matter could be reviewed when the Board takes up the specification of access limits following the completion of the Ninth Quota Review.

Mr. Landau made the following statement:

During the past few years, Chile's economic performance has been impressive, and the authorities have shown their ability to manage the economy cautiously, particularly in setting aside the windfall gains resulting from the rise in copper prices. Since 1985, the increase of investment in relation to GDP has led to a strong growth performance. Even more impressive, the surge in national savings, both public and private, has allowed a strong recovery in the external position.

In 1988, however, the economy entered a period of overheating owing to buoyant investment and consumption. Given a still fragile external position, as demonstrated by the staff's projections, the growth rates attained seem to be unsustainable, and we welcome the authorities' attempt to continue collaborating with the Fund, which demonstrates their commitment to sound macroeconomic policies. Therefore, we have no difficulty with this request for a stand-by arrangement in the first credit tranche.

Among recent developments, the decline in private savings as a proportion of GDP is a matter of concern and, combined with the decline in public savings anticipated for 1990, could trigger a serious weakening of the external position. In such a context, fiscal policy should play a key role in dampening internal demand pressures. That was not the case in 1988, as the fiscal impulse resulting from large reductions in taxes amounted to 0.6 percent of GDP. Therefore, given recent developments and the severe cuts already implemented in public spending, I fully agree with the staff that new revenue measures seem warranted. As to the structure of fiscal revenues, the background paper shows that, as in most Latin American countries, the share of direct taxes is very low. I would appreciate learning the staff's views on this situation and on whether there is a way to increase this proportion.

Concerning monetary policy, the recent course of action seems particularly adequate, and I agree that, given the already high level of real interest rates, further actions could be counterproductive. There seems to be an inverted yield curve of the financial markets, and I would appreciate some comments from the staff on that specific issue. Is it simply a result of the recent tightening of monetary policy, is it an indication that long-term inflationary expectations have already abated, or is it a sign of some rigidities in the functioning of the financial markets?

The viability of the external position must remain the centerpiece of the authorities' economic policy. The staff's medium-term projections demonstrate the feasibility of

maintaining Chile's external financing gap at manageable levels, providing that sound policies are preserved and that Chile is able to refinance the amortization of its commercial debt.

The external sector's buoyancy, however, is extremely encouraging, particularly the rapid increase in noncopper export earnings--over 10 percent a year in volume during the past five years. The opening of the economy since 1984 has been impressive.

Besides sound demand-management policies, exchange rate policy will have to play an important role in maintaining the competitiveness of the export sector--particularly of noncopper exports--and avoiding too rapid an increase in imports. The authorities' action aimed at reversing the real appreciation of the exchange rate seems to have been appropriate, and we welcome the authorities' intention to keep this matter under close review.

We also encourage the authorities to pursue their policy of exchange and trade liberalization and to extend it to capital movements as soon as this is considered feasible. In this context, unification of the exchange rate system could be envisaged. This policy should allow the elimination of distortions resulting from a multiple exchange rate system.

Given the still high level of external debt, we encourage the authorities to pursue their debt reduction operations and to continue implementation of debt conversion programs, as they played a significant role in attracting foreign capital.

Mr. Enoch made the following statement:

Chile's performance under its recently expired extended arrangement was generally very sound. Economic growth was good, and the external position improved significantly. Part of this improvement was attributable to high copper prices, which enabled Chile to build up reserves and to undertake a program of debt conversions and debt buy-backs. But the successful conclusion of the extended arrangement also owes much to the skillful management of the economy by the authorities.

The main problem recently has been a resurgence of inflation. As this chair warned in the Board's discussions of Chile last year, the Chilean authorities seemed not to have taken sufficient measures to curb the incipient overheating of the economy. As a result, the surge of consumer demand, and the dramatic rise in imports late in 1988, continued in the first half of this year. In trying to restrain inflation, the authorities allowed an appreciation in the real value of the exchange

rate, which resulted in a growing spread between the parallel and the official exchange rates and a deterioration in the noncopper current account. But throughout this period the authorities have been progressively tightening monetary policy, and monetary growth has now started to slow. Nevertheless, as the staff makes clear, inflationary pressures are persisting, and, unless these show rapid signs of abating, the authorities must be prepared to take further action. In particular, although interest rates are already high, further increases may be necessary to bring GDP and credit growth back down to sustainable levels and to reverse this year's projected decline in national savings.

In addition to the short-term need to restrain excess demand, the authorities have to consider the medium-term prospects for the economy. As the staff's medium-term scenarios show, the Chilean economy is projected to remain uncomfortably dependent on copper. With new mining capacity being opened, copper shipments are due to increase by 33 percent by 1992. Clearly, the Copper Stabilization Fund will have an important role to play into the medium term, but this alone is not sufficient to protect the external side; the Chilean authorities will need to promote export diversification and to reduce the excessive growth of imports. The rise in import volumes of 23.8 percent this year, as against 7.3 percent in the program, is worrying, even though some of it can probably be attributed to one-off factors and is doubtless related, at least in part, to the real appreciation of the exchange rate. Recent moves to reverse this appreciation are certainly appropriate, but undoubtedly more may have to be done. The program's aim of restricting import volume growth to 3 percent in 1990, while GDP grows at 4 1/2 percent, would seem to be very optimistic in the absence of further policy measures. The authorities will doubtless recall that the rapid rise in exports since 1984 was based on significant exchange rate depreciation, and they should be cautious about explaining away the present differential between the official and parallel exchange rates as due solely to political factors.

One development that overshadows the prospects for Chile's economy is the likely decline in the price of copper. The authorities' use of the Copper Stabilization Fund should insulate them to some extent from the effects of this decline, and the staff suggests that if copper falls to its trend price, the authorities should be able to manage the situation without too much difficulty, unless other exogenous variables, such as interest rates or oil prices, also deteriorate. As this chair has stressed before, however, and as the staff report notes, a return to the trend price is not the ultimate downside risk. The longer the present high price stimulates increases in capacity, the greater the risk that the copper price may fall

below its trend. This argues strongly that the Chilean authorities should not use up their room for maneuver in the face of possible adverse shocks by allowing rapid rises in domestic demand at this stage. There could be considerable medium-term benefits to the economy if the authorities err on the side of caution in their management of domestic demand and the external accounts. The choice would seem to be between continued vulnerability through the medium term to exogenous external shocks and real progress by Chile in overcoming its debt problems.

With access of only 15 percent of quota, it appears that the main purpose of the proposed stand-by arrangement will be to give the Fund's seal of approval to Chile's adjustment efforts and to provide some continuity over the period of the forthcoming election. This is a legitimate goal, but perhaps it could also have been achieved by either a classical stand-by arrangement or a move to enhanced surveillance. I would be interested in hearing from the staff or Mr. Feldman why the option of enhanced surveillance was rejected; is it because the enhanced surveillance procedure no longer serves as an adequate endorsement by the Fund of a country's policies, or is it because a further program involving the use of Fund resources is envisaged for 1990?

Apart from the signaling objective of having a Fund-supported program, the staff indicates that the stand-by arrangement is intended to support Chile's reserves while it is undertaking debt reduction. I note that the access proposed in the stand-by arrangement--SDR 64 million--is almost equal to the disbursement of US\$80 million planned by the World Bank to support debt reduction. The World Bank paper on this matter was explicit that Fund and Bank resources were intended to be provided in parallel.

This linkage with debt reduction brings up the question as to whether this is an appropriate use of Fund resources. The guidelines on Fund support for debt reduction operations state that about 25 percent of access under an extended or stand-by arrangement can be set aside to finance debt reduction operations. It is not entirely clear how the use of the whole of the resources under this stand-by arrangement to replenish reserves following a debt reduction operation accords with this provision.

Nevertheless, Chile is already well into its debt reduction program, and the proposed debt reduction operation is a continuation of a process that has already produced clear material benefits for Chile, and where resources used to support debt reduction have been used efficiently. Indeed, the debt reduction planned under this program was already envisaged under the previous extended arrangement. Moreover, as Chile does not

have a significant need for Fund resources, it makes much more sense to allow 15 percent of quota to be used, even if effectively for a debt buy-back, rather than to give Chile a stand-by arrangement equal to 60 percent of quota and to set aside one quarter of this for debt reduction.

Given these considerations, and given Chile's good track record and exemplary history of cooperation with the Fund, I can fully support this stand-by arrangement. However, this should not necessarily be taken as a precedent for other cases where there is a link with debt reduction. The intention of the Fund's guidelines was clearly to establish a framework within which the Fund could provide resources for debt reduction. While some of requirements of the set-aside provision may be curious, these are not arbitrary. In particular, they reflect the Board's wish to proceed cautiously in using Fund resources to support debt reduction. I can support the proposed decisions, and I encourage the Chilean authorities to guard against any slippages in economic policy, so that they can maintain and enhance their reputation for skillful management of the economy.

Mr. Clark made the following statement:

We welcome the significant economic progress made by Chile since 1985. In large measure, this has reflected better macro-economic policies and important structural changes. The result has been a high level of economic growth, a moderation of inflation, a strengthening of domestic savings and investment, and a much improved fiscal position. Externally, a notable diversification of exports has occurred which, together with the recent high prices for copper, has led to a marked improvement in Chile's external position and a reduced level of debt.

Over the past year, however, the economy has clearly become overheated. We agree with the staff that the recent rate of expansion of domestic demand, including the sharp acceleration in import growth, is not sustainable. We urge the authorities to be ready to take further restrictive measures, in addition to those already taken, if a sufficient slowing of growth does not materialize in the near term.

