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0404

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 89/121

10:00 a.m., September 11, 1989

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	C. Enoch
	Shao Z., Temporary
	C. S. Warner
J. de Groote	J. Prader
	L. B. Monyake
	S.-W. Kwon
	P. O. Montórfano, Temporary
	M. A. Fernández Ordóñez
	N. Kyriazidis
M. Finaish	A. M. Othman
	M. Pétursson
M. R. Ghasimi	
	B. Goos
	E. Kiriwat
	L. E. N. Fernando
	L. M. Piantini
	D. McCormack
Mawakani Samba	
	I. A. Al-Assaf
	M. Al-Jasser, Temporary
	J.-L. Menda, Temporary
	G. Serre, Temporary
	G. P. J. Hogeweg
	S. Yoshikuni

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

Also Present
IBRD: B. Sahin, Alternate Executive Director for Turkey; S. Dhar, Europe, Middle East and North Africa Regional Office; J. Salop, Africa Regional Office. African Department: M. Touré, Counsellor and Director; E. A. Calamitsis, Deputy Director; G. E. Gondwe, Deputy Director; W. Bier, J. M. Jiménez, L. F. Weniger. European Department: M. Russo, Director; M. Guitián, Deputy Director; L. Hansen, J. F. van Houten. Exchange and Trade Relations Department: J. T. Boorman, Deputy Director; T. Leddy, Deputy Director; A. Basu, J. J. Clark, S. Eken, H. G. J. Trines. Fiscal Affairs Department: J.-Y. Chu, H. R. Lorie. Legal Department: R. H. Munzberg, Deputy General Counsel; T. M. C. Asser, J. W. Head. Middle Eastern Department: S. Thayanithy. Treasurer's Department: M. N. Bhuiyan, D. Gupta, F. J. Lin, A. F. Moustapha, T. M. Tran, T. Voulgaris. Advisors to Executive Directors: J. O. Aderibigbe, M. B. Chatah, G. García, R. Wenzel. Assistants to Executive Directors: J. R. N. Almeida,, H. S. Binay, G. Bindley-Taylor, B. A. Christiansen, J.-F. Cirelli, H. E. Codrington, S. K. Fayyad, J. Gold, S. Gurumurthi, M. A. Hammoudi, J. Heywood, L. Hubloue, K. Ichikawa, C. J. Jarvis, M. E. F. Jones, K.-H. Kleine, K. Kpetigo, C. Y. Legg, W. K. Parmena, A. Rieffel, J.-P. Schoder, C. Sel, M. J. Shaffrey.

1. DESIGNATION PLAN AND OPERATIONAL BUDGET FOR SEPTEMBER-NOVEMBER 1989

The Executive Directors considered the proposed designation plan (EBS/89/174, 8/29/89) and operational budget (EBS/89/175, 8/29/89) for September-November 1989.

Mr. Fernández Ordóñez said that he was pleased that a staff paper on the principles for calculating currency amounts under the operational budget was nearly ready to be distributed. Executive Directors should have sufficient time to study that important issue prior to discussing it toward the end of 1989.

The Executive Board then approved the following decisions:

SDR Department - Designation Plan for September-November 1989

The Executive Board approves the designation plan for the quarterly period beginning September 11, 1989, as set out in EBS/89/174 (8/29/89).

Decision No. 9245-(89/121) S, adopted
September 11, 1989

Operational Budget for September-November 1989

The Executive Board approves the list of members considered sufficiently strong as set out in EBS/89/175, page 2, footnote 1 and the operational budget for the quarterly period beginning September 11, 1989, as set out in EBS/89/175 (8/29/89).

Decision No. 9246-(89/121), adopted
September 11, 1989

2. TURKEY - 1989 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1989 Article IV consultation with Turkey (SM/89/167, 8/10/89; and Sup. 1, 9/7/89). They also had before them a background paper on recent economic developments in Turkey (SM/89/184, 8/25/89).

Mr. de Groote made the following statement:

The policies successfully implemented by Turkey since the beginning of the 1980s have clearly set this country apart from the group of debt problem countries. While giving the highest priority to scrupulous service of the debt, Turkey has continuously reshaped the structure of the economy and expanded the liberalization of the trade and payments regime with the rest of the world. An increase in the share of foreign trade in GDP from 6 percent in 1980 to 16 percent in 1988 shows the progress in integrating the country into world markets and in establishing a sound basis for relations with external sources of financing. The Government's present debt strategy is based on the decision that borrowing is to be limited to the principal coming due; and additional constraint will thereby be imposed on the financial policies of the Government. Turkey's efforts have been appreciated by the markets: the spread on the last issues of medium-term bonds on the Euro-dollar markets is less than half of what it was in 1987 and the maturity has increased from five to seven years.

Confidence in the direction of the ongoing changes is also reflected in the sharp increase, since the beginning of this year, in workers' remittances and in capital inflows by residents. The public's trust in the maintenance of an open trade and payments system has recently been strengthened by the decision, taken on August 11 (Decree No. 32), to fully liberalize all exchange transactions and to eliminate or reduce to a low level the import duties in order to harmonize them with EEC standards. As another manifestation of confidence, direct investment tripled in value in 1988 and innovations in the form of "build-operate-transfer" (BOT) schemes are expected to attract additional foreign investments in the coming months. The privatization process also has provided interesting opportunities for foreign capital. Several large factories have recently been sold to foreign interests, and negotiations are under way for several similar ventures. The Turkish Fund, organized by the IFC to promote foreign equity participation in the Istanbul Stock Exchange, will start to operate in the fall, and preliminary applications have been made to MIGA. A project to introduce state economic enterprises on the Istanbul Stock Exchange is in the process of implementation. The prospects for next year also have to take into account the strong and steady upward trend in government revenue, which undoubtedly will influence the public's expectations about inflation. The envisaged further expansion of the taxable basis, through more effective methods for tax collection, will reinforce the public's view that the risk of an increase in tax rates is vanishing and that the day is approaching when a reduction in these rates can be implemented.

My authorities know that the country can sustain the balance of payments improvement only with a better performance on the inflation front. In 1988, public investment came almost to a standstill, and the expansion rate of GNP declined; the public sector borrowing requirement dropped from 9 percent in 1987 to 6.5 percent in 1988, and it will go further down in 1989. The most recent figures on the consolidated budget validate this forecast. The staff's estimate of a 16 percent decline in the central government deficit for the first seven months of this year, on page 2 of SM/89/167, Supplement 1, thus corresponds to a reduction of 50 percent in real terms. Nevertheless, the slowdown in domestic demand and the fiscal correction did not have the expected impact on the general price level. Part of the recorded inflation in 1989 reflects increases in the rates of indirect taxes and corrective price adjustment of goods and services sold by state economic enterprises, which previously had taken place in the second half of each year. Turkey also experienced in 1989 a severe drought, which led to a decline by 10 percent in agricultural production. Agricultural commodities weigh heavily in the consumer price index. The remaining rigidities in the structure of the financial sector and in the production of nontradables placed additional pressure on prices.

My authorities firmly intend to give a high priority to the fight against inflation. They expect a substantial effect from the measures taken in August: unrestricted access of the private sector to the international financial markets and the increase of foreign supplies in previously protected sectors will be supported by strict control of internal liquidity creation. Recent information on prices indicates a marked decline in inflationary pressures, while the threat of increased competition from abroad and the possibility of importing industrial inputs under more favorable conditions are already leading to a reduction of profit margins and a gradual stabilization of inflationary expectations.

In order to continue to counteract those expectations with sufficient supplies, the Central Bank needs to dispose of an appropriate level of reserves in the coming years. At present, Central Bank net reserves are at the comfortable level of $3.7 billion, corresponding to almost three months of imports, and this excludes available credit lines, which amount to about $2 billion. My authorities' forecast for the evolution of the balance of payments for the coming years is based on the maintenance of a sustainable reserve position as a result of the prevailing changes in the structure of foreign trade. Although the Turkish lira appreciated by 25 percent in real effective terms during the first six months of this year in the framework of the fight against inflation, exports continue to grow in the OECD markets, which is a clear sign that they have become less and less price elastic. At present, as a result of the diversification of exports achieved since the beginning of the reform, only 22 percent of exports are agricultural products, compared with 75 percent ten years ago. These results were achieved in spite of the existing barriers against Turkish exports in the industrial world, the abolition of export subsidies, and the closing of the Iraq export market as a response to concerns about the liquidity effects of the credit facilities previously granted to this country. An objective assessment of

Turkey's export performance shows that, when exports to Iraq are excluded, the comparison between the first six months of this year and last year gives an increase of 10 percent, and not a decline as mentioned by the staff, which based its view only on the results for the second quarter.

The assistance and advice given to Turkey by the Fund since the inception of the reform have been an essential ingredient in the program's success. My authorities fully realize that the disappointment in this Board about the inflation performance is more vividly perceived because of Turkey's standing as the star performer under adjustment policies. This view gives to my authorities an additional incentive for acting on this priority objective with the determination that has inspired their policies since 1980.

Mr. Al-Jasser made the following statement:

I commend the Turkish authorities for their perseverance in restructuring their economy and in institutionalizing efficiency and competitiveness. The revival of the Turkish economy during the past decade is exemplary indeed. The most important ingredients of that revival were probably the unshackling of the private sector and the redemption of its entrepreneurial innovation. Turkey can claim to show the membership what good structural reform can do for an economy. I hasten to add, however, that economic revival and structural reform are neither painless endeavors, nor smooth and uninterruptable. The crucial point, though, is that reversals should not be allowed to take place and interruptions should not be prolonged. The credibility and implementation of the adjustment program are crucial for building confidence in the economy. This confidence, as highlighted by Mr. de Groote, is indispensable not only for increasing capital inflows and workers' remittances, but also, and more significantly, for reducing uncertainty, which as Keynesian theory stresses, is essential for long-term investment. Hence, I am very heartened by the emphasis placed by the Turkish authorities on confidence building and on the credibility of their management of the economy.

I am also heartened by the continuation of the process of liberalizing the economy, especially in the areas of imports and domestic prices. I was glad to note from Mr. de Groote's statement and the staff report that, in consolidating their fiscal stance, the Turkish authorities have decided to limit government borrowing to the principal coming due, to limit the Treasury's access to short-term advances from the central bank at concessional interest rates, and to clear certain liabilities to the central bank. These measures, combined with the announcement by the Prime Minister that the Central Bank will have greater autonomy in setting and conducting monetary policy, are welcome.

The process of adjustment is not a smooth one. Turkey's bouts with inflation are but one living example. However, it is an example that may prove to be Turkey's Achilles heel. In previous meetings, I have affirmed that inflation is inimical to the process of economic development, especially in a market-oriented economy with considerable reliance on indirect finance. This brings me to the dangerous prospect of further disintermediation on the financial side of the economy. The high cost of financial intermediation in the economy, due to distortions in the system of reserve and liquidity requirements and taxation of financial assets, has created an unsustainable wedge between the deposit and lending rates. The larger that wedge the greater the pressures for further disintermediation and eventually a shortage of loanable funds and rationing of credit. The impact of such an eventuality on the long-term prospects of the economy could be unfortunate.

Therefore, I have been heartened by the emphasis in Mr. de Groote's statement on fighting inflation. Notwithstanding the impact of last year's drought and the decline in agricultural production, inflation has to be reined in, lest the gains of the past become endangered. While continuing to implement needed supply-side measures, the authorities still need to consolidate their fiscal stance, especially with regard to reducing government expenditures, particularly recurrent expenditures. The impressive performance on the revenue side of the budget needs to be matched by reductions in, or at least a freezing of, recurrent expenditures. This could go a long way toward not only easing inflationary pressures, but also enhancing confidence in the future of the Turkish economy. It is with this perspective in mind that I urge the authorities to consider seriously the second medium-term scenario developed by the staff. However, I have a reservation about the 15 percent inflation rate target. Is this rate not excessive, especially for a country aspiring to be fully integrated in the world economy? Moreover, of pivotal importance to fiscal consolidation is the reform of the state economic enterprises. Their listing on the Istanbul Stock Exchange can definitely help in introducing incentives for good performers, but I surmise that only profitable ones will be listed. The unprofitable ones ought to be liquidated, privatized, or reformed using the performance contract mechanism.

Turkey has implemented courageous policies that have revitalized its economy. However, the challenges I have mentioned can derail the economy if they are not dealt with decisively. It is important in this regard that tariff and nontariff barriers to Turkish and other developing countries' exports be removed. This is all the more relevant since Turkey has made great strides in liberalizing its import system. Finally, I support the proposed decision.

Mr. Finaish made the following statement:

There can only be few who would doubt the success of the stabilization and reform effort on which Turkey has embarked since the beginning of this decade. Today, Turkey continues to reap the benefits that accrued on the strength of that effort as evidenced by, among other things, the recent improvement in the terms of access to external financing and, in general, a rising confidence in the prospects of the Turkish economy. And, while throughout most of last year, policymakers had to contend with at times severe downward pressures on the exchange rate, the lira has recovered well this year--a turnaround that should not be underestimated, particularly in terms of what it implies for reducing the likelihood of a recurrence of destabilizing speculative foreign exchange activities.

This said, however, one has to keep in mind that the two major speculative episodes of last year were fueled by strong inflationary pressures, a condition that unfortunately continues to prevail in the Turkish economy. While the emergency stabilization packages that were introduced in the wake of those episodes were successful in stemming the downward pressures on the lira, it would be desirable to avoid having economic policymaking be dominated by short-term considerations. It would, therefore, seem essential that every effort be made to strengthen the medium-term orientation of economic policy formulation and implementation. Of course, the task involved is far easier said than done, but achieving it would be greatly facilitated once the corner is turned in the fight against inflation.

The high priority that the authorities attach to a reduction in inflation, which is conveyed in Mr. de Groote's statement, is welcome. Success on this front is urgently needed, particularly in the light of the recent liberalization of the exchange regime, as well as the current posture of exchange rate policy. The effort to reduce inflation should benefit from the recent import liberalization measures, but it will have to continue to be based mainly on a tightening of financial policies. In the fiscal area, this in turn requires that the authorities strictly adhere to their public sector borrowing requirement program target. We note from the staff report that doing so will require further action to offset the decline in indirect tax revenues related to import liberalization and the excess of wage payments over the budgeted amounts. We also note that the bulk of the adjustment will fall on investment spending, which, as noted in Mr. de Groote's statement, came to almost a standstill last year. We, therefore, agree with the staff that greater prioritization of investment outlays will be essential in order to mitigate the impact of restraint on growth prospects.

In the area of monetary policy, a key challenge facing the authorities lies in the urgent need to improve the efficiency of financial intermediation. Obviously, the currently negative after-tax real deposit rates do not bode well for the need to bring inflation under control. However, higher nominal deposit rates, if not accompanied by a prompt reduction in the taxation of financial intermediation, can only be expected to lead to an increase in an already excessively high break-even lending rate, which, in view of prevailing institutional arrangements, may, as noted by the staff, jeopardize the health of the banking system.

I have noted from page 11 of the staff report that the Turkish authorities attach considerable importance to receiving a clear signal from the European Community regarding Turkey's application for membership in the Community, as that would be important for the elaboration of Turkey's future development strategy. We note that a response from the EC was expected before the end of this year. As that time is drawing very near, I wonder whether the staff could provide any information on the status of Turkey's application.

I also wish to comment on the economic and financial implications for the Turkish economy of the recent huge influx of Bulgaria's Turkish-speaking minority into Turkey. As has been widely reported, well over 300,000 refugees have crossed Bulgaria's boarder into Turkey since May, and the number could increase even further. I wonder whether Mr. de Groote or the staff could comment on those implications. But, the economics of the matter aside, this problem, which has been characterized in the press as one of the biggest and unhappiest population movements in Europe since World War II, raises a number of important questions in the areas of international relations and human rights.

I realize, of course, that this is not the right forum for addressing human rights issues. However, given the serious dimensions of this problem, I cannot help but wonder about the curious silence that has surrounded it, which I find especially surprising at a time of rising interest in developments relating to human rights issues elsewhere. This substantial forced exodus represents a major infraction of human rights, and the international community can ill afford to look the other way, as doing so could, among other things, be seen as condoning ethnic purity and encouraging achieving it by similar means.

Mr. Goos made the following statement:

In general, it appears that the authorities are pursuing quite laudable economic objectives, particularly the emphasis on reducing inflation, strengthening market forces and the role of the private sector, and stabilizing the balance of payments position. The importance of vigorous pursuit of these objectives for the economic prospects of the country can hardly be overstressed, not least in the context of Turkey's intention to integrate its economy more closely into the European market.

However, from the paper it appears that, given present and prospective policies, economic developments are again likely to deviate substantially from the authorities' objectives. This regrettable prospect is borne out not only by the disappointing information provided in the supplementary paper on more recent economic developments, but also by the medium-term scenarios, which clearly indicate the need for substantive policy changes. The major shortcomings of the present policy stance are adequately addressed in the staff appraisal, which I fully endorse.

In particular, I share the staff's concern about the unevenness of policy implementation and the absence of a concrete strategy, notably in the monetary area. It is common wisdom that a stable and reliable policy framework is an essential prerequisite for successful economic management. There is also general agreement on the importance of a low rate of inflation, positive real interest rates, and an adequately functioning financial system for domestic savings, investment, and growth. On those scores, there is little doubt that the authorities have to strengthen their efforts considerably.

In this context, it is worth noting that inflationary pressures appear to be even more pronounced than is indicated in the paper. According to certain observers, Turkey's inflation rate for this year could be as high as 80-90 percent.

The need for more forceful stabilization efforts applies in particular to fiscal policy, where higher savings could contribute markedly to a reduction of the domestic imbalance underlying the existing price pressures. Achieving this reduction requires further expenditure cuts. But, at the same time--and particularly in view of the already drastic cuts in investment outlays and the still relatively low overall tax ratio--there seems to be also considerable scope for revenue enhancing measures. In this respect, we share the staff's concern that the expected improvement in tax revenues for this year reflects predominantly one-time-only effects. Moreover, I agree with the staff that a further rationalization of the budget process could make a significant contribution to strengthening the fiscal position, as could decisive and more thorough efforts at improving the financial position of the state economic enterprises.

Another area that requires urgent attention is the financial sector. Without going into detail, I am very concerned about the health of the banking system. What seems to be urgently needed now is the dismantling of credit controls and a substantial reduction, if not a complete abolition, of the taxation of financial intermediation, in order to enable the banks to efficiently mobilize domestic savings that are so badly needed for domestic and external stabilization and growth. Another crucial requirement for domestic stabilization seems to be the discontinuation of central bank financing of government expenditure, which--as evidenced by the information in the supplementary paper--severely undermines the effectiveness of monetary control.

We certainly welcome the efforts to enhance the convertibility of the Turkish lira. I wonder, however, whether the timing of those measures has been appropriate. In particular, I am worried that the existing large inflation differentials and exchange rate uncertainties might produce an incentive for substantial transfers into foreign currency-denominated assets. I therefore fully concur with the staff that the recent changes in the exchange rate regime make a tightening of financial policies even more urgent. Finally, I support the proposed decision.

Mr. Enoch made the following statement:

At the time of the previous Article IV consultation with Turkey, the Board expressed great concern that the Turkish economy was overheating and urged the authorities to tackle inflation as a matter of urgency. This chair emphasized the need to set and implement policies in a medium-term framework. It is therefore a great disappointment to find that policy has been erratic, and that the concern over inflation has now developed into a heightened fear of stagflation.

There is some good news to set against that disappointment. The surplus on the current account in 1988 was a considerable achievement, especially as welcome steps were being taken at the same time to remove artificial export incentives. But even on the external side there is certainly no room for too sanguine a view. Some of the favorable influences on the external balance must be regarded as transitory, including lower oil prices and subdued domestic demand, while some of the negative influences--such as the sharp drop in the trade with Iraq at the end of the year--may not be speedily reversed.

The staff report catalogues the very disappointing level of activity growth in 1988, despite the bumper harvest, and the staff update seems to dash earlier tentative hopes for any rebound this year. Yet this subdued activity has not yielded any benefit in the form of lower inflation; the rate of price increases doubled in 1988, and very little attenuation is expected this year. Even worse, there are signs that higher inflationary expectations may be becoming entrenched. Real wage flexibility in the past has been marked in Turkey, but the very high wage increases that have recently been agreed, as well as reports of implicit indexation, are disturbing, and I note the staff's doubts that enterprises can absorb these increased costs as the authorities hope.

Overall, the picture now is one of stagflation, apparently the result of an unbalanced fiscal policy as well as a loose monetary stance. While the authorities did achieve their fiscal deficit reduction goal in 1988, they had to compress investment, rather than current expenditures, to offset considerable revenue shortfalls.

There is no doubt considerable scope for cutting fat out of the investment budgets of state enterprises. However, in doing so as an emergency measure, the need to assign appropriate project priorities may have been neglected. Tables 1 and 2 in the background paper dramatically show how the reduction in public investment affected growth in 1988. Developments this year are difficult to assess, but the reported rapid growth in current expenditure is not reassuring, and the position will no doubt be worsened by the problem of the refugees from Bulgaria, which Mr. Finaish has highlighted.

There are three points that deserve emphasis on the fiscal side. The first is that, in line with the stated intention to reduce the role of government in the economy, the privatization process might warrant revitalization. The second is that the complexity of the fiscal accounts makes policy administration harder and thus warrants simplification. And the third is the essential need to improve tax administration and collection; I would be interested in hearing from the staff whether there may be scope for some technical assistance in this area.

Notwithstanding these criticisms, the authorities did, through great efforts, achieve their overall targets in 1988. However, they are unlikely to do so this year, and such failure will serve to compound the laxity of monetary policy. In 1988, monetary targets were greatly exceeded, and although the stance of policy was tightened late in the year, it was soon relaxed again. The impact of the rapid growth in broad money was increased by the acceleration in velocity. This is a very worrying development not only as an inflationary pressure in itself, but also as a symptom of inflationary expectations.

Developments in 1989 have not been encouraging, and there must be concern that maturing time deposits from last year will only fuel velocity. The authorities' reluctance to announce monetary growth targets is probably not helpful at this juncture; it only adds to the uncertainty about monetary policy, including the relationships between the different monetary concepts. It is perhaps particularly at a time of high, and possibly explosive, inflation that monetary growth targets, to which the authorities are seen to be committed, are important in providing a nominal anchor.

A further disturbing issue identified in the staff appraisal is that although the reserve money targets for 1989 may be consistent with the program targets overall, they may not be attainable. It is therefore urgently important to improve the Central Bank's methods of monetary control. But, in addition, to make policy really effective, it is important to remove the constraint created by the tax on fiscal intermediation on achieving positive real interest rates on both sides of the balance sheet. Moreover, the quality of intermediation needs improvement through a stronger banking system. I endorse the comments made by Mr. Goos on this subject, and I would welcome further information from the staff on the World Bank's involvement in this field.

Concerning the fiscal-monetary link, I welcome the reported restructuring of government liabilities and the protocol limiting government recourse to central bank advances. But I have heard with concern recent reports that the authorities are considering the issue of a bond that could be redeemed on demand; this seems to run counter to the entire strategy of lengthening the debt.

In the external sector, the central policy issue is the appreciation of the real exchange rate and the need to maintain competitiveness. I agree with the staff that the sustainability of the current account surplus cannot be taken for granted; the updated information for this year lends support to this view. I fear that Mr. de Groote may be too optimistic when he suggests that continued export growth in the face of real appreciation indicates declining price elasticities; there might instead be a significant risk that the lags are such that the full effects of the appreciation on export volumes have not yet fed through. The sensitivity analysis provided in the appendix to the main staff paper makes clear the importance of the real exchange rate. I endorse the staff suggestion that upward pressure on the exchange rate might be attenuated by acceleration of the welcome process of trade liberalization to which the authorities continue to be committed.

Concerning the desirability of Turkey maintaining surpluses, I see the logic of the staff's doubts as to whether surpluses are appropriate at this stage of development. However, Turkey is not starting from a position of equilibrium. Data in the staff report and the background paper clearly bring out how high Turkey's stock of debt and debt-service ratios still are. Notwithstanding the economic achievements of the earlier part of this decade, Turkey may therefore still be vulnerable to swings in creditor sentiment, especially after the economic developments of the past 18 months, and it will therefore need to be prudent in setting both its domestic and external objectives.

The staff provides three scenarios for the Turkish economy, as well as a useful sensitivity analysis. I recognize that the authorities may disagree with some aspects of the underlying model, but these scenarios illustrate very clearly where the balance of risk lies. I was particularly struck by the skepticism with which the staff seems to regard the achievability of the authorities' objectives, given the policies that are now in place, as well as the benefits that could be derived from further fiscal action. Given that the fiscal targets seem somewhat unambitious, I hope that the Turkish authorities will give this analysis close attention.