The Chilean economy remains vulnerable to external developments, particularly in world copper markets. Fluctuations in copper prices have a major impact on economic growth, government finances, and the external position. In these circumstances, we can understand the use of a conservative estimate of the long-term trend copper price as the basis for economic and fiscal projections and the drawing up of policies. We would be interested, however, in whether the staff considers the copper price assumptions used by the authorities consistent with projections

in the latest world economic outlook. It would appear that, at least in the short term, copper prices may well be higher than those assumed in the program. For example, the authorities are forecasting an average copper price in 1989 of US\$1.17 a pound, followed by a decline in prices to their long-term trend in 1990--a London Metal Exchange price of US\$0.79 a pound, less discounts for quality. However, the price of copper on the London Metal Exchange averaged US\$1.32 a pound in the first nine months of this year. Prices would have to weaken substantially more than they have in recent weeks for the price assumption to be met. This suggests that for 1989, and possibly for 1990, copper receipts may well be significantly larger than projected.

We note that the Copper Stabilization Fund is to remain in place and that benchmarks under the program are to be adjusted for changes in deposits to the Stabilization Fund. While we welcome the maintenance of a mechanism to partially sterilize windfall gains from higher than expected copper prices, the authorities need to be alert to the potentially inflationary effect on private sector income of higher copper prices. There has been a significant acceleration of inflation this past year with the overheating of the economy. We regard the inflation target for 1990 as the bare minimum.

With higher copper prices than assumed, Chile's current account deficit in 1989 is also likely to be smaller than projected and the balance of payments position stronger. It seems likely that net international reserves could increase by significantly more than the US\$500 million that is envisaged in the program for 1989. In this regard, we are not certain why this target was revised down from the US\$880 million originally envisaged. Perhaps the staff could comment on the reason for the revision of the likely outcome for 1989.

Despite the considerable progress made over the past few years and its much stronger external position, Chile is requesting a one-year stand-by arrangement in the first credit tranche. We recognize the desire of the authorities to consolidate this progress and to reassure financial markets and creditors during a period of political uncertainty. For these reasons, we can support the request for a stand-by arrangement.

In the context of the current focus on debt reduction, however, there are a number of interesting questions that arise in the case of Chile, which have been raised by other speakers. On the one hand, this is a country that has made remarkable progress, largely as a result of adopting sensible and credible economic policies. One would like to reward such good performance. On the other hand, by virtue of being so successful, it is now not so obvious that Chile has a serious debt overhang problem. For example, private investment, including foreign

direct investment, has been buoyant, and the economy has been growing strongly. It is difficult to make the case that a large debt overhang is acting as a deterrent to investment, and that incentives for future investment have been eroded because of the expectation that the benefits of improved economic performance will largely go to increased taxes to service debt. In fact, this past year, Chile reduced taxes, and its fiscal position remained quite strong. Chile's external debt burden has also moderated markedly over the past few years, and even on the assumption of long-term trend prices for copper, the medium-term scenario shows a further improvement in debt ratios, with the ratio of external debt to GNP declining from 65 percent at end-1989 to 52 percent at end-1994.

In these circumstances, the reaction of commercial banks to Chile's second buy-back operation and developments in the price of Chilean debt on the secondary market will be of considerable interest. It may help in assessing whether Chile, or other countries in similar situations, have debt overhang problems that justify support by international financial institutions to reduce debt. It may be found, for example, that banks will recognize the progress made by Chile and as a result be reluctant to sell debt at enough of a discount to make the exercise worthwhile. If banks also prove willing to refinance maturing debt, this would be a clear indication that Chile was returning to creditworthiness and did not have a debt overhang problem. Such is the price of success.

Mr. Schioppa made the following statement:

I am in fundamental agreement with the staff appraisal and I can support the proposed decisions. It is undeniable that considerable success has been achieved by Chile over the past four years, as evidenced by the relatively high rate of growth, the reduction in inflation, the dramatic recovery of investment and savings, and the noticeable improvement in the external accounts.

It is unfortunate, therefore, that signs of overheating became manifest in the latter part of 1988 and in the first half of 1989, when some acceleration of inflation and a weakening of the external accounts were recorded. Furthermore, the deterioration in the current account occurred despite a radical improvement in the terms of trade.

So far, the authorities appear to have responded to the situation almost exclusively through a tightening of monetary policy, whereas the fiscal stance seems to have been, if anything, relaxed as a consequence of the tax reduction measures implemented in 1988. Furthermore, the staff report does not

indicate any major changes, either in the prospective developments of the economy or in the policy instruments, that the authorities intend to implement to reduce inflation to the targeted level.

In fact, while the authorities recognize that further increases in real interest rates are undesirable in view of possible adverse effects on investment, they do not seem to feel that immediate corrective measures are required in the fiscal field, unless the monetary measures adopted so far do not succeed in dampening the rate of growth in domestic demand. In their projections, the authorities appear to assume that the present policy mix is adequate to achieve the desired reduction in inflation and the return of the growth rate to more sustainable levels. On the basis of recent experience, this might seem a slightly optimistic expectation, and I join other speakers in welcoming any comments by the staff that would support such an expectation.

Another aspect of the situation in Chile on which some elucidation would be welcome is the effective degree of indexation in the economy and its contribution to the resilience and strength of inflation. I understand that, while wage indexation was abolished in 1982, it is still effectively applied in the public sector, whereas in the private sector periodic adjustments to nominal wages are agreed upon presumably on the basis of the expected rate of inflation, a process that often leads to significant increases in real wages.

Furthermore, most, if not all, financial instruments are indexed. This feature appears to be an important element in sustaining and perpetuating the inertial element of inflation. In fact, the indexation of financial instruments might severely limit the ability of the authorities to control the rate of expansion of liquidity in the economy and force them to resort to unduly high real interest rates.

As we all know, the problem of indexation of financial instruments is of significance not only in the case of Chile, but also in a number of other countries that have been experiencing persistently high rates of inflation. As far as Chile is concerned, I wonder whether it would not enhance the influence of the monetary authorities if the indexation of financial instruments was abolished. In such a case, market forces would be allowed to determine both the interest rate and the exchange rate, while the monetary authorities would intervene only to the extent necessary to determine the appropriate rate of expansion of the monetary aggregates. I would therefore welcome any comments by the staff or Mr. Feldman on the prospects of implementing a full deindexation of the economy at this juncture.

Mr. Di made the following statement:

We continue to be impressed by Chile's economic performance and the wide-ranging efforts of the authorities in implementing financial adjustment and structural reforms. As a result of the authorities' sustained commitment to pursue comprehensive and consistent economic adjustment, Chile has made more progress over the past year in maintaining strong economic growth, increasing domestic savings and investment, and strengthening the external position. I am in broad agreement with the staff appraisal and with the general thrust of the authorities' program for the remainder of 1989 and for 1990, which maintains the medium-term framework and objectives developed under the extended arrangement.

Since our discussion for Chile's 1988 Article IV consultation (EBM/88/124), the country's economy has continued to perform commendably and the strong growth has maintained its momentum. In the first half of 1989, real GDP growth was 10 1/2 percent higher than in the same period of 1988 as a result of sustained, fast growth in noncopper exports and a continued surge in copper exports, for which the price was considerably higher than expected in the program for the year. Despite the weaker than expected current account outturn, which was due largely to a sharp increase in imports, net official international reserves have increased rather than declined as envisaged in the program. The continued strong economic performance and the healthy trend of economic development are welcome and commendable.

Nevertheless, the authorities would be well advised to continue prudent management of macroeconomic policies in the light of the intensified pressures of domestic demand that have resulted in a steep rise in imports and an acceleration in inflation. We welcome the steps that have been taken by the authorities in the fiscal, monetary, and exchange rate policy areas so as to keep the overexpansion of domestic demand in check. However, to preserve conditions for sustained growth and external viability, it will be important for the authorities to take further corrective action, as indicated by the staff, if the expansion of domestic spending cannot be slowed down in the next few months.

Moreover, while it is important for the authorities to maintain the current thrust of macroeconomic policies, it is essential that efforts be reinforced to deepen the structural reform with a view to tackling those factors that may threaten the steady growth of the economy. As indicated in the staff report, the medium-term outlook is highly sensitive to assumptions about international interest rates and petroleum and copper prices, indicating that the economy is still overly

reliant on exports of primary commodities, especially copper. Also, the high level of external debt and the debt service burden continue to place the country in a vulnerable position, despite the progress achieved thus far in both areas.

It is apparent that, under the circumstances, Chile's economic growth and external viability are still largely subject to changes in exogenous factors beyond the control of the authorities. While it is advisable for the authorities to further diversify the economy away from overreliance on copper exports and to reduce external debt to manageable levels, it is also essential at this stage for the country to receive continuous support for its adjustment efforts from the international community.

Noting that the authorities' request for a one-year stand-by arrangement is to support a program consistent with the medium-term policy framework underlying the extended arrangement, we believe that it will be beneficial to the country's economic adjustment effort. We therefore fully support the authorities' request and the proposed decisions.

Mr. Yoshikuni made the following statement:

I join other Directors in commending the Chilean authorities for their remarkable achievements under the extended arrangement and their intention to continue the adjustment efforts supported by a stand-by arrangement. On many occasions, Chile has been referred to as one of the successful cases of the debt strategy. Nevertheless, the current overheating of the economy is a worrisome development. The strong growth of domestic demand has continued to accelerate since the latter half of 1988, resulting in the resurgence of inflation and a rapid deterioration in the external balance. The policies implemented so far have been only partially successful in curbing the overheating, despite the strong growth of exports which provided the authorities with significant room for maneuver.