I have two brief final questions and two observations. First, I strongly agree with the staff that Turkey should move to eliminate its multiple currency practice as soon as possible, and I would be interested to hear whether the possibility of Turkey moving to Article VIII status, following the recent examples of Indonesia and Korea, was raised. Second, there was some discussion last year of the problem of fictitious exports, but that subject was not mentioned in this year's papers. I would be interested in hearing whether it is still considered a problem, or whether policies put in place last year are considered to have solved the problem. Third, I am interested in the appendix to the background paper on the behavior of private sector savings, but the model postulated there needs further testing: therefore, I look forward to the coming discussion on the staff's cross-country study of national savings. Finally, I was struck by the figure in the staff report of 108 million as the size of Turkey's stationary population. Apparently, this is the first time that this measure has been included among the social indicators listed in a staff report. That figure clearly highlights the demographic dimension of economic policy formulation, which the Board started to address in its latest discussion of the world economic outlook.

Mr. Menda made the following statement:

Turkey's economy experienced a remarkable recovery in the beginning of the 1980s, which made a return to voluntary international lending by 1983 possible. However, significant slippages have occurred in recent years. The public sector borrowing requirement reached 8.9 percent of GNP in 1987, and, given the lax course of monetary policy, the overall situation in Turkey led to overheating of the economy and mounting inflationary pressures, as was mentioned during the previous Board discussion of Turkey.

We share the staff's view that economic policy has been increasingly dominated by short-term considerations. In addition, developments in 1988 point to the lack of consistency of these policies: on the one hand, drastic cuts in public sector investments provoked a dramatic slackening of economic growth, with manufacturing output falling by 10 percent, while much of the growth was accounted for by an excellent agricultural harvest; on the other hand, despite this recessionary context, inflation still accelerated, spurred by large price adjustments in the public sector and rapid monetary expansion. External developments were more satisfactory, with the external current account reaching a significant surplus. However, given the lack of buoyancy of private investment and the existence of capacity constraints, my authorities feel less optimistic than the staff about the external prospects. The staff could usefully explain the reasons behind the lack of responsiveness of private investment mentioned a few times in the report.

This mixed picture clearly indicates that the authorities should turn to a more coherent strategy in the medium term, a point underlined by Mr. Goos and Mr. Enoch. Basically this strategy should aim at strengthening demand-management policies with a view to releasing more resources to the private sector and reinforcing the competitiveness of the export sector.

A clear priority should be given to maintaining control over public finances in order to reduce the public sector borrowing requirement during the coming years. Part III of the background paper, on public finance, stresses that the fiscal decentralization process initiated in 1983 has made it very difficult to control extrabudgetary funds and local government finances, thereby weakening the overall control of expenditures. Furthermore, the reduction in the public deficit in the course of 1988 appears to have relied primarily on the state economic enterprise sector, which is all the more worrisome since the staff admits that the available data are not fully reliable. I would welcome further information from Mr. de Groote or the staff on the exact situation of this sector and on the measures envisaged by the authorities to strengthen budgetary controls.

On the expenditure side, we noted last year the necessity of a restrictive pay policy in the public sector, and real wages in that public sector declined by 10 percent in 1988. However, this trend has been reversed since the beginning of the year, and very large increases were granted in July. We urge the authorities to be more cautious in this area. In the area of current expenditure in general, the staff seems to doubt the feasibility of further restraint. I would appreciate hearing further comments on this question, since the burden of fiscal adjustment has relied essentially on investment expenditure cuts that do not appear to be fully warranted.

On the revenue side, the shortfall experienced last year, and other developments in recent years, point to the need to enhance the responsiveness of tax revenues. We welcome the measures envisaged in this area by the authorities, but we recommend avoiding excessive reliance on indirect taxes.

But fiscal adjustment measures will not be sufficient to restore the control over the nominal evolution of the economy. Monetary policy is to be considerably strengthened, and the financing of the public sector borrowing requirement through the banking sector should be rapidly eliminated. We agree with the staff that the first steps that have been taken to give more autonomy to the central bank are welcome. However, the recent wage increases in the public sector have been financed by the central bank, resulting in a considerable injection of liquidity.

I share the staff's views on the measures to be taken to strengthen the efficiency of monetary policy. Clearly, the return to positive real interest rates is of the utmost importance. Furthermore, like previous speakers, we think that, given the high cost of financial intermediation, a broad range of measures, including the elimination of the distortionary impact of taxation, seems necessary to reform the banking system and to develop financial markets.

As to the external sector, I feel somewhat doubtful about the strength of the current account. If one must stress the remarkable performance of the export sector, one must be reminded of the contribution of the active exchange rate policy conducted by the authorities during the 1980s. Given capacity constraints caused by insufficient private investment, it is highly probable that the external accounts will soon turn negative, which reinforces the need to implement a strict demand-management policy, complemented by further measures to liberalize imports and reduce export subsidies. Furthermore, the authorities should continue to pursue a flexible exchange rate policy and avoid excessive appreciation of their currency. The 25 percent effective appreciation since the beginning of the year seems largely excessive.

The debt-service ratio is reaching a level at which great caution is required, and I would stress that the recent decline in the external debt was due only to exchange rate effects. The OECD has estimated that, when the exchange rate fluctuation is eliminated, the external debt increased by $1.2 billion in 1988.

We agree with the staff appraisal, and strongly urge the authorities to take the necessary measures to avoid further slippages. The benefits of the efforts made since the beginning of the 1980s are at stake.

Mr. Warner made the following statement:

At the discussion of last year's Article IV consultation with Turkey, we recalled our high regard for Turkey's past success in restoring strong economic growth, reducing inflation, and strengthening its external position. At the same time, however, we noted a number of disappointing developments that threatened Turkey's past achievements.

Unfortunately, despite a few positive developments over the past year, such as the emergence of the first current account surplus since 1973, domestic economic performance has continued to be disappointing: GDP growth in 1988 was markedly lower than expected; the inflation rate continued to accelerate; and the fiscal deficit remained at a high level. The performance last year and in the first part of 1989 was apparently due, at least in part, to the adoption of some restrictive policy measures, which were needed to correct the overly expansionary policies followed in 1986/87, and which we support. However, even in the past year, there seems to have been a certain measure of policy drift that must be addressed.

The continued high rate of inflation is particularly disturbing, given the accompanying risks of a costly wage/price spiral and its effects on export competitiveness and real interest rate levels. Indeed, the recent very high wage settlements--on the order of 140 percent in the public sector--have set an unfortunate example for the rest of the economy, notwithstanding the past erosion in real wages. Absent efficiency gains in the state economic enterprises, these wage increases have fueled domestic price increases. Meanwhile, there has been a real effective appreciation of the lira and an erosion of external competitiveness. Furthermore, the staff notes the emergence of a policy dilemma early this year between the goals of reducing inflation and maintaining export competitiveness. Rising prices have resulted in declines in real interest rates to levels that the staff believes are probably negative in real terms.

Clearly, the main challenge ahead is to return to more disciplined monetary and fiscal policies, so as to create a more stable policy environment in which Turkey can maximize growth amid price stability. With regard to fiscal policy, we recognize that containing the overall public sector borrowing requirement in 1988 to close to its programmed level in lira terms represented a considerable effort. Yet, at 6.5 percent of GDP, the public sector borrowing requirement is still quite high by international standards. The 1 percent cut targeted for 1989 would certainly be a step in the right direction, but it may not go far enough.

Indeed, the staff report casts doubt on the sustainability of fiscal adjustment. On the expenditure side, we are concerned that the authorities have had to resort to across-the-board cuts in investment expenditures, as this will tend to lower growth prospects over the medium and long term. The large increases in public sector wages also suggest that greater efforts will be needed to reduce the number of public sector employees to contain the size of the overall wage bill. On the revenue side, we welcome the efforts to improve tax collection, but in the absence of larger expenditure cuts, we wonder whether revenues will be strong enough to bring about the programmed level of adjustment. In fact, the staff report suggests that even a 1 percent cut in the public sector borrowing requirement will probably require additional measures; perhaps the staff would comment on which additional measures, if any, have been adopted or are under active consideration.

Regarding monetary policy, the inconsistent stance in 1988 and early 1989 has no doubt undermined the credibility of monetary policy and contributed to inflationary pressures. For 1989, the authorities have decided not to announce monetary targets, lest their overshooting cast further doubt on the conduct of monetary policy. We wonder whether this reluctance to announce targets will not, in itself, further undermine confidence in government policy. In the circumstances, there may be considerable benefit in publicizing monetary targets, since the need to meet the preannounced targets could give the authorities additional ammunition to stave off pressure to relax policy prematurely. In addition, we fully support the authorities' intention to give greater autonomy to the central bank.

There is also a clear need to strengthen the banking system, especially by reducing the high cost of financial intermediation and by improving bank supervision.

As to the external accounts, we share the staff's skepticism that the current account surplus can be maintained in the face of large domestic imbalances. Indeed, the supplement to the staff paper reports a significant weakening in the second quarter. Moreover, as regards a permanent easing of Turkey's external constraint, it must be borne in mind that exogenous developments, not to mention domestic ones, could reverse the increase in invisibles receipts.

We welcome the recent steps taken to enhance the convertibility of the Turkish lira and to liberalize imports. However, we agree that maintaining more open policies in these areas will require appropriately restrained domestic policies.

The medium-term scenarios are very helpful in illustrating the likely effects of the main policy alternatives facing the Turkish authorities. The analysis makes a strong case for an enhanced fiscal effort, which would result in not only a dramatically smaller fiscal burden on the economy, but also a substantially lower rate of inflation, a stronger current account, lower external debt and debt service, and faster economic growth by the end of the medium-term period. The analysis makes equally clear the hazards of policy slippages, especially rapid inflation. It appears that even the present policy course will result in persistently high rates of inflation, far in excess of the authorities' objectives.

In conclusion, we continue to admire the progress made in past years in achieving macroeconomic objectives and in restructuring the Turkish economy, but continued growth with price stability, current account strength, and financial stability are now in jeopardy. There is obviously a need for strong fiscal and monetary policies so that Turkey can regain a path of sound economic performance.

I support the proposed decision.

Mr. Hogeweg made the following statement:

Turkey has a highly commendable record of initiating fundamental reforms and liberalization of its economy since the early 1980s, and clearly the will to go further along this road is still evident. However, more recently this process has been thwarted by macroeconomic policy slippages, and, more generally, the staff notes the short-term perspective of policymaking and transitory measures that run counter to medium-term aims.

Recent developments are clearly unsatisfactory. Measures to restrain the economy have had a striking--excessively strong--effect on the real economy: growth has almost disappeared, and the current account deficit has turned into surplus, yet the inflation rate has failed to react. I believe that these adverse developments indicate that some essential ingredients for the smooth functioning of the Turkish economy are still not in place. I take it that this problem was also in Mr. de Groote's mind when, during the recent world economic outlook discussion, he referred to Turkey as a country where the invisible hand needed help to perform its essential functions.

Policy slippages and short-term emergency measures are of course closely connected with the visibility of success of the medium-term direction of policies. Such success will, in turn, depend on the comprehensiveness of the policies pursued, as well as the correctness of their sequencing. The staff is undoubtedly right in advocating a return to a more medium-term orientation of policies, but this will be possible only once remaining obstacles to effective economic management and the functioning of the economy have been tackled.

Fiscal restraint is clearly needed, and much has been accomplished already. The medium-term scenarios indicate that, without further deficit reduction than is now envisaged, the Government's targets will prove elusive. But most important, it is the structure of restraint that has to be changed. Cuts in public investments are not desirable, because they frustrate growth. In the same vein, the public enterprises should emphasize improving efficiency--not raising prices--in order to restore profitability. Furthermore, the level of taxation of financial intermediation is clearly unhelpful for monetary management.

As to monetary policy, the degree of autonomy of the central bank is clearly insufficient. Recent measures go in the right direction but not far enough. The central bank should be in a position to counteract slippages in the fiscal area, rather than be forced to finance them, and the instruments at the disposal of the central bank should allow it to adequately address circumstances as they arise.

Events in the past year clearly illustrate these points. The current account surplus posed a policy dilemma. Appreciation of the exchange rate would impair competitiveness, while interventions would add to a money supply already being fed excessively by central bank financing of government wage increases without sufficient power for the central bank to counter this expansion. This combination goes a long way toward explaining the failure to reduce the inflation rate;

the continued inflation creates an environment that invites indexation, is not conducive to growth, and makes stopgap measures unavoidable.

With its bold initiatives in the early 1980s, Turkey provided lessons for other countries. It is also providing lessons in its handling of its current problems. I trust that the ability to solve these problems will also prove most instructive.

Mr. Fernández Ordóñez made the following statement:

The economic policies implemented in Turkey during the first half of the 1980s were well designed and courageously implemented. As Mr. de Groote stressed in his opening statement, these policies warranted the substantial financial support that was provided by the multilateral institutions. However, in reading the staff report we observed that, for a third year in a row, the momentum has been lost, and that a certain ambiance of confusion continues to dominate the economic policy scene. Not all the results are negative; the external sector is a good example of a satisfactory outcome. However, many developments have been negative, the acceleration of inflation being the most disappointing. During this period, the Turkish authorities have adopted some measures that go in the right direction. We especially welcome the reduction in import duties and attempts at fiscal consolidation.

Nevertheless, there seems to be a great gap between the authorities' targets and the measures that are actually being adopted. The latest example is the question of the consistency of the sixth five-year plan. It is of course difficult to disagree with objectives such as a rate of growth of 7 percent or a reduction of the inflation rate to less than 15 percent by 1994. However, the staff has proved consistently that, as with the proposed measures, the targets are unlikely to be met.

What is badly needed in the current situation is to re-establish credibility on the basis of two pillars: explaining clearly to the economic agents the direction of the program; and keeping steadily in that direction. In recent years, there has been a certain lack of orientation in economic measures--for example, the zigzag in monetary policy, and certain fiscal measures, such as the large increase in wages.

The Turkish authorities do not need to learn from anyone but themselves how to re-establish credibility. They need to go back to the program lines launched at the beginning of this decade and reduce inflation, open the economy--which could be facilitated by the current positive external results--and stick to rigorous financial policies. The best results will come only if the authorities follow the recommendations of the staff, which we fully endorse.

Mr. Yoshikuni made the following statement:

As Mr. de Groote very clearly illustrated in his opening statement, the successful management of Turkey's economy in the first half of the 1980s has removed Turkey from the group of problem debtor countries. In particular, the implementation of comprehensive structural measures, including import liberalization, was instrumental in strengthening Turkey's credibility in international financial markets. Viewed in this light, however, the performance of the Turkish economy since 1986 has been less than encouraging. A high rate of inflation, reflecting expansionary financial policies aimed at high economic growth rates, recently made it necessary for the authorities to resort to selective measures that not only hurt growth prospects, but also reversed some of the achievements gained through the successful adjustment policies. It is interesting to note that this adverse shift in economic management appears to have coincided with the expiration of the successive stand-by arrangements with the Fund. I endorse the thrust of the staff appraisal.

Given the importance of containing inflation, I agree with the staff that the authorities may have to tolerate a slower rate of growth than this year's already modest target of 3 3/4 percent. In this connection, the recent sharp downward revision of the growth estimate to 0.2 percent seems inevitable, particularly to stave off a rise in inflationary expectations, which would bring about a vicious cycle of wage and price increases. In my view, given the strong public desire to compensate for the erosion of real wages, it would have been difficult to avoid excessive wage hikes if the authorities had stuck to the original target growth rate.

On the fiscal front, I, like other Executive Directors, attach importance to strengthening tax revenues in view of the reduced reliance on indirect taxes as a result of import liberalization. Given the complexity of the direct tax structure, I agree with Mr. Enoch that the possibility of technical assistance in this area should be explored.

In the area of monetary policy, the continued rise in currency circulation as well as in reserve money, despite the authorities' commitment to monetary restraint, is a cause for great concern. To maintain the central bank's credibility it is essential to introduce and modify instruments to efficiently control the monetary aggregates through market-oriented measures. As the staff rightly notes, the absence of broad monetary targets entails serious risks, particularly in view of the need to contain inflationary expectations and to forestall a wage and price spiral. In this connection, a recent initiative to strengthen the independence of the central bank is no doubt a first step in the right direction; however, much remains to be done in this area. On the other hand, the expected increase in the sale of government bonds, as a result of reduced dependence of the Government on central bank financing, would give the central bank a very good opportunity to expand its operations in the open market. Therefore, I encourage both the Government and the central bank to expedite the expansion of the secondary market in government securities. Also, the problem of different interest rates for preferential and nonpreferential lending and the associated financial disintermediation should be monitored carefully by a comprehensive study of average and effective interest rates, taking into account such factors as the tax deductibility of funds.

I generally welcome the changes in the exchange and trade regime announced in recent weeks, particularly the measures to enhance the convertibility of the Turkish lira and further liberalize imports. Such measures will help make up for the reversal in the adjustment process since the beginning of 1988 and pave the way for EC membership and, as Mr. Enoch suggested, Article VIII status in the Fund. At the same time, I would stress that these measures should be accompanied by strong macroeconomic policies aimed at restoring external viability.

Mr. Kwon made the following statement:

I would like to join the previous speakers in commending the Turkish authorities for the courageous adjustment and reform programs that have been implemented since the early 1980s. The staff papers, however, present a particularly depressing picture of a previously successful adjustment process that appears to have lost its way.

The staff rightly focuses with concern on the increasing dominance of short-term considerations in Turkish policy setting and, in particular, recourse to ad hoc solutions to deal with problems resulting from slippages in implementation of the earlier, more integrated program. What we see is the pre-eminence of piecemeal solutions, rather than the comprehensive approach that underpinned Turkey's earlier success.

Mr. de Groote's opening statement focused on past successes and the impetus these have given to improved financial market and investor confidence. But it is clear that this confidence will prove difficult to preserve if the adjustment momentum is not re-established. Inflation, and particularly the evidence of deeply entrenched and worsening inflationary expectations, bear witness to this risk. Therefore, I welcome Mr. de Groote's indication that his authorities are committed to containing inflationary pressures; this is the key to putting the longer-term strategy of adjustment with growth back on track.

But the staff's medium-term projections highlight the immensity of the task ahead and, indeed, the insufficient policies to achieve the objectives of the sixth five-year plan. A substantially tighter fiscal stance than that envisaged by the authorities, is required even though the authorities' objectives are ambitious and were made more so by the recent public sector wage increases, which have served only to further reduce the flexibility for expenditure cutting. And the evidence in the staff's supplementary paper that expenditures are continuing to increase at a faster rate than expected highlights the need for quality cuts aimed at improving the primary balance. Therefore, the staff's focus on the need for improved budgetary controls and procedures seems particularly relevant, as would be the implementation of initiatives to improve the efficiency of the state economic enterprises.

Looking to the medium term, much seems to depend on the authorities' forecast of a 3.5 percent increase in private savings as a percentage of GDP over 1990-94 to fund the increase in private investment needed to substitute for planned cuts in public investment. As we all know, however, such increases in private savings are hard to achieve in practice.

Success at lowering inflation will no doubt help this process, but, as structural adjustment progressively increases access to foreign goods and services, there is a danger that consumption demand will increase by more than anticipated. Therefore, it seems crucial to re-establish credibility in the operation of a monetary policy aimed at preserving medium-term price stability. I largely endorse the staff report's conclusion concerning the need to avoid the uncertainties and inconsistencies of recent history. It is apparent, for example, that the 1988 liberalization of exchange rate arrangements had a less positive impact than might otherwise have been the case because of the failure to support it with appropriately firm financial policies. I also agree with the staff on the importance of re-establishing as soon as possible positive after-tax interest rates on bank deposits. Substantial and far-reaching financial market and tax reform would seem to be necessary to remove the existing distortions between deposit and lending rates and to fundamentally strengthen the banking sector. I should note that the recent agreement between the Treasury and the central bank with an eye to, inter alia, increasing the latter's autonomy in areas of monetary policy is a very welcome first step.

But I suspect that national savings will continue to be inadequate to fund the necessary investment in new export productive capacity and much needed infrastructure; hence, continued recourse to foreign savings should not be ruled out by the authorities. I recognize that the unexpected surplus on the current account has been a source of comfort to the authorities, facilitating a significant improvement in Turkey's external financial position. But the understandable desire to continue to build up reserves and reduce the debt and debt-service burden should not be pursued at the expense of access to the foreign savings necessary to sustain growth. The recent measures to further reduce import restrictions and liberalize access to foreign exchange will help in this regard while also easing pressure on the real effective exchange rate. Whether or not the inflow of foreign savings is well used, however, will depend on the totality of Turkey's adjustment effort. We hope that the authorities do not lose sight of this fact.

Mr. Ghasimi made the following statement:

The Turkish authorities are to be commended for their determination in implementing a set of fiscal and monetary policies aimed at controlling domestic demand and removing excess liquidity in the economy, which are crucial to the containment of inflationary pressures in the economy.

We basically agree with the staff appraisal. The performance of the economy was somewhat mixed during 1988, owing to the intensity of the difficulties facing the authorities, particularly the higher than expected rate of inflation and, to some extent, the variation in economic measures and policy reforms, which resulted in contrasting performances of the internal and external sectors.

As to the external sector, we noted the stronger than expected current account performance, owing to the substantial increase in export earnings from the services sector as well as the considerable decline in imports. The reversal of the current account position led to an augmentation of gross reserves in the banking system, which enabled the country to meet its external financial requirements without any problem. As is specified in Mr. de Groote's statement, Turkey's continuous efforts to liberalize the trade and payments regime, resulting in a rather high ratio of trade to GDP of 16 percent in 1988, is indeed admirable.

On the other hand, the performance of the economy deteriorated further on the domestic side, and the outcome was somewhat different from the envisaged targets. The unfavorable developments were as a result of the implementation of certain economic measures and the changed stance of the policies aimed at checking the strong upward trend of prices that had emerged in mid-1987 and accelerated sharply around the end of this year.

As to output growth, the implementation of fiscal policy combined with a relatively tight monetary policy during part of the year--in response to rapidly rising inflation--was reflected mainly in a decline in public and private investment, a 10 percent fall in manufacturing output, and a slower GNP growth rate of 3.4 percent this year. However, given the crucial role of the agricultural sector in the economy, we are pleased that the output growth in this sector improved sharply, from 2.1 percent in 1987 to 6.9 percent in 1988. Given the substantial agricultural potential of the country, we hope that the authorities continue strengthening the performance of this sector in the future.

The performance of the public sector was mixed. As Table 14 of the staff report shows, the Government succeeded in containing expenditures, which were, for the first time in several years, within the initial targets and even the revised targets. In contrast, the lower than envisaged direct and import taxes caused total tax revenues to decline from the envisaged target. However, we are encouraged to note that the public sector borrowing requirement is estimated to have declined from 8.9 percent of GDP in 1987 to 6.5 percent in 1988, which is consistent with the authorities' programmed target.

The most unfavorable development in the economy was on the price front. It is indeed disappointing to note that, despite the slower rate of economic growth, the upward trend in prices intensified during 1988. In fact, the considerable increase in the prices of products of state economic enterprises, the unevenness of monetary management, and the lower imports during the year were among the factors that contributed to the increase in prices in 1988. We agree with the staff that in dealing with this profound economic problem the authorities should be persuaded to adopt a medium-term strategy.

As to the program for 1989, we are glad to note that the authorities have continued to attach the highest priority to containing inflationary pressures. However, as has been acknowledged by the staff, the significant increases in state economic enterprises' prices, the renewed strong wave of wage increases, and the augmentation of indirect taxes, all witnessed around mid-1989, will no doubt be translated into intensified inflationary pressures.

As to the other aspects of the envisaged program for 1989, we welcome the intention of the authorities to support the activities of the small-scale enterprises, to promote further the role of the private sector in the economy, and to encourage further foreign investment.

The authorities' intention to expand the taxable base, improve tax administration, and enhance the efficiency of the tax system is appropriate. With regard to the Government's policy of reducing expenditures, it is regrettable that the burden is envisaged to fall mainly on investment. In this respect, it is important that the authorities consider carefully the priorities in their economic management in order to nullify the adverse impact of a decline in investment. This consideration seems to be particularly important in light of the forecast slowdown in agricultural production for 1989, as well as the lower private sector activities in the manufacturing sector during the initial months of the year.

As to the medium-term outlook for 1990-94, we welcome the authorities' intention to continue pursuing the export-oriented growth strategy. Furthermore, the authorities' determination to promote and enhance the role of the private sector in the economy and to augment the efficiency of the public sector are definitely steps in the right direction. Like Mr. Finaish and Mr. Enoch, we wish to hear from the staff about the financial and economic implications of the huge movement of refugees to Turkey. We support the proposed decision.