In this connection, I welcome the fact that the program before us rightly aims at tackling inflation and strengthening the external balance. However, since the economy is still vulnerable to changes in world economic conditions, particularly copper prices, there seems to be room for further tightening in the event that the projected sharp fall of copper prices in 1990 and stagnant price developments thereafter cause a greater than expected deterioration of Chile's terms of trade.

While I generally endorse the staff's appraisal, I would like to touch upon a few policy areas. First, I welcome the

authorities' cautious stance on monetary policy. It is encouraging that the growth of narrow money has slowed with the rise in real interest rates; however, broad money continues to expand. In my view, a tight credit policy should aim at curbing private consumption. In other words, further emphasis could be placed on raising domestic private saving, as the growth of domestic saving lags behind the strong increase in private investment.

Second, the fiscal balance continues to show a small deficit--about 0.3 percent of GDP--at the trend copper price, which means that fiscal policy is making only a limited contribution to the cooling down of the economy. Fiscal policy could bear a more significant burden of adjustment in the event that any additional tightening is required.

Third, on external policy, it is necessary to lessen the economy's dependence on copper exports by diversifying exports. In the short run, however, the authorities' most urgent need is to curb the current strong growth of import demand, which casts a shadow over the prospects for sustained economic growth. While the significant growth of imports between 1988 and 1989 is attributed mainly to project-related imports, the underlying trend growth of import demand certainly reflects consumption elements. Along with the introduction of aggregate demand control, a realistic exchange rate policy is essential to strengthen Chile's external viability. In this regard, the resumption last June of swift adjustment of the exchange rate is welcome. With regard to the capital account, I would appreciate it if the staff could elaborate on the recent situation of capital flight.

Fourth, on medium-term prospects, I commend the authorities for their determined efforts to resolve the external debt problem. That being said, large financing gaps are still projected after 1991. While it may be possible to narrow the gaps through further debt rescheduling and debt reduction operations, we should not overlook the downward risk in the projection considering the fragility of the economy with regard to external developments. In this context, I wonder whether it would be helpful to consider the possibility of another medium-term program supported by the Fund. I would appreciate the staff's comments on this point.

Finally, on the use of Fund credit in support of debt reduction, I generally associate myself with the points made by Mr. Enoch. Accordingly, while I have no difficulty in supporting the proposed decisions, I would appreciate it if the staff could clarify the relationship between the proposed decision on the stand-by arrangement and the guidelines on debt reduction operations, specifically whether the arrangement constitutes a

flexible application of the guidelines or whether it should be considered outside the context of the guidelines.

Mr. Evans commended the Chilean authorities on their impressive success under the extended arrangement. It was, however, regrettable that there had been some slippage in performance over the past 12 months, although in some part that slippage had been due to success, to the extent that it had reflected strong investment growth. There was considerable doubt as to whether current policies were adequate to correct the slippage, and he noted that in the quantitative benchmarks set for the program there seemed to be little linkage between those benchmarks and policy requirements, at least for the short term. The staff might wish to comment. Mr. Feldman had assured Directors that the authorities were willing to adopt further measures if necessary. From the evidence before the Board and comments of previous speakers, he believed that the authorities would be well advised to consider further measures earlier rather than later.

With respect to the request for the stand-by arrangement, it was not clear that Chile was in need of further use of Fund resources, Mr. Evans commented. However, the request seemed to be for a classical stand-by arrangement, namely, one that provided confidence to the financial sector regarding the Fund's support if needed. By no means were the Chilean authorities required to draw under that stand-by arrangement, and he would advise them to consider that possibility, particularly in light of Mr. Clark's remarks on copper prices and the possibility of a greater buildup of reserves in the current quarter. Nevertheless, he had no hesitation in supporting a stand-by arrangement in such circumstances, as he believed they were the circumstances for which stand-by arrangements had been designed. The arrangement would provide the Chilean authorities time to determine the direction of their relations with the Fund beyond 1990 and whether enhanced surveillance might not be considered for that period.

Mr. Kleine said that he agreed with the staff report, in particular the statement that the authorities should take additional corrective measures if domestic demand continued to grow at an unhealthy pace. He was not sure that the liquidity overhang that had emerged at the end of 1988 had been eliminated. If price increases persisted, it might be necessary, at least temporarily, to raise interest rates even further and to take additional measures to restrict credit. He also endorsed the staff's recommendation on exchange rate policy. He could support the proposed decisions.

Mr. Rieffel commented that, as other Directors had noted, Chile's economic performance in 1988 had indeed been impressive. At the same time, as Mr. Feldman had pointed out, consumption per capita remained below the 1981 peak level after four years of strong adjustment, which underscored the long-term nature of the adjustment process and the importance of avoiding slippages.

He was pleased that Chile had met all performance criteria under its extended arrangement in the first half of 1989, Mr. Rieffel continued. Yet the economic performance for the full calendar year appeared less impressive. To some extent, the weaker performance appeared to be related to policy shortcomings. In retrospect, for example, the decision in late 1988 to allow the exchange rate to appreciate had been mistimed. Of course, he welcomed the steps taken during 1989 to tighten financial policies and to adjust exchange rate policy. Nevertheless, he agreed with the staff that it might be necessary to consider further adjustments in interest rates and exchange rates. In particular, he noted that the authorities expected import growth to slacken sharply in 1990. He urged the authorities to watch that indicator closely and to take appropriate action if import growth remained buoyant.

Looking forward, he welcomed Chile's decision to seek Fund support for its continuing adjustment efforts, Mr. Rieffel said. He also welcomed the use of Fund resources in connection with completing the buy-back of commercial bank debt that had been envisaged under Chile's extended arrangement. The program for 1989-90 seemed adequate, but he had four concerns. First, he regretted that the inflation target for 1990--12.0 percent--was not lower than the target originally adopted for 1989--12.0 percent. He would like to see Chile aim for single-digit inflation. Second, the copper price assumption for 1990 appeared to be very conservative, and he would appreciate some elaboration by the staff or Mr. Feldman on how the authorities intended to use additional resources if copper prices were higher.

Third, most financial instruments in Chile were indexed, Mr. Rieffel noted. He understood that that might have been an important means of achieving financial stability in the past, but he would appreciate the views of the staff on the possibility that the practice would interfere with efforts to reduce inflation below 10 percent. Fourth, most capital movements remained subject to controls. He believed that the authorities should begin the process of eliminating those restrictions without further delay and move toward unification of the exchange rate. Those steps should be an important part of any Fund-supported program that followed the stand-by arrangement.

He wished to raise a point that went beyond the case of Chile, namely, the analysis of the capacity to repay the Fund, Mr. Rieffel said. As the Board was aware, his chair had been particularly interested in that analysis; therefore, he welcomed its inclusion in the staff report on Chile. However, the staff seemed to have settled on a standard conclusion that was not very meaningful. The standard phrase was that the staff "expects the member to continue to meet its financial obligations in a timely manner." The Board needed to know not the staff's expectation--which tended to be the same from country to country--but the staff's assessment of the risks to the Fund--which varied considerably from country to country. He believed that the risk was low in the case of Chile, and therefore the issue was not particularly important in the

present situation. But he would like to see the staff adopt a more thoughtful and informative approach in the future.

Chile's success had been due in large part to prudent policymaking during a period of high copper prices, which had fostered strong growth in noncopper exports, Mr. Rieffel remarked. The operation of Chile's Copper Stabilization Fund should be studied by other countries that depended heavily on one or two export commodities. Perhaps the establishment of such a fund should be a condition of Fund financing in those countries.

He was optimistic about Chile's medium-term balance of payments prospects, but the staff projections pointed to some vulnerability owing to the uncertainty of future flows of commercial bank financing, Mr. Rieffel noted. Perhaps Chile needed a more aggressive approach than the one implied in the staff projections, namely, an approach involving a faster increase in the rate of domestic savings, a much smaller current account deficit by 1994, and net repayment of external debt to private creditors in order to accelerate the return to voluntary financing. He supported the proposed decisions.

The staff representative from the Western Hemisphere Department noted that some speakers had asked why a stand-by arrangement, rather than enhanced surveillance, had been proposed in the present case. He believed that the Government's request for a stand-by arrangement had been not so much related to the undertakings under the restructuring arrangement with commercial banks as prompted by domestic factors. Elections would be held in December, and the outgoing Government was desirous of having a stand-by arrangement, with the use of Fund resources, to provide a smooth transition. The arrangement would indicate a commitment to the policies set out in the extended arrangement framework during the elections and transitional period, and it would ensure continuity of policies while providing the incoming Government with flexibility as to its future relationship with the Fund. Without an arrangement with Fund resources, the new Government might encounter more resistance to using that option.

The staff mission had participated in informal discussions with the representatives of all political parties in Chile, and a positive attitude toward the Fund existed across the political spectrum, the staff representative said. However, it was difficult to know at the present time what the future relationship between the Fund and Chile would be.

The considerations behind the low level of access of 15 percent of quota were mainly cyclical, the staff representative explained. Chile was at a point where any program should involve net repayment to the Fund. Because of the country's relatively comfortable balance of payments situation, the question had been asked whether it might not be a candidate for the strengthened debt strategy. In assessing a member's debt situation, the staff looked for debt and debt-service levels that were manageable over the long run with adequate rates of growth and steady progress in reducing the debt burden. Chile met those conditions and showed that a country could, with the right policies, achieve high rates of growth in

the presence of a large debt burden. As to whether there was a case for incorporating a faster rate of debt reduction as part of the program, the issue had been discussed in a preliminary manner with the Government--whether instead of completing the second stage of debt buy-backs envisaged in the extended arrangement, a more global approach might not have been preferable, since Chile would face maturities falling due from 1990 onward. The Government, however, had taken the position that it would be in power for only a few more months, as elections would be held in December; a more comprehensive solution would take a long time to negotiate and therefore should be left to the incoming Government. The present Government preferred to limit itself to implementing the debt buy-back arrangements incorporated in the extended arrangement.

Difficult trade-offs existed on the question of exchange rate policy between the short-term goal of curbing inflation and the longer-term objective of strengthening the balance of payments, the staff representative remarked. Clearly, a more aggressive exchange rate policy would not help in reducing inflationary pressures. However, the staff's position was that exchange rate policy should be oriented toward the longer-term consideration of maximizing export diversification. The staff had felt that the authorities' plan to appreciate the peso in real effective terms by a small amount six months previously, while not causing irreparable damage, was not advisable for the longer run. Demand-management policies should play the main role in curbing inflation. At the moment, the authorities were relying mainly on monetary policy, and perhaps more emphasis should be placed on fiscal policy.

In seeking to minimize the spread between the official and parallel exchange rates, the authorities had a number of ways to influence the rate of exchange in the parallel market--for example, by varying access to that market--the staff representative continued. The authorities could change the amount of debt conversion rights that were auctioned by the Central Bank; the resources for debt buy-backs by residents, in effect, came from the parallel market. In general, the authorities viewed the parallel market as a safety valve in the presence of capital controls. Unification of the exchange market raised the issue of whether Chile could remove all capital controls; to date, the Government believed that the political environment was not conducive to such action, but perhaps the incoming Government might be in a better position to address the issue after the elections and change of administration.

On the question of structural policies, Chile had made important strides in almost all areas in recent years, the staff representative commented. For example, Chile had a low uniform external tariff rate of 15 percent; it had a flexible exchange rate system; it had made progress in privatizing public sector enterprises and in privatizing the health, education, and social security systems; it had adopted liberal labor laws; and it had a system of indexation of financial instruments that had consistently ensured positive real interest rates. The reduction in the size and scope of the public sector had been such that the level of expenditures had perhaps impinged on the quality of services. It was

therefore possible that the incoming Government might reverse some of the compression of public sector expenditures. The main area remaining to be addressed was the opening of the capital account, which could be considered after the political transition.

The question had been raised as to whether the use of the resources of the Copper Stabilization Fund for debt reduction was wise or whether it would not have been better to hold resources in reserves, the staff representative noted. On balance, the staff agreed with the authorities on limiting the amount of resources used for debt buy-backs to a relatively small amount. The buy-back operation itself was advantageous economically, with a rate of return of about 18-20 percent at the discounts obtained by the authorities. However, there was also a strong argument for holding liquid reserves against the possibility of not being able to raise new financing from the market when needed in the future even after debt had been reduced substantially. With those considerations in mind, the authorities and the staff had agreed that the limit on the buy-back operations should be US\$500 million and that the authorities should seek additional support from other creditors for those operations. In addition, the authorities had also provided special debt conversion arrangements for food exporters and mortgage holders. Access to those arrangements was limited to holders of mortgages of less than US\$5,000 and exporters of fruit who had suffered losses as a result of the ban on Chilean grape exports in 1989. By giving those Chilean residents access to official exchange to buy back debt at a discount in the secondary market, the Central Bank was in effect giving a subsidy. The total amount of debt operations that had taken place under those schemes was US\$300 million, and the subsidies amounted to over US\$100 million, or about 1/2 percent of GDP.

The ceiling on the contracting of external debt was indeed liberal, the staff representative commented. In Chile, the issue was not so much to limit the country's access to external markets, but rather to help the country get back into a voluntary relationship with external creditors. As a result, the program limit on external debt at that point was largely symbolic.

The inverted yield curve of the financial market reflected the short-term stance of monetary policy with the Central Bank pursuing an aggressive open market policy mainly with short-term instruments, the staff representative explained. As a result, short-term rates had been pushed up significantly, but longer-term rates had not risen so much. That situation reflected the expectation that rates would come down over the medium term.

The stand-by arrangement was not directly linked to debt reduction, the staff representative said. The World Bank had also decided not to link its financial market loan directly to a debt reduction operation but rather, like the Fund, to support Chile's overall program, which included a debt reduction component. As Mr. Enoch had pointed out, with the set-aside provisions that had been applied in other countries, to obtain an

amount of resources similar to the amount requested under the stand-by arrangement just for debt reduction, the nominal amount of the stand-by arrangement would have had to be raised to about 60 percent of quota, which would not have been appropriate given Chile's cyclical situation.

The Chilean program was based on a Copper Stabilization Fund that in effect took the 1987 copper price in real terms as the long-term trend and sterilized a portion of any excess over the trend price, the staff representative stated. It was likely that in 1990, copper prices would be higher than assumed in the program. For the longer term, the benchmark price used for the Stabilization Fund was close to the world economic outlook price, discounting for quality. The realized price that Chile received for its copper was about US\$0.05 below the London Metal Exchange (LME) price, and the medium-term world economic outlook projections were close to the figures used in the present case, or possibly about US\$300-400 million higher, as the world economic outlook indicated an average price of about US\$0.95 a pound for that period whereas the program assumed an LME price of US\$0.85 a pound. It was uncertain whether the better than projected copper price in 1989 would allow the reserve target for 1989 to be exceeded by a significant margin: reserve accumulation from January through early November had been only about US\$230 million so that it was unlikely that the target of US\$500 million for the end of 1989 would be significantly exceeded.

It should be noted that the reserve target had been lowered for 1989 from US\$880 million to US\$500 million partly because import levels had been higher than expected, and because of the ban on fruit exports, which had resulted in a loss of about US\$200 million in exports, the staff representative continued. As for 1990, the program laid major emphasis on restraining total imports: if imports were kept on track and copper prices were higher than projected, there would be more room for maneuver.

The quantitative quarterly indicators that had been set out in the program were designed to trigger policy action, the staff representative commented. During the discussions, the authorities had observed that the steps they were taking--particularly the tightening of monetary policy--would take some time for their effects to be felt, and that it was perhaps premature to judge whether additional measures were needed. Economic developments would have to be kept under close review. The quarterly benchmarks represented a trajectory for the economy that was designed to indicate whether further actions were necessary. The staff had agreed with the authorities to review the program in January, though it was not a formal requirement of the program.

On the question of the extent of indexation in Chile, the staff representative noted that formal wage indexation had been abolished. However, in practice, the private sector tended to base negotiations on the past behavior of the cost of living index. In the public sector, the wage bill was usually adjusted in line with inflation, but with considerable flexibility with respect to the timing of the wage increases. As to indexation in the financial markets, almost all financial contracts were

expressed in terms of a market-determined interest rate plus monetary correction, based on an index that moved in line with the consumer price index. The system had some distinct advantages and seemed to have functioned well in Chile. One advantage was that it eliminated the risk premium in financial contracts; since there was ex post protection against variations in the rate of inflation, there was no need to add an extra margin to cover the risk of an acceleration of inflation. As a result, it appeared that in Chile, ex post real interest rates had been lower than in other countries that had adopted a fully market-determined system, such as Bolivia. Another advantage was that it fully protected savings in local currency and reduced the incentive to hold dollars, thereby giving the authorities more flexibility in exchange rate policy. Again, taking the example of Bolivia, despite the free market-determined and highly positive real interest rates in Bolivian currency, almost 80 percent of all financial instruments were denominated in U.S. dollars, complicating the task of managing an exchange rate policy. In Chile, the indexation system for financial instruments had been associated with a rapid increase in domestic savings over the past few years. Chile's experience with indexation could warrant further study by the staff.

The balance of payments figures did not suggest that capital flight was an important factor in Chile, the staff representative said. On occasion, capital flight had occurred for short periods, as reflected in variations in the spread between the parallel and official exchange rates. On three occasions, the gap between those rates had approached 20 percent: the first instance was in 1985, before the Fund extended arrangement and the associated financing package had been put in place, when there was a high level of uncertainty as to whether the financing would be available. The second occasion was shortly before the plebiscite of 1988, reflecting mainly political considerations, and the third occasion had been in the recent run-up to the general elections. However, since the staff report had been issued, the spread had declined to about 10-11 percent.

Finally, the staff had taken note of Mr. Rieffel's comments on the inclusion of a more substantive analysis of the capacity to repay and an assessment of the risk to the Fund, the staff representative from the Western Hemisphere Department commented.

Mr. Kabbaj commented that if Chile had requested a stand-by arrangement with regular access of, say, 60 percent, with a set-aside amount, and had negotiated debt reduction operations that were limited to one technique--in the present case, debt buy-backs--he could have supported the request so long as the use of resources was judged to be optimum by the Fund. However, many of his colleagues had stated that several debt reduction techniques should be employed, and he would be interested in having the staff comment on the issue.

The staff representative from the Exchange and Trade Relations Department remarked that the guidelines on the Fund's role in debt reduction operations, as elaborated, did not specifically address the situation encountered in the case of Chile. First, the guidelines envisaged a

situation where substantial financing gaps would have to be filled and where access to Fund resources would be substantial, as warranted by the strength of the program and the need for financing. In the present situation, other considerations had prompted the staff to recommend limited access. Second, the guidelines foresaw in the setting aside of resources and the phasing of set-asides, as well as in potential augmentation for interest support, a situation where a financing package involving debt reduction had yet to be negotiated and presented to the Board, along with an indication of the achievement of balance of payments viability in the medium term and the efficient use of Fund resources. In the case of Chile, the authorities had already reached agreement with the commercial banks on debt buy-back operations and the staff was familiar with the buy-back terms. There existed a strong expectation that Fund resources would be used efficiently. Therefore the spirit of the guidelines had indeed been met.