Mr. Pétursson made the following statement:

Turkey's economic development has, in many respects, been favorable in the 1980s. The structural changes that have been implemented have brought the country closer to an open market economy where progress in liberalizing the external sector as well as reforms in the financial markets are, perhaps, the most noticeable features. However, much still needs to be done to reform the economy further and to put it on a stable and sustainable growth path.

I basically endorse the authorities' broad economic objectives. However, as previous speakers have stated, the present situation is characterized by signs of imbalances and by adjustment that is insufficient to attain these objectives. The low rate of economic activity forecast for this year is by no means encouraging and does not seem to have induced--at least not to this point--marked abating of price pressures. I am also concerned about the weakening of the current account forecast for this year; I am therefore not quite as optimistic as Mr. de Groote that this area will not be a reason for concern in the near future.

Given the immediate and far-reaching challenges for the economy, it is of the utmost importance that the authorities ensure that stabilization policies are firmly implemented on all fronts. The measures implemented in recent weeks are steps in the right direction, but they seem to need further strengthening if the economic progress achieved in the 1980s is not to be lost.

I broadly agree with the staff's assessment of the economic situation and with the broad thrust of most interventions this morning. I will highlight a few points. First, I understand the authorities' intention to maintain a relatively stable exchange rate in order not to fuel inflationary pressures. However, the substantial appreciation of the lira has drastically eroded competitiveness, as the staff has clearly shown. While some of the more established industries may be able to cut further their already low profit margins, I would expect the appreciation to most adversely affect new export-oriented business and other foreign exchange earning industries, such as tourism. It is clear that moderate appreciations of the exchange rate can, in a suitable climate, positively stimulate efficiency in industry and temporarily dampen inflationary pressures, but this does not seem to be the case in Turkey; nor has the appreciation been moderate. Hence, I share the staff's view--and welcome the authorities' recent action--that rather than jeopardize the economy's competitiveness, the authorities should pursue trade liberalization more actively and further reduce export incentives to reduce pressure on the exchange rate.

Second, it appears that the expansion of monetary aggregates should be contained by--among other ways--use of broader money targets. A general increase in the efficiency of financial markets is also needed. Implementation of positive interest rates would be a logical first step, along with decisions to limit the Central Government's access to subsidized credits from the central bank and to grant the monetary authorities greater autonomy in the area of monetary policy.

Third, and most important, there is a need for swift and decisive policies to strengthen the fiscal sector. While I appreciate the authorities' efforts to reduce the fiscal deficit and the public sector borrowing requirement, I believe that more ambitious targets should be set for correcting imbalances in the Treasury proper and the state enterprises. I wish to emphasize in particular the need to restructure state enterprises, which represent a sizable share of the Turkish economy. I strongly encourage the authorities to increase their efforts to improve the efficiency of these entities, partly by increasing their exposure to competition. Moreover, suppression of prices of services provided by the enterprises may have temporary positive effects on the rate of inflation, but should clearly be avoided, as should the subsidization of capital for investment purposes for these enterprises. In this connection, I, like Mr. Al-Jasser, welcome the authorities' intention to introduce state enterprises on the stock market, as this could help to expedite their reforms.

I support the proposed decision.

Mr. McCormack made the following statement:

During the 1980s, Turkey has undertaken a series of adjustment programs, and, as Mr. de Groote noted, these have paid off handsomely. Nevertheless, the Turkish economy is now in a very vulnerable position, and considerable further reform seems required if Turkey is to eradicate inflation and continue on a sustainable path of rapid growth.

I would like to associate myself with the analysis of earlier speakers, especially Mr. Enoch and Mr. Warner. With regard to fiscal policy, the staff report indicates that Turkey has reached its targets for the overall public sector borrowing requirement, although it also notes that the intended composition has not been achieved. The increases in indirect taxes and public enterprise prices have certainly complicated anti-inflationary policy, and the cuts in capital expenditures are likely to jeopardize long-term growth prospects, unless, as the staff suggests, there is greater prioritization of investment spending. The point that perhaps has not been stressed in the discussion is that the report also describes the statistical difficulties that exist in the fiscal sector. I wonder whether, on balance, these problems have the effect of understating the extent of the fiscal imbalances; I note the staff is noncommittal on this point. It would seem very difficult to implement appropriate fiscal management without reliable information, and I urge the authorities to give high priority to improving this situation and to improving tax administration, which also leaves much to be desired at present.

The report suggests that the monetary policy stance has been more relaxed than planned and than is required in present circumstances. In particular, real interest rates have not reached the intended level of 4 percent, but rather are somewhat negative. Although real interest rates provide an important indication of monetary conditions, I have some doubts about how appropriate such an indicator is in a situation of accelerating inflation, and when the rate of inflation is already quite high. In most such cases, ex post interest rates are almost inevitably lower than initially expected. Against this background, I see more merit in the public announcement of monetary targets, thereby providing a nominal anchor for the system and also a degree of self-commitment by the authorities. I would be interested in staff comments on this matter. I agree with the staff that there are obvious difficulties in the conduct of monetary policy that need to be addressed. In particular, I welcome recent steps by the authorities to give more autonomy to the central bank. I join previous speakers in urging the authorities to move quickly to reduce the cost of financial intermediation.

As to the anti-inflationary strategy, the slowdown in the economy is evidence that the combination of tighter fiscal and monetary policies is having an effect. However, as the staff indicates, it seems that these policies have affected real variables quite rapidly, but have yet to have an impact on prices. Such lags are inevitable in an economy such as Turkey's, which has been struggling with inflation for some time, and in which inflationary expectations are well ingrained and difficult to eradicate. As the staff's medium-term scenarios show, it is very unlikely that Turkey will succeed in bringing down its inflation rate gradually while maintaining a relatively high growth rate of 7 percent. Against this background, there is a possibility of having a deep recession or a very prolonged slowdown to eliminate inflation.

Although in general I have considerable doubts about anything that smacks of a heterodox approach, I wonder whether, in this situation, it may not be possible to devise ways of reducing inflation without the accompanying high cost in the form of lost output. The staff notes the restiveness of labor in the past, and now, after the adjustment in real wages this year, labor may be willing to cooperate with some wage freeze or similar quantified incomes policy formula. This action could be conceived of as a necessary complement to an exchange rate policy assigned primarily to achieve anti-inflation objectives. Moreover, Turkey has quite a high level of reserves, which would enable it to defend a relatively hard exchange rate target for a limited period, and this effort might have some positive benefits. I wonder whether any such strategy has been contemplated.

Finally, with regard to the external sector, the unexpectedly large current account surplus may have also had a negative side. First, it has led to a very sharp appreciation of the currency, which, even if it has not yet done so, will, if maintained over time, affect the competitiveness of the economy. Second, it may have given the authorities a false sense of confidence that may have delayed some policy actions, particularly in the monetary area. We urge the authorities to act quickly along the general lines suggested by the staff. The current account performance also in part reflects the inflow of workers' remittances that came about because, inter alia, of increased confidence in the Turkish economy. However, these inflows would not appear to be sustainable in the current circumstances of high rates of inflation.

In conclusion, I commend the authorities on their performance over the 1980s. I agree with Mr. de Groote that Turkey has been one of our star performers--which is all the more reason that its current economic difficulties should be of special concern. The situation now is serious, and we urge the authorities to redouble their efforts in order to avoid jeopardizing the hard-won gains made earlier in the decade.

The Deputy Director of the European Department commented that it would be useful to recall the difficulties the staff had foreseen in the previous year in its assessment of the outlook for the Turkish economy. At that time, the staff had not expected the strengthening of the current account that had subsequently materialized; nor had the staff anticipated the decline in the public sector borrowing requirement that had actually taken place in 1988. And yet, at present, the staff was not surprised by the difficulty encountered so far in bringing the current high rate of inflation down. It was not easy to render those impressions mutually consistent. It was true, as Mr. McCormack had noted, that the rate of inflation had been high in earlier parts of the adjustment period. But while the rate had been high by some standards, in fact it had not reached its present levels. What was clear--and perhaps explained the evolution of the Turkish economy--was the major change that had taken place in the quality of the adjustment process in Turkey in the period since 1985. Prior to that year, adjustment had been based on opening up the economy and reducing controls, with a clear emphasis on market mechanisms; since then, the thrust of the adjustment had revolved around aggregate demand expansion as the main engine for growth. Demand increases had been instrumental in bringing the growth rate to high levels--7-8 percent per year--but the critical issue remains the soundness and sustainability of such growth rates.

In assessing developments in 1988, the staff had been somewhat puzzled, the Deputy Director continued. The staff's feeling was that the performance had been mixed: while the outcome for some important variables had been rather impressive, performance on the policy side had lagged well behind, as was well illustrated by the unevenness of monetary policy. More important, the staff had felt that the quality of the adjustment effort had worsened.

Difficulties in evaluating economic performance in Turkey were compounded by problems with the statistical data base, both in terms of quality and timeliness, the Deputy Director continued. The staff did not have sufficient grounds, for example, to ascertain whether either the fiscal deficit or the public sector borrowing requirement foreseen for 1989 were understated. The staff's impression was that, given the typical bias in the estimates, the outlook would be for a somewhat larger deficit or borrowing requirement, but it would not wish to venture beyond that statement. The authorities recognized the data problem and planned to look into it promptly; specifically, they intended to improve data collection and the quality of statistics in the state economic enterprises. The staff still did not have final 1988 data for those enterprises, but it felt that the final outcome would not be very different from the one shown by the estimates.

With regard to the external accounts, the staff had questioned the sustainability of the current account position; in so doing, the staff had focused on the cyclical factors behind the current account improvement which had been important and could change over time, the Deputy Director said. On their part, the authorities had made a strong and coherent argument that structural elements were behind the current account surplus, which suggested that the present external position might be maintained or even strengthened. The staff had not disputed this possibility but had argued that if this was the case, it provided an opportunity to open the economy further; all aspects of economic management would be helped by further liberalization, including the dilemma confronted by monetary policy in 1989 between inflation control and protection of competitiveness.

The staff considered that a strong reduction in the rate of inflation was of crucial importance in Turkey in itself and to provide credibility to the Government's policies, the Deputy Director remarked. But inflation had remained stubbornly high and, in the meantime, a marked appreciation of the real exchange rate had taken place, which did not augur well for competitiveness. The policy could be described as follows: in the past few years, the authorities had attempted to buy growth with aggregate demand expansion increases, that was to say, with inflation; at present, the approach appeared, in contrast, as an attempt to control inflation by forfeiting growth via losses in competitiveness. It was true that, in the short run, real exchange rate appreciations could help in the inflation fight, but over the longer haul the approach would be self-defeating unless accompanied by action to eliminate the fundamental imbalance behind the price pressures. The authorities were fully aware of that dilemma, which brought to the forefront the issue of the autonomy of the central bank and the strength of the implementation of fiscal policy.

In the area of fiscal policy, Directors had asked about the extent to which current spending could be controlled, the Deputy Director recalled. In the light of the large wage adjustments that had already been granted, it was clear that the scope for action on that front was limited. In the main, that explained the authorities' focus on investment for purposes of expenditure control. In that context, like many Executive Directors, the staff had pointed to the implications of further investment reductions on the growth potential of the economy and had emphasized the need for efficient investment; toward that end, it had encouraged the authorities to set investment priorities that would avoid jeopardizing the achievement of the economy's growth potential.

On the revenue side, given the authorities' objective of reducing the size and role of the Government in the economy, the staff had suggested that attention be focused on improvements in tax administration and on reductions in exemptions, the Deputy Director continued. The staff felt that there was considerable scope for increasing revenues by improving tax administration.

The autonomy of the central bank was yet to be totally established, and even if it was achieved, there would be a need to improve the instruments available to the central bank to conduct monetary management, the Deputy Director said. In particular, the bank's asset portfolio would have to be improved to give the bank an appropriate basis to engage in open market operations.

The question had been asked whether the target of a 15 percent inflation rate by 1994 was ambitious enough, the Deputy Director commented. That target had been set by the authorities, and it had been included in one of the staff's scenarios in order to show the policies that would be required to meet that target. On the basis of that analysis, the staff had concluded that the fiscal program the authorities had in mind required strengthening if the inflation target was to be reached. Some of the Turkish officials thought that the target was quite ambitious, given the current rate of inflation. However, it could be argued that, with the right policies implemented at the right time and over a sustained period, a lower inflation rate by 1994 might be attainable. It was of course difficult to know ex ante whether policies of the appropriate strength and quality would actually be put in place and sustained and, therefore, how far inflation could be reduced over the medium term.