The question had also been raised as to whether a particular debt ratio could signify the need for a country to increase its participation in debt reduction, the staff representative recalled. He, in fact, had another view: that the objective was to see a country return to voluntary financing. Chile would have financing requirements from 1991 onward of principal repayments to commercial banks, which would constitute an important test of whether the banks would be forthcoming on voluntary terms for a country with Chile's record of successful adjustment. Given secondary market prices and the high yields on alternative uses of funds, Chile was perhaps not approaching the limits of the usefulness of further debt reduction operations. However, it was not clear that much further scope existed, and that aspect would have to be kept under consideration.

As to whether the Fund would have a view on the number of items included in a menu negotiated between a country's authorities and its commercial bank creditors, the guidelines merely stated that the menu should make a substantial contribution consistent with the objective of achieving balance of payments viability and that the Fund's financial support of the debt reduction operation should constitute efficient use of the institution's resources, the staff representative from the Exchange and Trade Relations Department stated. If those conditions were met, it was up to the authorities and the banks to choose the items and no a priori view should prevail. In many cases there was a desire, particularly on the part of the commercial banks, to include in a debt reduction package a wide menu in order to attract the voluntary participation of many commercial banks according to their portfolio preferences. However, a situation in which only one item was presented could arise; such a case would be surprising, but the possibility should not be excluded.

Mr. Hogeweg noted that the staff report had alluded to a possible link between access under the program and buy-backs: access would be in support of the program as laid out; and the arrangement would support gross reserves while the member was undertaking debt reduction. Interpretation could vary, and of course money was fungible, but those passages could be read to mean that indirectly the Fund was helping to finance the

buy-backs. One could also argue, however, that the buy-backs were being financed from other sources, and that the Fund was merely maintaining reserves at a prudent level. In that manner, he found a discrepancy between the comments on the link in the staff report and the views just presented at that meeting by the staff. In similar cases, perhaps the staff could present in future reports a more explicit delineation of the reasoning behind the issue.

Mr. Feldman stated that during the present transitional period, the authorities were seeking a flexible agreement without discontinuing Chile's strong relationship with the Fund. They considered that at the present crucial juncture for Chile, it was necessary to obtain support in the form of a stand-by arrangement. Enhanced surveillance was not attractive to his authorities during the transitional period before a new Government took office because the effect of perhaps subsequently moving to an upper credit tranche arrangement with the Fund would not project a favorable image to domestic and international markets. However, moving from an extended arrangement to a stand-by arrangement, as requested, was preferable and left more room for maneuver to the incoming authorities.

The consensus of the Board was that some overheating existed in the Chilean economy, but no consensus prevailed on how to tackle that situation, Mr. Feldman continued. Some Directors had recommended the use of monetary and exchange rate policies, while others had cautioned against an excessive role for those economic tools and had emphasized fiscal policy. Recently, the Chilean authorities had implemented monetary and exchange rate policy as the main instrument. Inflation had been contained successfully, although some acceleration had occurred, related mainly to the exchange rate measures of June and July. He did not expect any dramatic change in fiscal policy in the forthcoming months, unless strong macroeconomic imbalances should occur. The authorities remained committed to taking whatever measures were necessary, but as the staff had pointed out, they had preserved the utilization of exchange rate policy, and fiscal policy in a longer-term perspective, as instruments devoted mainly to resource allocation, rather than to tackling short-term macroeconomic imbalances.

Indexation, while not in general use in Chile, had worked in the financial market to preserve competitiveness and to achieve an increased degree of modernization and financial strengthening, Mr. Feldman commented. While the risks that prevailed in other countries with much higher rates of inflation did not exist in Chile, the rate of inflation was high by international standards, and therefore indexation was used as a way to ensure contracts' credibility and to make operations within the domestic markets attractive. Once Chile had moved to a lower rate of inflation, say, a single-digit rate, the market would start creating instruments without indexation-linked mechanisms.

The question of the optimal level of indebtedness was linked to other issues regarding Chile's possible move to a unified exchange rate market or to a more liberal policy on capital movements, Mr. Feldman remarked.

Those issues in turn could not be disassociated from Chile's external viability and its access to markets on a voluntary basis.

Chile was unique in that strong front-loading of structural reforms had taken place, although admittedly further reforms remained to be introduced, Mr. Feldman noted. Such reforms were a permanent challenge to any country, but the scope of the measures introduced in Chile called for reflection on their implementation. The market was reacting to some of the reforms, and perhaps modifications would have to be introduced. The issue was more the fine-tuning of existing structural reforms rather than the introduction of new ones.

No formal linkage existed between the use of the Fund's resources and debt reduction operations, which had already been agreed with the banking community, Mr. Feldman stated. The resources of the Fund and the World Bank, would not be formally linked to debt reduction operations but would be extremely helpful in consolidating the Chilean situation, both domestically and externally, during the present transitional period.

The Chairman made the following summing up:

Executive Directors welcomed the continued progress made by Chile during the past year and warmly commended the authorities on the major achievements of macroeconomic adjustment and structural reform recorded since 1985. They noted that since 1985 real GDP growth had averaged more than 5 percent a year, the rate of inflation had been halved, and unemployment had been reduced sharply, while the current account deficit and the level of external debt had declined. A major surge in domestic savings and a large increase in investment had resulted from the consistent application of appropriate fiscal, monetary, exchange rate, and structural policies. More recently, Chile also had benefited from high world copper prices, and Directors endorsed the precautionary measures of the authorities to sterilize a significant portion of the windfall gains through the Copper Stabilization Fund and debt buy-backs.

Directors commended the authorities on their commitment to continue with their basic economic strategy. In the present circumstances, Directors saw signs of overheating of the economy, and they were concerned about the medium-term prospects for the external position. Therefore, they considered that primary emphasis needed to be placed on moderating the growth of domestic demand, and they urged the authorities to adopt a more ambitious inflation target. While noting the measures taken during 1989 to tighten credit and reverse the real appreciation of the peso, they encouraged the authorities to be ready to take additional action in the coming months should the unsustainable rapid growth of imports and high rates of price increase continue.

In particular, Directors encouraged the authorities to stand ready to take further action on a timely basis to restrain credit. At the same time, they cautioned that credit policy should be supported by fiscal policy to avoid overdependence on high interest rates and the attendant negative impact on private investment. Some Directors believed that the circumstances required a stronger reliance on fiscal policy, and that active consideration should be given to measures to strengthen fiscal revenues, not only to dampen demand pressures but also to lay a stronger foundation for financing essential government expenditures in the future. Directors also commented favorably on Chile's privatization program and financial sector reforms.

Directors observed that exchange rate policy should remain focused on strengthening the balance of payments position for the longer term and boosting export diversification by maintaining a satisfactory degree of competitiveness. For this reason, they welcomed the steps taken to reverse the earlier modest appreciation of the peso. Directors recommended that the authorities take actions conducive to the elimination of the spread between the rates in the official and parallel exchange markets, and to unify the exchange system.

Directors continued to be impressed with the progress Chile had made in the last few years in reducing its external debt, including through a wide range of market-oriented debt conversion mechanisms. A second direct buy-back of debt to commercial banks was expected to be completed shortly if appropriate terms could be obtained, which fitted into the debt strategy envisaged under the previous extended arrangement. Directors noted also the key role of Chile's open exchange and trade system in promoting sustained economic expansion and encouraging domestic and foreign investment. Nevertheless, Chile's balance of payments remained highly vulnerable to fluctuations in copper prices, international interest rates, and oil prices, and significant financing requirements might emerge after 1990. The medium-term outlook thus reinforced the need for Chilean economic policies, at the present juncture, to lean toward the side of caution.

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

The Executive Board then took the following decisions:

Stand-by Arrangement

1. The Government of Chile has requested a stand-by arrangement for the 12-month period beginning November 8, 1989 in an amount equivalent to SDR 64 million.

2. The Fund approves the stand-by arrangement set forth in EBS/89/193, Supplement 1.

3. The Fund waives the limitation in Article V, Section 3(b)(iii).

Decision No. 9278-(89/142), adopted
November 8, 1989

Exchange System

Chile maintains multiple currency practices relating to the dual exchange market system, and exchange restrictions relating to import payment deferment requirements, as described in EBS/89/193, that are subject to approval under Article VIII, Sections 2(a) and 3. The Fund welcomes the intention of the authorities to eliminate these measures. Accordingly, the Fund grants approval of them until October 31, 1990 or the conclusion of the 1990 Article IV consultation, whichever is earlier.

Decision No. 9279-(89/142), adopted
November 8, 1989

2. GHANA - 1989 ARTICLE IV CONSULTATION; AND ENHANCED STRUCTURAL ADJUSTMENT FACILITY - REQUEST FOR SECOND ANNUAL ARRANGEMENT

The Executive Directors considered the staff report for the 1989 Article IV consultation with Ghana and the member's request for the second annual arrangement under the enhanced structural adjustment facility (EBS/89/195, 10/13/89). They had before them a background paper on recent economic developments in Ghana (SM/89/216, 10/27/89) and a policy framework paper covering the period 1989-92 (EBD/89/291, 9/21/89). They also had before them a statement by the Acting Managing Director, which read as follows:

There follows for the information of the Executive Directors the text of a memorandum that I have received from the President of the World Bank to serve as the basis for my statement on the matter to the Board. This text summarizes the main points covered by the Executive Directors of the Bank and IDA in their October 10, 1989 discussion in Committee of the Whole of a paper entitled "Ghana: Policy Framework Paper, 1989-92."

1. Directors commended the Ghanaian authorities on the gains that had been made to date under the Economic Recovery Program and their unwavering commitment to reform. Expressing support for the program's continuation as outlined in the policy framework paper, they welcomed Ghana's sustained effort in many areas, including structural reforms of financial and trade

policy, civil service reform, and macroeconomic policy implementation. The achievement of GDP growth of over 5 percent a year since 1984 was cited as an example of adjustment with growth. Directors noted that continued progress was dependent on implementation of the measures summarized in the paper, adequate external assistance, and a revival of private investment.

2. Directors expressed concern about the operation of the foreign exchange market. They noted that the spread between the auction rate and the rate prevailing at the foreign exchange bureaus appeared to be excessive and failed to provide the right price signals to importers and exporters. In this connection, Directors noted the importance of the planned unification of the foreign exchange markets, which would improve both private sector confidence and incentives for export diversification.

3. Some Directors cautioned that the program laid out in the policy framework paper might strain the administrative capacity of the Government. It was noted, however, that in many instances the program represented a continuation of reforms initiated earlier and that the Bank had provided support through technical assistance. Directors welcomed the Government's efforts to attract and motivate higher-level staff in the civil service and the progress that had been made in this area.

4. Directors also welcomed the reduction in the rate of inflation that had occurred during the last 12 months. But they were concerned that the rate still remained relatively high and threatened the program's supply-side response. It was noted that the projected expansion in agricultural production, accompanied by continued fiscal and monetary discipline, was expected to moderate the increase in prices over the near term. Directors stressed the importance of positive real interest rates in reducing inflationary pressures and speculative tendencies and increasing private sector savings.

5. Directors stressed the importance of accelerating reforms in the financial sector. They noted that progress in this area was central to the success of the overall program. They welcomed the authorities' plans to implement a more market-oriented monetary policy. They pointed to changes in the banking laws and more effective bank supervision and stressed that the financial restructuring of the banks should commence as soon as possible.

6. Directors noted that progress on divesting state enterprises had been slower than planned. They welcomed the Government's commitment to accelerating the pace of implementation of state enterprise reform. More generally, some Directors

were concerned about weak implementation capacity and welcomed the Government's efforts to address problems in this area.

7. Directors observed that the achievement of the growth target of at least 5 percent a year depended on a strong private investment response to the new policy environment. They thought the Government could best encourage the private sector by consistently implementing appropriate macroeconomic policies. They welcomed other measures which the Government planned to take to stimulate private investment, including the streamlining of investment approval procedures and revisions to the Investment Code. They stressed that progress on both financial sector and state enterprise reforms would be critical ingredients in the growth of private investment. Directors also stressed the importance of removing constraints to growth in agriculture and industry.

8. Some Directors commented that the program of actions to mitigate the social cost of adjustment (PAMSCAD) represented a relatively modest effort, did not appear to be fully integrated with the adjustment program, and was characterized by a slow pace of implementation. In this connection, Directors welcomed the measures that the Government was taking to strengthen PAMSCAD and to speed up project execution.

9. Directors urged donors to support the program outlined in the policy framework paper and stressed the importance of donor coordination.

The Deputy Director of the African Department made the following statement:

Since the issuance of the staff report, there have been a number of developments which the staff would like to bring to the attention of Executive Directors. These developments, described in a recent communication to the Fund from the Secretary for Finance and Economic Planning, relate to the banking sector, state enterprise, and exchange reforms envisaged in Ghana's program of structural and financial adjustment.

In the area of banking sector reform, after consultation with a World Bank review mission, the Ghanaian authorities have decided to broaden the scope of the bank restructuring program by adopting a "frontal" approach involving a simultaneous preparation of restructuring plans for all the banks facing difficulties, instead of the original "selective" approach focused on two to three banks at a time. The authorities recognize that this expanded approach would increase the demands upon the capacities of both the foreign consultants and the local implementation management team (Technical Committee), but

they believe that it will ultimately save about one third of the time initially planned for the bank restructuring program. In this context, draft restructuring plans for the Social Security Bank (SSB) were submitted by the consultants to the Technical Committee in mid-October 1989; similar plans are expected to be prepared for the Ghana Commercial Bank (GCB) and the National Investment Bank (NIB) by end-November, and for the National Savings and Credit Bank (NSCB) or the Bank for Housing and Construction (BHC) by end-December 1989.

The authorities have also been in contact with several foreign financial institutions with a view to obtaining management and institutional support for the distressed local banks. A number of foreign institutions have already expressed interest, and representatives of the Housing Development Finance Company of India and the Private Development Corporation of the Philippines have recently visited Ghana to assess the management needs of the BHC and the NIB, respectively. Representatives of other foreign institutions are expected to visit Ghana before the end of 1989 to review the needs of the GCB, NSCB, and SSB. The Government intends to conclude assistance arrangements as quickly as possible, in the expectation that at least three external management teams with line authority will be in place by year-end. Meanwhile, the composition of the executive boards and the senior management structures of the affected banks are currently under review with the aim of appointing, where appropriate, suitable local directors and managers.

With regard to the divestiture program, an agreement for the sale of the Government's interest in a sixth joint venture-- Neoplan Ghana, Limited--which was expected to be concluded by end-August 1989, has not yet been reached. The negotiations with the joint partner ran into unexpected difficulties that could not be resolved, and both sides are currently re-examining their positions.

Finally, in the area of exchange reform, the establishment of a wholesale market for foreign exchange in the form of special auctions to authorized dealers, envisaged for early October 1989, has been delayed. The delay has been caused by a number of unforeseen factors, including domestic administrative constraints and the authorities' decision to accelerate the bank restructuring program. However, the guidelines for the conduct of the special auctions have been prepared, and the Secretary for Finance and Economic Planning has informed the Fund of his expectation that the special auctions will be instituted in November.

Mr. Ghasimi made the following statement:

My Ghanaian authorities welcome this opportunity to review and assess once again with the Fund the progress achieved under the program of structural and financial reforms. They continue to find the regular discussions with the staff, as well as the recommendations by Directors, very constructive and helpful. Since the Board had the opportunity to review economic developments in Ghana during the first annual arrangement under the enhanced structural adjustment facility last May, I propose to limit this statement to highlighting some of the main results achieved during the period 1988-89 before addressing the remaining considerable challenges facing the authorities in the period ahead.

With respect to economic and financial developments, the main macroeconomic objectives of the program were achieved in 1988. In this connection, it is worth mentioning that real GDP increased by 6.2 percent in 1988, compared with a rate of 4.8 percent in 1987; inflation was reduced from 34 percent in 1987 to 27 percent in 1988; the overall fiscal deficit was kept within the program target at 2.6 percent of GDP, and the authorities were able to reduce considerably their indebtedness vis-à-vis the banking system; and the balance of payments recorded a surplus for the second consecutive year despite the deteriorating external environment reflected in a continued worsening of the terms of trade.

On the question of structural adjustment, although delays in implementing some of the anticipated measures were unavoidable, the overall implementation of policy reforms proceeded along the timetable specified in the program. The measures implemented in 1988 include the following:

- elimination of controls on the sectoral distribution of credits, full liberalization of interest rates, and strengthening of the regulatory framework of the financial sector by establishing higher capital adequacy ratios, tightening risk exposure limits, and reinforcing accounting and auditing standards;

- pursuit of the reform of the exchange system with the establishment of foreign exchange bureaus;

- initiation of the state enterprise reform program, although at a pace slower than planned;

- further liberalization of the trade system; and

- increases in producer prices and improvement of the financial position of the Cocoa Board.

These measures were complemented by the pursuit of tight fiscal and credit policies, as well as by prudent external debt management aimed at improving the maturity profile of Ghana's external debt.

Notwithstanding the substantial improvement in the country's external and internal financial position, as well as the gains realized in per capita income, the economy of Ghana is still fragile and vulnerable to external factors, particularly in view of the depressed outlook for the world cocoa market. It is against this background that the authorities have updated and extended their adjustment program to cover the period 1989-92. The revised medium-term strategy encompasses the objectives of achieving an average annual real GDP growth of at least 5 percent, reducing further the rate of inflation to 5 percent in 1992, generating an overall balance of payments surplus that would accommodate the elimination of the remaining external arrears, and slightly increasing gross official reserves.

The macroeconomic objectives for the period of the second annual arrangement under the enhanced structural adjustment facility are as follows: achievement of a rate of growth of real GDP of 6 percent in 1989 and 4.8 percent in 1990; reduction of the rate of inflation to 15 percent by the end of 1989 and to 10 percent by the end of 1990; and realization of an overall balance of payments surplus of \$110 million in 1989 and \$90 million in 1990.

These macroeconomic objectives will be sustained by perseverance in the implementation of the necessary structural reforms. In this connection, the authorities will continue their policies of liberalizing the exchange and trade systems, as well as restructuring the financial sector and strengthening the mobilization of resources. They will also further streamline the operations of the Cocoa Board and enhance the efficiency of the civil service. Particular emphasis will be devoted by the authorities to accelerating the pace of reform and adjustment in three key areas, namely, inflation, the foreign exchange system, and the state enterprise sector.