The staff had no additional information of the status of Turkey's application to join the European Community to that provided in the report, the Deputy Director remarked. As to the references made to the Turkish population moving into Turkey from Bulgaria, it would certainly complicate domestic financial management, as it involved costs that the Government would have to bear. In all likelihood, a significantly stronger effort than initially foreseen would be required to keep the public sector borrowing requirement in line with present plans.

The staff had discussed with the authorities the possibility of Fund technical assistance in the data management area, but no concrete agreement had been reached, the Deputy Director said. Once the concrete area where technical assistance could be provided had been identified, the staff would certainly be willing to propose to the authorities available options for assistance.

A question had been posed by Mr. Enoch concerning the staff's doubt about the appropriateness of a sustained current account surplus for Turkey; Mr. Enoch had indicated that prudence was needed because the debt was large, the Deputy Director said. That was true enough, but the judgment about the desirability of a current account surplus over the medium term would have to take account of two other essential factors: one was the ability shown by Turkey to fulfill strictly all its external debt obligations at times when the current account was in deficit and the debt-service burden was very heavy; the other was the assessment of how long Turkey should be a capital exporter as opposed to a capital importer. The staff felt that, even with the present debt stock, foreign savings could be imported in nondebt creating modalities, which would make compatible some external resource inflows into Turkey with an appropriate evolution of the debt stock relative to the size of the economy.

The staff had discussed with the authorities the possibility of Article VIII status for Turkey, the Deputy Director noted. Indeed, the matter had actually been raised by the authorities themselves, as the staff had refrained from raising it, pending an assessment of whether the balance of payments position provided reasonable assurances that renewed resort to restrictions would not be necessary after undertaking the obligations of Article VIII. In this regard, the measures that the authorities had introduced in August 1989 were clearly in the right direction, and the staff would therefore resume the discussions of the issue of Article VIII status during the next consultation. The staff attached great importance to the liberalization measures that the authorities had undertaken; implementing those measures had clearly required a degree of courage, as they would likely intensify the pressure for prompt policy action.

Uncertainty seemed to be the main factor behind the lack of private investment, the Deputy Director commented. In turn, uncertainty was probably traceable to the unevenness in policy implementation and the consequent lack of clear signals and transparency that it conveyed to decision makers. In that connection, it would be important for the authorities to clearly explain their policy intentions and to keep their commitments. Another possible factor was related to inefficiencies associated with the large wedge between bank lending and deposit rates, although it was difficult to judge the extent to which that was the case as borrowing costs were tax deductible.

As to the possibility of a wage freeze, mentioned by Mr. McCormack, it was important to recall that the success of the Turkish adjustment effort was based on two critical factors: first, an appropriate real exchange rate; and, second, a large measure of real wage flexibility, the Deputy Director of the European Department remarked. Continued real wage downward flexibility in the future seemed increasingly unlikely. In fact, indexation clauses had begun to proliferate in recent wage agreements. He doubted that current conditions in Turkey were appropriate for a wage freeze and accompanying nominal exchange rate fixity, particularly given what had already happened to the real exchange rate. In general, to be effective, in addition, to an initially reasonably appropriate relative price structure, heterodox approaches based on economy-wide price freezes required transparent and strictly implemented macroeconomic policies. In contrast, approaches that permitted for price flexibility allowed better for policy departures from the intended path and need not throw the strategy off course, as prices could adjust and influence the economy in the right direction, a possibility that did not exist with a freeze.

Mr. de Groote said that the much higher than expected rate of inflation in recent months was due to the corrective price adjustments for goods and services produced by state economic enterprises, the poor harvest, and the increases in direct taxes. At the same time, as Mr. Enoch had pointed out, those factors certainly did not suffice to explain why the traditional instruments used to control the movement of prices had had so little effect in recent months. Indeed, during the period under review, there had been reinforcement of the control of liquidity creation, the public sector borrowing requirement had been reduced, and the exchange rate had appreciated. Given all those factors, the acceleration in the rate of inflation was difficult to explain.

The staff might be right that more stringent control of internal liquidity and a further reduction in the public sector borrowing requirement could exercise a positive influence, Mr. de Groote continued. And it was undoubtedly true that the behavior of state economic enterprises still caused an undesirable expansion of liquidity. But to understand the resistance of inflation to traditional means of action, one certainly had to take structural elements into account, as was noted by Mr. Hogeweg and Mr. McCormack. Those elements could be briefly summarized as the market imperfections that Joan Robinson had described. The market remained divided into many segments in which each producer and retailer retained their positions because they had privileged relations with their customers. The pervasiveness of oligopolies started with production, as a few domineering groups owned some of the important banks and retail channels; those oligopolistic tendencies moved down to the coin shops on street corners, which granted credit to local customers at unconscionable conditions out of their own cash, thus maintaining the same customers over time. There was very little searching by customers for the best price available.

The Government's policies were undoubtedly aimed at reducing structural rigidities, Mr. de Groote commented. The liberalization of imports and exchange transactions would certainly affect profit margins and the cost of financial intermediation. The measures adopted to increase efficiency in the financial sector should lead to the same result. The ongoing effort to enhance fiscal discipline and to enlarge the tax base was also intended to affect the protected position of retail channels and liberal professions, Mr. de Groote said. In addition, they would increase competition by reducing profit margins and should contribute to the education of consumers, who would be given increasingly more interesting alternatives. In sum, the various measures were designed to encourage strong supply responses. Ultimately, those responses would be based on a powerful upsurge in the population's desire to consume, and on the increasing awareness by the population of the different market conditions that could facilitate an increase in consumption. The Government's actions to correct market imperfections enjoyed very strong popular support.

In handling the very difficult trade-off between the fight against inflation and the need to support income increases that would be sufficient to meet the public demand for higher consumption, the Government also had to consider how to treat imports, Mr. de Groote commented. Importers could be expected to maintain the volume of imports only if they in turn could expect sustained income growth. There was therefore a certain rate of income growth that was necessary to make liberalization successful.

As was clear from his opening statement, he agreed with most of the Directors' various suggestions for additional demand-management measures and measures to control liquidity, Mr. de Groote said. He also agreed that it was difficult to know why the interest rates on deposits were still negative. However, much higher interest rates would further complicate the task of rehabilitating the banking sector, which clearly had a large burden to carry in the form of nonperforming loans. At the same time, high real rates would be perceived as an indication of failure in the fight against inflation. If interest rates were seen as reflecting the expected evolution of prices, and not necessarily the past evolution of prices, the reduction in the public sector borrowing requirement probably should not be sanctioned by a major increase in real rates, which in any event would not correspond to the present situation with respect to internal demand. In that connection, it was very revealing to note that the banks had serious difficulties in placing their surplus funds.

The recent short-term borrowing by the treasury from the public should be seen as a clear sign of the authorities' commitment to avoid liquidity-creating borrowing from the central bank to meet temporary upswings in the need for cash, Mr. de Groote remarked. The unfavorable harvest had led the Government to increase support prices, to disburse the support in most cases in one single payment rather than in installments, as has been done in previous years. To meet those and similar needs, the borrowing from the public, which of course entailed certain budgetary costs, had a clear announcement value in the sense that it showed the Government's decision to control liquidity creation and the authorities' commitment to fight inflation.

Foreign borrowing was limited to coverage of principal coming due, and the same rule was being applied to internal borrowing, Mr. de Groote noted. The Government was firmly committed to achieving that objective. He fully agreed with Executive Directors who had called for increasing the autonomy of the central bank, and that objective was in the process of being realized. The central bank had been given one especially substantial new instrument, namely, the elimination of the possibility for the Government to borrow from the central bank for additional expenditure, except for the renewal of principal coming due.

The authorities had decided to create a secondary market for government securities once the tax that at present burdened financial intermediation was eliminated, Mr. de Groote said. The tax on intermediation was very high and had been criticized by a number of Executive Directors.

The authorities clearly planned to reorganize the whole process of intermediation, with the assistance of the World Bank, thereby making it possible to organize a secondary market in due course.

The balance of payments forecast was based on the far-reaching ongoing changes in the structure of foreign trade, Mr. de Groote remarked. Exports had definitely become less price elastic, and the value they added to income continued to increase, as he had shown in his introductory statement; in fact, they had no equivalent in other adjusting countries during the past ten years. There was clearly a basic trend, and it was for that reason that he believed that he was not being overly optimistic in considering that the trend would continue. It was also useful to note that the elimination of duties on imports would have a substantial effect on industrial imports and, therefore, on exports, as well as on the finances of state economic enterprises. At the same time, some of those enterprises would have to be privatized. Some of those enterprises would be reorganized on the occasion of minority participation by foreign capital, and other enterprises would have to be dismantled.

His authorities fully realized that enhanced competition from abroad would exercise its strongest impact on state economic enterprises, and that the enterprises would be able to resist only if they were rapidly reorganized, Mr. de Groote went on. The ongoing negotiations with the World Bank on industrial rehabilitation should contribute to a positive outcome.

The need to reorganize fundamentally the whole sector of state economic enterprises explained the priority that was given to the continuous improvement in the country's infrastructure, as was shown by the spectacular improvements in telecommunications and transportation, including the functioning of the Istanbul airport and the modernization of many harbors, Mr. de Groote said. In some cases, foreign interests had also taken up a share of the rehabilitation of infrastructure--for example the construction of the World Trade Center in association with the Bectel Company. All the improvements in infrastructure, to which the World Bank had greatly contributed, provided the background for the sound development of modernized and competitive enterprises that could be gradually detached from the still overprotected state economic enterprise sector.

The appreciation of the exchange rate was one of the instruments that his authorities had relied on to control price increases, which would otherwise probably have been even larger, Mr. de Groote commented. They intended to continue to let the exchange rate respond to basic market forces. In addition, the expected increase in imports resulting from liberalization, as well as the need for the banks to make reimbursements toward the end of 1989 for increases in advances from foreign correspondents, would probably lead to a moderate downward adjustment in the exchange rate. Such an adjustment would be welcome in terms of its potential positive effects on the current account, but it would only be considered once the inflation rate had clearly fallen. Such an adjustment would of course go some way toward meeting the concerns that had been expressed by several Executive Directors. He agreed with Mr. Pétursson that the exchange rate was especially important in terms of its effects on tourism, but he did not agree that the appreciation of the exchange rate entailed a special risk, because profits of exporters would already be low. The paradoxical fact, of course, was that profits of exporters seemed to be substantial; exports to the OECD area had expanded substantially. The quotas maintained by the OECD served paradoxically to increase the profit margins of the exporters that faced the quotas; that was one of the strange side effects of the insufficient degree of liberalization in OECD countries.

It was important to note that, during the past month, the exchange rate market had been in equilibrium, Mr. de Groote said. The absence of pressure on the foreign exchange rate was clearly indicated by the fact that the central bank had purchased foreign currencies in an amount equivalent to approximately $100 million--clearly a limited amount--during the past three months, and there had been no need to support the currency during that period. Another expression of confidence was the regularity in the amount of gold purchases by the public from the banks and the absence of any indication that the public would have to exercise a preference for gold against local currency. The Turkish lira was more convertible than many Executive Directors might have realized; it was possible for Turkish citizens to buy gold from the banks against Turkish lira, and that gold was supplied by the central bank, which obtained the gold on consignment from abroad at the market price. Hence, there was indeed convertibility in the traditional sense that corresponded to the traditional habits of the population. That important barometer of confidence had reacted positively in recent months mainly because the public's confidence in the Government's determination to continue the liberalization process, including the integration of Turkey in the international markets.

Other signs of that confidence were the fact that remittances were high and that direct investment in small- and medium-sized enterprises with funds repatriated from abroad was spreading in all areas, Mr. de Groote continued. In many respects, the reactions of the public in Turkey were the same as those observed some time ago in Spain, and they explained the confidence that the Government continued to enjoy in its basic option of favoring the rapid integration of the country in the world economy.

The timing of the convertibility measures was appropriate because demand was very slack, Mr. de Groote commented. Those measures had to be introduced at a time when one would expect that they would give rise immediately to a boom in import demand. His authorities hoped that the move to convertibility would be gradually digested over the coming months, and would have only a very gradual, progressive effect on the exchange rate in the direction that he had indicated.