First, although the authorities are encouraged by the deceleration in inflation registered during the first half of 1989, they consider that the level of inflation remains high. They are resolute in their efforts to combine a balanced incomes policy with effective control of monetary expansion, so as to realize a considerable reduction in the rate of inflation in 1989. In this regard, and drawing on the recommendations of a recent Fund technical assistance mission, the Bank of Ghana will implement a new system of monetary control and liquidity management based on the use of market-oriented instruments and designed to absorb excess reserves of commercial banks. This

change in monetary policy will assist the authorities in restoring and maintaining positive real interest rates which, in turn, will be crucial in combating inflationary pressures.

Second, an important element of the program for 1990 will be the unification of the foreign exchange markets. This objective will be accomplished in a phased manner through the gradual reduction of the spread between the foreign exchange bureau rate and the auction rate. This dual exchange arrangement will be replaced in the second quarter of 1990 by an extended interbank system through which the exchange rate of the cedi will be freely determined by the supply and demand for foreign exchange.

Third, with regard to state enterprise reform, the authorities' efforts are definitely gaining momentum and will be accelerated. Already, 15 of the 32 enterprises originally selected have been divested and 4 additional enterprises will be divested by the end of 1989: the remaining selected enterprises will be divested by the end of 1990. Furthermore, the authorities have broadened their divestiture program and liquidated 4 enterprises, and they intend to liquidate 7 more enterprises not included in the original program by the end of 1989.

Concomitant with the pursuit of the adjustment program, and in order to alleviate the adverse impact on the poorest and most vulnerable groups, the authorities began implementation in early 1988 of the program of actions to mitigate the social cost of adjustment (PAMSCAD). In this respect, despite the delays in the disbursement of donors' financial support, as well as domestic administrative constraints, the authorities were able to launch several programs designed to facilitate resettlement of public sector employees, to create labor-intensive public works, and to introduce several community projects. While the authorities are encouraged by donors' support, they believe that the acceleration of disbursements is essential if timely implementation of PAMSCAD is to be sustained.

My Ghanaian authorities would like to reaffirm their clear and uninterrupted commitment to faithfully pursue the adjustment program. They hope that their sincere efforts will continue to be paralleled by appropriate financial support on highly concessional terms. They believe that such support is crucial in view of the prospects of depressed world market conditions for cocoa, as well as the country's heavy debt service burden.

Finally, my Ghanaian authorities wish to acknowledge the Fund's technical assistance in various fields, particularly regarding instruments of monetary control and capital income tax.

Extending his remarks, Mr. Ghasimi, commenting on the staff statement, said that his authorities regretted that unavoidable delays had occurred in the implementation of some of the measures envisaged in the program, and he wished to reassure Executive Directors that those measures would be implemented as soon as possible.

Draft restructuring plans for one bank--the Social Security Bank--had been submitted by the consultants to the Technical Committee, and similar plans would be prepared for the other two banks, Mr. Ghasimi continued. The first submission had been made in mid-October and submissions for the two remaining banks would be prepared by the end of November. Divestiture of Neoplan Ghana, Limited was delayed because the parties concerned had unfortunately been unable to reach an agreement. One of the issues had been a valuation of the assets of the company, which potential purchasers would pay for government shares. The parties concerned had been asked to review their positions and to start renegotiations as soon as possible.

The delay in the establishment of the wholesale foreign exchange market had been of an administrative nature, and at present the necessary guidelines were being discussed with top-level policymakers, and members of the Council were being briefed, Mr. Ghasimi explained. As soon as those briefings were completed, his authorities were determined to initiate the wholesale market promptly.

Mr. Ismael made the following statement:

I commend the Ghanaian authorities for their successful efforts in implementing the structural adjustment program, supported by structural adjustment and enhanced structural adjustment arrangements with the Fund. The country's basic macroeconomic objectives under the Economic Recovery Program are largely being realized. Thus, Ghana has become one of the examples of developing countries where the positive results of implementing an adjustment program can be cited. The country's successful structural adjustment efforts merit our continued support, and I can endorse the proposed decisions.

I am in broad agreement with the staff's analysis and appraisal of the Ghanaian economy. The progressive liberalization of the Ghanaian economy has increased the incentives in favor of directly productive activities and exports, as well as saving and investment. I am pleased to note that the overall implementation of most of the policy reforms has proceeded along the timetable specified in the program.

Nevertheless, Ghana still faces major structural and financial problems, which can only be resolved through intensification of its reform efforts over the medium term. I concur with the staff that the growth of output continues to be constrained by inadequate domestic saving and investment; the rate of inflation, although reduced, remains fairly high;

implementation of the state enterprise and financial sector reforms has been slow; and the sharp weakening of world cocoa prices has made Ghana's external position vulnerable.

Against this background, the authorities will need to monitor developments closely and take appropriate actions in a number of key areas. First, it is essential that strong efforts should be made to raise the level of domestic savings. For this purpose, actions should be initiated to achieve financial sector reform and encourage private sector activity. Second, in view of the slower progress in reducing inflation, measures should be taken to achieve a positive real interest rate and to control monetary expansion through the use of market-oriented instruments. Third, the reforms relating to public enterprises should be accelerated and completed within a specified time frame. Fourth, the declining world cocoa price has made Ghana's external payments position vulnerable; there is an immediate need to diversify the economy. The unification of foreign exchange markets would improve both private sector confidence and incentives for export diversification.

The medium-term program as reflected in the policy framework paper has aptly emphasized the measures to be initiated for adjustment in the Ghanaian economy. The statement by Mr. Ghasimi reflects the commitment of the authorities to adopt these measures.

Ghana has made positive strides in its structural adjustment efforts in recent years and, therefore, deserves further financial support from the Fund in the country's endeavor to achieve economic recovery. I am confident that the Ghanaian authorities will persevere with the adjustment program under the second annual arrangement.

Mr. Hogeweg made the following statement:

The staff report provides encouraging reading on Ghana's highly commendable adjustment effort, which has been pursued consistently since 1983. Ghana is now very close to reaping the fruits in some crucial policy areas for which the groundwork had been laid in previous years. I refer, for instance, to the transition to truly market-oriented monetary management and to the unification of the exchange markets. Both are scheduled to take place within this program period.

Of course, in Ghana's case, adjustment is far from finished. Indeed, in any country the need to adjust to a changing economic environment and at the same time to follow prudent financial policies is a never-ending process, but many Fund members could learn from Ghana's example.

Two quite separate issues have been at play in Ghana's adjustment effort in recent years. First, it is necessary to remove impediments to the functioning of the economy, such as incorrect price signals, allocative inefficiencies, and macro-economic imbalances. The second issue is the need to adjust to adverse terms of trade developments, especially falling cocoa prices. The report does not separate the two, but I would appreciate staff comments on these issues.

It is my impression that in the first area--dealing with structural impediments and macroeconomic imbalances--Ghana has been very successful. Even in actual circumstances of worsening terms of trade, Ghana has achieved high growth rates, a sharp deceleration of inflation, and an improved external position. These successes might have been even more striking in the absence of adverse terms of trade developments. Perhaps in that case the staff would not have had to state that Ghana's reform program is now at a critical phase, and perhaps Ghana's dependence on substantial external, highly concessional assistance would have been less.

Of course, there are important interrelationships between the two issues I have analytically tried to separate, if only because adjustment to the terms of trade is inescapable, although at the same time it is facilitated by structural reforms. But I would like to highlight on the one hand that Ghana's programs have addressed much more than the adjustment to the terms of trade and, on the other hand, that the terms of trade developments have regrettably delayed the manifestation of the full benefits of adjustment.

The staff mentions that the present program has been designed to smooth adjustment to the decline in cocoa prices by rephrasing the desired further reduction in the inflation rate and by scaling down the originally targeted buildup of gross official reserves. Of these, I especially regret the rephrasing of inflation targets. It is important to recognize that a noninflationary environment in itself is of crucial importance for growth, and particularly for private sector activity and diversification of the production base. I support the proposed decisions.

Mr. Enoch made the following statement:

Despite a further significant deterioration in its terms of trade, Ghana's economy has, over the past year, continued to perform strongly under the authorities' Economic Recovery Program. In 1988, output grew briskly for the fifth year in succession; and most of the Program's macroeconomic objectives were comfortably achieved or even exceeded. In addition,

significant progress has been made in a number of key structural areas. Most notably, interest rates were completely liberalized; sectoral credit controls have been eliminated; a revised Banking Act has been put in place; and there have been further useful reforms of the exchange and trade system.

Nevertheless, while considerable progress has been made over recent years, deep-seated rigidities continue to hamper economic growth, and Ghana's medium-term prospects are still constrained by the country's very narrow export base. These underlying problems are both a cause and a symptom of perhaps the central difficulty facing the Ghanaian economy, namely, the weakness of the indigenous private sector. The steady progress made since 1983 in correcting macroeconomic imbalances and improving the growth performance of the economy has largely resulted from a sustained increase in public sector saving. Thus, while improved incentives have been put in place for the private sector, its response has so far been rather weak.

To some extent, this reflects the sequencing of the authorities' adjustment effort. For example, the restructuring of the financial sector has been left until a relatively late stage in the adjustment process. This delay has clearly inhibited the growth in private saving and investment. To some extent, too, the absence of a strong private sector response can be attributed to the authorities' difficulties in pressing ahead as expeditiously as they had intended with certain key reforms. Problems have arisen, for example, in the authorities' divestiture program, which has become bogged down over the past few years in a series of political, technical, and legal difficulties. In this connection, the delay reported by the staff in the divestiture of a sixth joint venture is disappointing, and it is to be hoped that the remaining problems can be quickly resolved. Finally, the continuing weakness of Ghana's private sector owes something to the fact that agents have not always responded as vigorously as the authorities had expected to those reforms that were put in place. This, in turn, perhaps indicates that private sector behavior in any country depends as much on confidence and future expectations as it does on the existing framework of policy.