Several Executive Directors seemed to feel that Turkey lacked medium-term policies, Mr. de Groote commented. In that connection, there might well be some misunderstanding about the authorities' policy stance. The adjustment in Turkey was different from adjustment efforts elsewhere in the sense that the Turkish approach definitely was not gradualistic, and one medium-term goal--integrating Turkey into the world markets--had given a clear direction to all Turkish policies since the beginning of the 1980s. Strong measures were taken at carefully chosen moments to implement that basic goal--for example, the liberalization decisions of the early 1980s and August 1989. Establishing a rigid plan that would remain vulnerable to external shocks, such as the exogenous evolution of external prices, would hamper the Government in the achievement of its basic aims by wrongly giving the public the impression that a setback was occurring whenever the plan had to be adjusted for external circumstances. Developments in recent years clearly showed that Turkey's progress in dismantling rigidities and making structural adjustments had been achieved through very strong decisions that had always gone far beyond what the Executive Board had expected, and he was confident that that trend would be continued in the coming years.

The staff had mentioned the idea of the qualitative progress of the adjustment in Turkey, Mr. de Groote recalled. Major changes in that area could certainly be expected. The authorities had no other basic option than to integrate rapidly Turkey into world markets. The results had been spectacular during the past nine years, and the Prime Minister had recently confirmed that it remained his fundamental decision to continue to accelerate the pace of that progress in the coming months, and the Prime Minister's efforts clearly enjoyed strong popular support.

The treatment of the Turkish population in Bulgaria was clearly a violation of human rights, Mr. de Groote said. The Turkish residents of Bulgaria had always been active and productive and had been considered loyal citizens. They had been used in their traditional homeland to a pluralistic society and a divergence of religious and ethnic backgrounds. In the circumstances, they had undoubtedly been placed in a traumatic situation when they had to leave Bulgaria, and international public opinion should certainly attach more importance to that situation than it had thus far. His Turkish authorities clearly attached to that situation the importance that it deserved. At the same time, the budgetary implications of the refugee movement should not be overestimated, for a number of reasons. First, there was an extraordinarily high level of family solidarity in Turkey, and families had not broken their traditional links with relatives living in Bulgaria. Most of the families returning to Turkey from Bulgaria were, for a transition period, benefiting greatly from those traditional links. Even families returning to Turkey who did not have relatives in the country were benefiting from the general tradition of social solidarity in the country; hence, before resorting to government assistance, the refugees had some means of private assistance. The main economic effect of the migration appeared to be a likely loss of highly skilled labor and national income in Bulgaria.

The authorities were fully aware of the slippage in the area of price performance, Mr. de Groote commented. They were aware that the inflation had political implications, and they were firmly determined to act. He hoped that the Government would continue to enjoy the Board's strong support in the coming period.

The Acting Chairman made the following summing up:

Directors paid tribute to the major economic achievements of the Turkish authorities in the 1980s. The determined pursuit of policies of adjustment, economic restructuring, and liberalization had produced a more outward looking and more efficient economy, thus fostering balanced growth. However, developments in recent years contained elements of an interruption in that process and of retreat from the strong and transparent medium-term focus of policy earlier in the decade. In that context, Directors observed that, while performance in the Turkish economy had yielded positive results on some fronts in 1988--especially the remarkable external current account surplus--inflation had continued to accelerate, and growth and investment, particularly in the manufacturing sector, had slumped. In the view of Directors, this reflected an uneven stance of macroeconomic policy management with perhaps too much emphasis on short-run considerations.

Domestic developments and prospects in 1989 were a source of concern on several fronts. Directors noted the rapid growth of liquidity in a setting of negative real interest rates, which, in combination with high wage increases, had resulted in a sharp reacceleration of inflation. This remained the most critical problem facing the authorities. Directors welcomed the recent reassurances of the Turkish authorities in that regard and urged the pursuit of sustained and strict financial policies as a prerequisite for inflation control and for the efficiency of the recent liberalization measures. Such a strategy was seen as necessary for the resumption of sound growth in the economy, and thus to avoid the present unfortunate indications of what some Directors referred to as stagflation.

Directors welcomed the substantial cut in the public sector borrowing requirement in 1988. However, questions were raised as to both the quality and the sustainability of the adjustment achieved. The weakness of direct tax revenues was of particular concern. Directors welcomed the authorities' intention to improve tax administration and collection, by reducing exemptions and improving auditing, and stressed that there was ample scope for action to strengthen tax buoyancy.

Directors stressed the need for a further significant cut in the public sector borrowing requirement in 1989. The large pay awards granted to both civil servants and workers in the state economic enterprises would make achievement of this a difficult task. In the absence of new initiatives to contain current outlays, which were seen to be urgently required, the bulk of the adjustment would have to continue to fall on investment expenditures, which, as many Directors noted, were already sharply curtailed in 1988. To minimize the adverse impact on growth, appropriate priorities would have to be set in the choice of investments. Measures were also needed to improve the efficiency of the state enterprises, which remained a substantial drain on the budget.

Directors expressed concern as to the timeliness and quality of the fiscal statistics in Turkey. The lack of adequate statistics could lead to serious difficulties for policy-makers, and the authorities were encouraged to move swiftly to improve matters on this front, with technical assistance from the Fund as needed.

Directors generally agreed that monetary policy in 1988 had been uneven and thus had impaired monetary policy credibility. To an important extent, this reflected the lack of autonomy of the central bank, but it was also noted that the difficulties had been compounded by the failure to maintain positive real interest rates for much of 1988. Several Directors expressed concern about the reluctance of the authorities to announce monetary targets in 1989. Directors called for a steady and transparent strategy for monetary policy, which they felt to be an essential element of the anti-inflationary program. Real interest rates on Turkish lira deposits appeared once again to be negative, a development which would result in additional inflationary pressures, and possibly compromise the balance of payments performance.

Directors welcomed the recent protocol between the central bank and the Treasury limiting the scope for short-term advances and providing for the clearing of Treasury arrears to the central bank. They urged that further steps to bolster the central bank's autonomy be taken. Directors noted that, in contrast with real deposit rates, which were negative, real lending rates were very high, due largely to the heavy taxation of financial intermediation. They stressed that this level of taxation encouraged disintermediation and could further endanger the health of the banking system, and urged the authorities to reduce it promptly. More generally, Directors encouraged continued financial sector reform to strengthen the banking system and permit the financial sector to play a stronger role in mobilizing savings and allocating them to productive investments.

On the external side, Directors welcomed the strengthening of the current account in 1988. While noting that some factors contributing to the strong current account were likely to be sustained--tourism and other invisibles were mentioned--some

Directors stressed caution concerning the sustainability of the current account surplus. Several Directors noted that the improvement in the current account had posed a dilemma between inflation control, through its effects on monetary policy, and the protection of competitiveness, through its impact on the exchange rate. They welcomed the recent import liberalization measures, which would not only have beneficial longer-term structural effects, but also dampen inflationary pressures in the short term. A number of Directors expressed concern about the rapid real appreciation of the exchange rate in 1989, especially in view of the recent signs of weakening in the current account. Such an appreciation would not only impair competitiveness, but also have potentially adverse implications for the capital account. While welcoming recent measures to enhance the convertibility of the Turkish lira, Directors stressed that the greater openness of the exchange and trading system made the correction of internal imbalances all the more urgent. In that context, the hope was expressed that continued external strength would lead the authorities to move to Article VIII status in the Fund.

Directors generally welcomed the emphasis of the Sixth Five-Year Plan on strengthening market forces and the role of the private sector. Directors welcomed the recent improvement in Turkey's external debt indicators, and the further progress envisaged in that area in the Plan. Directors felt, however, that the macroeconomic targets in the Plan, particularly for growth and inflation, while desirable, would be difficult to achieve, given the proposed stance of policies and the possible slippages in 1989.

In sum, it was clear that speakers were unequivocally of the view that the achievement of the Plan's objectives would require a resolute return on the part of the authorities to the steady medium-term orientation of policies that had been adhered to earlier in the decade if they were to achieve growth with price stability and external competitiveness.

It is proposed that the next Article IV consultation be held on the standard 12-month cycle.

The Executive Board then approved the following decision:

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

2. Turkey maintains the exchange restrictions described in SM/89/167 under the provisions of Article XIV, Section 2, except that a multiple currency practice arising from the system of import guarantee deposits is subject to approval under Article VIII, Sections 2(a) and 3, and bilateral payments agreements with Fund members give rise to exchange restrictions subject to approval under Article VIII, Section 2(a). The Fund regrets the continued maintenance of a multiple currency practice embodied in the system of import guarantee deposits and the remaining bilateral payments agreements with Fund members. The Fund welcomes Turkey's intention of eliminating in 1989 the system of import guarantee deposits and encourages Turkey to eliminate the other restrictions as well, as soon as possible.

Decision No. 9247-(89/121), adopted
September 11, 1989

3. NIGERIA - 1989 ARTICLE IV CONSULTATION, AND REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff report for the 1989 Article IV consultation with Nigeria (SM/89/174, 8/14/89; and Cor. 1, 8/23/89) and a staff paper on the review under the 18-month stand-by arrangement for Nigeria approved on February 3, 1989 (EBS/89/159, 8/14/89; and Cor. 1, 8/23/89). They also had before them a background paper on recent economic developments in Nigeria (SM/89/175, 8/18/89).

Mr. Monyake made the following statement:

On behalf of my Nigerian authorities, I would like to express my appreciation to the staff for the incisive presentation of their reports on both the 1989 Article IV consultation and the first review under the stand-by arrangement. The authorities are in broad agreement with the thrust of the staff appraisal. Indeed, I am instructed to reassure the Executive Board of Nigeria's resolve to remain firmly committed to the implementation of its structural adjustment program for the attainment of an early recovery of the economy and maintenance of a sustainable growth and viable balance of payments position.

The performance of the Nigerian economy since the previous Article IV consultation has been sufficiently explained in the staff report, and I will therefore avoid repetitions. However, I wish to stress that in 1988/89, the outturn of performance has been better than anticipated under the program, in most respects--notably, GDP growth, which was more than twice the anticipated growth rate, the substantial reduction of fiscal and external sector imbalances, and the observance of stipulated credit targets. It is noted that less progress was, however, attained on the inflation front and with respect to exchange rate developments. In these areas, the authorities have met serious challenges, which are being addressed with a view to finding early and lasting solutions. Meanwhile the current demand-management policies have been strengthened, while additional measures are being designed to address other structural weaknesses in the economy.

Budgetary tightening has been the main thrust of fiscal policy, involving a substantial cut in nondebt service outlays and reductions in subsidies and transfer payments to parastatals. As already outlined in the staff reports, the outturn of fiscal performance showed considerable improvement during the review period. The overall budget deficit, on a commitment basis, declined to 10.8 percent of GDP at the end of 1988, compared with 16 percent six months earlier. The ratio is expected to decline further to 8.1 percent in fiscal year 1989, compared with 12.1 and 9 percent program targets for 1988 and 1989, respectively.

The need to improve revenue mobilization efforts is recognized and the authorities have already taken steps to ensure enhanced non-oil receipts by broadening the tax base and instituting measures to increase the efficiency of tax collection.

The stance of monetary policy has remained restrictive, and observance of stipulated credit targets is being rigorously enforced. The central bank stands ready to reinforce these measures from time to time, as it did in April and June 1989, when the problem of excess liquidity in the banking system became worrisome. Also, a stabilization account has been established at the central bank to neutralize the expansionary impact of increased earnings from oil exports in excess of $16 per barrel.

The impact of these measures has been salutary in terms of keeping the banks on track in observing prescribed credit targets and attaining moderation in the growth of narrow money. The threat to the stability of the banking system, following the withdrawal of public sector deposits in June 1989 highlighted in the staff report has been effectively handled by the central bank. The central bank has been supportive of the system, so as to avoid a confidence crisis in the financial system and to ensure a smooth payments system. Nevertheless, the central bank continues to monitor developments and will take prompt corrective measures when necessary. Already, surveillance of the banks has been strengthened and the central bank's efforts are being complemented by the newly established Nigeria Deposit Insurance Corporation (NDIC).

My authorities attach great importance to the use of interest rates as an instrument for enhancing resource mobilization and allocative efficiency. This underlines its policy of interest rate deregulation since 1986. The principle of official determination of the treasury bills issue rate which appears to be the only remaining shackle restraining greater flexibility of interest rate movement, will be removed when the system of treasury bills issue by tender takes off this month. It is anticipated that the rise in nominal interest rates, which is likely to emerge, and the anticipated decline in the current high rate of inflation will facilitate the attainment of a positive real rate.