Against this general background, the program to be supported by the proposed second annual arrangement seems well directed at the main weaknesses in Ghana's economy. At its center lie two fundamental reforms designed to eliminate current distortions and to improve the incentive structure in the economy--the proposed unification of the exchange rates and the acceleration of financial sector reform.

On the exchange rate, it is clear that the current two-tiered arrangement has not worked well. A large differential

has persisted between the auction and bureau rates, bringing with it an implicit series of taxes and subsidies on international transactions. The staff argues that the spread between the two rates is a reflection of the current regulatory framework. However, I am not sure that this can provide a full explanation; it seems rather that the auction rate has been held below market-clearing levels for some time.

It is important that the staff get to the bottom of why the current system has failed, since the proposed new arrangements have certain elements in common with the existing structure. In particular, the Bank of Ghana will continue to supply foreign exchange to the market by means of regular weekly auctions, open only to "authorized" dealers. In these circumstances, it will be critical to ensure that the wholesale auction rate is, in practice, freely determined by supply and demand. If, once again, the auction rate were held up, a differential would quickly re-emerge, in turn leading to speculation and capital flight as well as to a loss of competitiveness. In this context, I was interested to see Chart 5 in the staff report, which appears to suggest that Ghana's real and nominal effective exchange rates have remained more or less constant over the past three years. I also note from paragraph 11 of the authorities' memorandum on Ghana's economic and financial policies that the Bank of Ghana will, under the new system, supply resources to the market after satisfying the Government's demand for imports as well as its needs for debt service payments and reserves accumulation. I would be interested to hear how wide a definition of government imports is intended to receive this prior allocation of foreign exchange. Does it, for example, include public enterprise imports? And finally, on this subject, I note the recent delay in introducing the wholesale auction system and hope that this will be speedily resolved.

Alongside exchange rate unification, a further key element in the authorities' program is the planned financial and monetary sector reform. Clearly, the first priority will be to mop up the large existing excess reserves of the commercial banks which have thwarted attempts to establish positive real deposit rates over recent years. I note that the present intention is to sterilize at least $\text{G} 6$ billion over the next few months. While this would represent a worthwhile operation, I wonder whether it will be sufficient to permit a reduction in the current level of reserve requirements, which has contributed to the large spread between deposit and lending rates.

The authorities' plan to move toward a greater reliance on market-based instruments of monetary control is welcome and could become something of a test case for other countries in Africa. However, there are considerable risks involved in making this transition, particularly given the oligopolistic

nature of the banking sector and the absence of competition from overseas. Against this background, it will be very important for the authorities to move quickly to extend their reform plans beyond the three major banks so far singled out for restructuring. In this connection, I note the change in approach to restructuring reported today by the staff. If indeed this does lead ultimately to the saving of about one third of the time initially planned for the bank restructuring program, this is to be welcomed.

The early establishment of positive real interest rates and a market-based system of credit allocation, through the development of a sound and responsive banking sector, should create the conditions for an increase in private sector saving and investment. However, financial sector reform and exchange rate unification will need to be accompanied by continuing efforts to strengthen the public finances and by an acceleration in the authorities' long-delayed enterprise divestiture program. In this context, I would particularly emphasize the importance that should be attached to increasing the uniformity of the corporate tax and tariff structures. This would not only reduce distortions, it would also improve the investment climate by giving a greater sense of permanence and stability to the business environment. Nor should the divestiture program's success be judged primarily in terms of its impact on the budget. Its central aim is to improve the efficiency and the dynamism of the state enterprise sector--where practical, by transferring ownership and control to the private sector, and where not, by creating the appropriate incentives structure for public sector managers.

I have two concerns, one related to the program and the other to the staff report. My first concern is that the program--perhaps inevitably--has little to offer in the way of specific measures to promote export diversification. Accordingly, despite the ambitious projected growth rate of nontraditional exports, by the end of the program period Ghana is likely to be as dependent as ever on cocoa and gold export earnings. I would be interested to know whether the staff is continuing to encourage an expansion of cocoa production in Ghana in the face of the current supply overhang in world markets. I note, for example, that cocoa exports are projected to rise by nearly 40 percent over the program period; that the authorities have maintained the incentive to produce cocoa by raising the producer price for the 1989/90 season; and that the staff is expecting a major expansion in private sector investment in the cocoa sector. In addition, I would be interested to have the staff's assessment of how the cut in producer prices in Côte d'Ivoire is likely to affect official Ghanaian cocoa exports.

Second, on the presentation of the program in the staff report, this chair has emphasized on previous occasions the need to increase the transparency of the documentation accompanying requests for enhanced structural adjustment arrangements. In this case, I would have found it particularly useful to have seen the new medium-term projections set alongside the previous program assumptions. Such a presentation would have made it clearer to the Board that the authorities' response to the further deterioration in the external environment has been a balanced one, combining further adjustment, particularly on the fiscal side, with--in the staff's words--a "smoothing" of the external adjustment path and a more leisurely reduction in the rate of inflation.

While some reduction in the pace of external adjustment is perhaps inevitable in the face of a major terms of trade shock, it is less clear why the staff has built a softer inflation target into the program. Other things being equal, a sharp fall in export prices might have led to a reduction in inflationary pressure. With the steps being taken to mop up excess liquidity in the banking sector, and despite the short-term boost to food prices resulting from the major flooding in Ghana, I hope that it might be possible to bring inflation down more rapidly than the staff is now projecting.

With these comments and questions, I fully support the proposed program. It contains a number of far-reaching elements which, I have every confidence, the authorities will implement with determination and success to maintain the country's reputation as something of an economic model in sub-Saharan Africa.

Mr. Landau made the following statement:

The background paper clearly shows the need to place more emphasis on structural reforms, especially through the restructuring of the banking sector and public enterprise divestiture. However, despite the deterioration in the terms of trade, the buoyancy of the economy and the early results of diversification have led to a major improvement in real per capita income and a significant turnaround in the external position in the first year of the enhanced structural adjustment arrangement program. Performance during the period 1988-89 has been characterized by the rigorous implementation of tight fiscal and monetary policies together with prudent debt management. Progress is also attributable to the international financial community's strong support and the authorities' firm commitment to implementing the different measures agreed under this program. Therefore, the authorities must maintain the momentum of adjustment and avoid

further slippages in order to offset some of the concerns expressed by previous speakers about the successful outcome of this program.

As regards macroeconomic policies, there is certainly a need for continued control over inflation and a better mobilization of domestic saving and investment in the public and private sectors. In this respect, pursuit of the growth-oriented fiscal strategy as indicated in the program is welcome. The authorities should now focus on rationalizing the structure of the tax system, and with respect to the expenditure side--as intended--proceed with a selective increase in public service salaries in order to attract qualified people.

Monetary and credit policies are, in contrast, of paramount importance in maintaining the pace of adjustment. The new system of monetary controls elaborated with the technical assistance of the Fund should be rigorously implemented in a timely manner in accordance with the three steps described in the report. In the context of inflationary pressures, controlling monetary expansion should be given the utmost attention, with due consideration, nevertheless, to ensuring sufficient credit availability to meet the needs of the private sector.

Concerning the external sector, the persistence of a wide spread between the official and the parallel exchange rates remains worrisome. Taking into account the delay in establishing a wholesale market for foreign exchange, we have some reservations as to whether the target date can be reached. More comments from the staff on the "unforeseen factors" that caused this delay would be welcome. We are also wondering whether the projected unification of the exchange markets for mid-1990 is not overly optimistic.

Decisive action needs to be taken at this stage to avoid a loss in confidence in the system. The present situation precludes the possibility of providing positive signals to importers and exporters and may be considered an impediment to the diversification of the economy.

As regards the balance of payments outcome, there is no room for complacency in light of the prospects for Ghana's traditional exports. Thus, a close monitoring of current account developments, coupled with the possibility of undertaking additional measures as needed, remains important. Moreover, the authorities should seize the opportunity of existing and programmed surpluses to reduce external payments arrears.

The crucial impact of structural reforms, on the momentum of the program cannot be overemphasized. I fully support the sectoral policies described in the updated policy framework

paper. However, we urge the authorities, as an essential and decisive task, to focus on accelerating the public sector's comprehensive reform, including the public enterprise divestiture program. Further improvement in trade and price liberalization in line with the increased participation of the private sector is also critical. The less than favorable response of the private sector is indeed disappointing. Exchange rate policy undoubtedly favors traditional exports, but it is somewhat more difficult to assess its impact on the industrial and services sectors. We wonder whether, in this respect, monetary instability has not impeded, rather than helped, adjustment in the private sector. We would appreciate some comments from the staff on this matter.

As to banking sector reforms, we note the authorities' recent decision to adopt a "frontal" approach instead of the previous "selective" approach. We would appreciate a preliminary assessment from the staff of the consequences of this decision on implementing the program.

We consider that, at this stage, this program contains more uncertainties than before. We share the staff's analysis that the authorities are facing a critical phase and that more attention should be paid to the three key areas reported by the staff. With these considerations in mind, we can support the proposed decisions.

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

APPROVED: June 29, 1990

JOSEPH W. LANG, JR.
Acting Secretary