The overall balance of payments position worsened in 1988 due partly to the weakening of oil export prices and due largely to the high level of debt-service payments. As the deficits increased, further external payments arrears were accumulated and the level of official reserves was depleted to finance the deficit gap. Indeed, these developments constrained the ability of the authorities to adequately fund the official foreign exchange market, thus causing a further slide in the naira exchange rate.

In 1989, however, developments in the external sector showed some improvement as a result of increased oil prices. But debt-service payments are expected to absorb a considerable proportion of the increased export earnings. This followed the rise in international interest rates above program estimates and the likelihood that outstanding debt may exceed what was officially recognized initially. In addition, other foreign payment commitments are expected to be met, particularly those relating to the maintenance and investment spendings in the oil sector. Furthermore, Nigeria faces the compelling need to build up its external reserves, which have fallen substantially below the conventionally acceptable level; the current level is less than one month of imports. Indeed, considerable efforts were made to raise the level of gross external reserves by the end of June 1989.

Notwithstanding all these constraints, my authorities are prepared to meet all legitimate debt obligations. Except where the amount of debt outstanding is in dispute, such as claims by Paris Club creditors put at $6 billion above the amount officially recognized (and for which adequate provisions have been made in an escrow account pending the outcome of the ongoing reconciliation exercise to resolve the conflict), Nigeria has to date met all its officially recognized debt-service payments, including the arrears accumulated in 1988. I must add here, however, that the task has been a difficult one and has crystallized into a situation in which one third of the country's export earnings finance debt servicing; and this is projected to rise to about 50 percent in 1990, even after rescheduling. Investment spending has therefore been seriously constrained.

It is significant to note that the implementation of this program has been pursued with total commitment and, sometimes, under severe social tension and in an atmosphere of strong political pressures. At this stage, I would like to draw the attention of the Executive Board to the request by my authorities for an early review of the existing program to allow for adjustments of some of the performance targets under the existing arrangement. This has become necessary in view of the changes in some key variables that are exogenous and were not foreseen when the current program was framed in December 1988. Important among such variables are the rise in oil export prices above the original projection; the higher rate of inflation than was assumed in the program; the substantial depreciation of the naira, in excess of what was anticipated; and the rise in international and domestic interest rates, which has added to the debt-service burden. The required adjustments of the performance targets, the details of which are contained in Table 5 of EBS/89/159, prepared in consultation with the Fund staff, will in no way represent a weakening of Nigeria's reform efforts.

Before I conclude by taking a look at the medium-term growth prospects of Nigeria's adjustment program, I will comment briefly on the two major problem areas raised by the staff.

First, I would like to emphasize that my Nigerian authorities share the concern of the staff about the two closely related problems of the high inflation rate and the wide spread existing between the official naira exchange rate and the parallel market rate. As the staff has noted, the authorities have been taking steps to address both problems, and I can assure the Board that they remain flexible and will adjust their policies and adopt additional measures if the problems persist. Maintenance of budgetary discipline, which has been accorded high priority, and the recent amendments to the central bank's monetary policy measures are considered to be steps in the right direction and have in fact shown encouraging results in moderating the intensity of both problems.

With regard to exchange rate policy, the staff has rightly observed that the authorities have refrained from direct intervention in the foreign exchange market. Nonetheless, developments are being closely monitored with a view to taking appropriate policy measures that can influence the market. The measures taken by the authorities lately have led to a precipitous change in the parallel market rate and have narrowed the gap between the two market rates. It is also expected that, as the supply situation in the official funding of the market improves, the gap will be further narrowed. It may also interest the Board to note that the authorities have licensed a number of bureaux de change to further reduce the relevance of the parallel market in the system. Three such institutions commenced operations in August 1989. However, caution should be exercised to avoid relying on the parallel market rate as a true index of currency overvaluation. There is some premium built into this rate, for obvious reasons, and it cannot be taken as an equilibrium rate. However, my authorities will continue to monitor the situation and will maintain a flexible approach, having in mind the objective of ultimately achieving a unified rate at an appropriate level determined by the interplay of market forces.

On the inflation front, my authorities believe that, while demand pressure is a major cause of inflation, it should be admitted that there are other structural elements in Nigeria's inflation problem. It is admitted that in dealing with this problem the current strong demand-management measures should continue. However, they have to be complemented by other policy initiatives, which would enhance the supply situation generally and arrest the deterioration in the value of the naira as a strategy for cost reduction. There is optimism on the part of the authorities that a buoyant crop harvest expected this year, given the favorable weather conditions, will, from September, contribute to a substantial reduction of the inflation rate.

The success achieved to date reflects the commitment of the authorities to the program, with an understanding that the medium-term growth objectives of the country would be met through the structural adjustment efforts. However, it appears that this optimism is weakening, as the medium-term outlook of the economy remains precarious. Any future deterioration in the oil industry would, to the mind of the authorities, stall growth prospects and reduce external balance viability. Saddled with a heavy debt burden, my authorities believe, and have emphasized, that it would be extremely difficult for the Government to promote a development-oriented economic policy when a substantial proportion of its resources is used for foreign debt servicing. In order to achieve its medium-term growth objectives, therefore, Nigeria requires generous debt relief from its commercial creditors and a substantial reduction in its official debt under the Toronto initiative. It is expected that the Executive Board will lend its support to Nigeria's appeal in this regard. It has always been the view of this chair that adjustment efforts become meaningful only when they facilitate the restructuring of the economy to achieve increased productivity and diversification of its productive base.

Mr. Enoch made the following statement:

When Nigeria's stand-by arrangement was approved in February 1989, many Directors emphasized the uncertainties surrounding the program assumptions and strongly urged the authorities to show flexibility and determination in keeping the program on track. These warnings have proved to be well founded. In the few months since our last discussion, there have been significant changes in many of the key assumptions underlying the program. Nevertheless, with a mixture of good fortune and good management, the authorities have been able to keep broadly to the original program targets, and for this they deserve our commendation.

Indeed, in some respects the performance of the economy has been better than expected. Clearly the oil sector has benefited significantly from the buoyancy of world prices. However, more encouraging for Nigeria's medium-term prospects, the growth in the non-oil sector now looks likely to be somewhat firmer than was originally projected. To some extent, the improved performance of the non-oil sector reflects the boost given to competitiveness by the sustained real depreciation of the naira over recent years. However, it also provides evidence that the liberalization program launched by the authorities in 1986 is already beginning to have a material impact on the country's prospects.

Nevertheless, for the foreseeable future, these prospects will remain clouded by Nigeria's continued vulnerability to the vagaries of the world oil market, and by the existence of deep-seated structural weaknesses in the economy, which are reflected in Nigeria's low sustainable growth rate. As the authorities recognize, unless this growth rate can be improved over the medium term, it will be impossible to satisfy the population's aspirations for higher living standards after the collapse in per capita income in the period since 1980. However, it is also clear that the need to improve per capita income underlines the importance the authorities should attach to the process of stabilization and adjustment. Attempts to alleviate poverty by relaxing macroeconomic policies have not worked in the past and are unlikely to succeed in the future. Indeed, the experience of the past few months suggests that social unrest in Nigeria is more likely to be provoked by the inequitable effects of inflation than by prudent measures to restore domestic equilibrium.

It is this inflationary threat that has emerged as the major problem currently confronting the Nigerian economy. With hindsight, it is clear that the inflationary momentum already present in the economy was considerably underestimated at the time the program was designed. This seems to have been the result in part of statistical deficiencies, and I endorse the staff's comment that the authorities need urgently to improve their statistical information. Hopes that the inflationary momentum would be reversed by a strong agricultural supply performance have so far not been realized, partly because this failed to take into account the significance of expectations in sustaining the inflationary process.

The authorities' response to the increase in inflation has been encouraging, although in some respects it has fallen short of what the program called for. On the positive side, the authorities have moved decisively to keep fiscal policy on track, despite the temptations provided by the surge in oil revenues. Indeed, in the face of a sharp increase in foreign interest payments and the need to allocate somewhat more spending to social programs, the authorities have acted in a determined fashion to keep other government spending under firm control, despite the pressures caused by higher inflation. While this provides further welcome evidence of the authorities' political commitment to the program, I think that if a further tightening of policy proves necessary, the main priority should be to raise government receipts and to reduce parastatal and petroleum subsidies. Perhaps there is also scope to increase further the differential in the two-tier petrol price to reduce effective subsidies on at least a proportion of sales.

The progress in monetary policy has been more uneven. It is disappointing to see that the authorities have been slow to introduce positive real interest rates, despite increasing signs earlier this year that the liquidity overhang in the economy was more substantial than had previously been thought. On the other hand, as inflationary pressures mounted, the authorities decided to implement a sharp monetary squeeze with a set of measures in April and June designed to reduce--through more direct means--both the demand for and the supply of naira credit. Preliminary indications are that these measures have indeed sharply reduced bank liquidity, pushing up domestic interest rates. However, as the staff points out, until the treasury bill rate is fully liberalized, domestic interest rates will not fully reflect market conditions. I would be interested to hear whether this interest rate anchor was in fact removed at the end of August as agreed. Mr. Monyake has suggested that the new auction system will be coming into play this month, but I would welcome confirmation that this is in line with earlier assurances. In addition, I would find it useful to have the staff's latest assessment of the impact on the banking sector of the recent monetary squeeze. How real is the danger that a confidence crisis might emerge? Does the staff have serious concerns that such a crisis could push the program significantly off track?

The authorities have tended to attribute the recent surge in inflation to the large depreciation in the naira seen at the start of this year. This view has had two unfortunate consequences. First, it initially led to delays in identifying the appropriate policy response. Second, it perhaps discouraged the authorities from adopting, as wholeheartedly as they had originally intended, the key objective of exchange rate unification.

In some respects, the reform of the exchange rate system was a cornerstone of the authorities' stand-by arrangement, and it is therefore regrettable that this reform has not been followed through. The continuing wide differential between the official and parallel rates has not only reduced the foreign exchange resources of the central bank, but also encouraged widespread speculation; and the existence of any differential strongly suggests that the official rate has not been determined by market forces, despite the authorities' assertions to the contrary. I fully agree with the staff that the exchange market issue is probably the most important one that the authorities now have to face, and I would be grateful to receive a clearer indication from the staff of when the differential is likely to be eliminated and by what means.

Notwithstanding the fact that the official exchange rate remains overvalued, Nigeria's external position in 1989 is likely to be stronger than originally expected, mainly as a result of the sharp rise in oil prices. However, this prospect should not obscure the fact that Nigeria's medium-term prospects are likely to remain difficult. In the near term, a new uncertainty has entered the frame, namely, the disagreement between Nigeria and her official creditors on the size of the country's outstanding debt. While resources have prudently been put aside to meet possible additional debt-service payments arising in 1989, it is not clear that similar provision has been made for payments arising in future years. Clearly it is very important that agreement be reached soon on the size of Nigeria's debt.

The authorities' determination to keep the program on track against a shifting external background, and their willingness to take tough measures in the face of growing domestic unrest, provide considerable reassurance that they are prepared to see the adjustment process through. In these circumstances, I fully support the proposed decisions.

Mr. Mawakani made the following statement:

We are greatly encouraged to note that, despite the expansionary policies of the first half of 1988 and the many uncertainties that surrounded the 1989 program at its inception, the performance of the Nigerian economy was quite satisfactory in

1988 and, so far in 1989, it has turned out better than programmed. Noteworthy are the overachievement of most of the indicative targets for end-December 1988, the rate of economic growth--which was more than double the target for 1988--the impressive fiscal performance, and the observance of the performance criteria for end-March 1989. While it is undeniable that the favorable price developments in the oil market helped to some extent in the achievement of these results, full credit should be given to the Nigerian authorities, who have shown an unfaltering determination in adhering to the adjustment program in the face of strong social pressures.

The staff reports suggest that there is a convergence of views between the Nigerian authorities and the staff on the required modifications in policy direction and the areas where the authorities need to focus their attention during the remainder of the program period in order to consolidate the gains achieved so far. I am in broad agreement with the staff appraisal, and I will comment on the social aspects of the program and on the two main areas where performance has been disappointing, namely, inflation and the exchange rate. I will then conclude with the external debt situation.

When the Board considered Nigeria's request for the current 15-month stand-by arrangement, this chair, among others, expressed concern about the absence of specific compensatory measures targeted at the most vulnerable segments of the population and the continued deteriorating standard of living. The heavy reliance on expenditure reduction measures in the authorities' fiscal adjustment efforts might have exacerbated the adverse impact of the program on these groups. Without questioning the Nigerian authorities' commitment to the adjustment program--in fact, they have demonstrated their commitment beyond any doubt--it will be unrealistic to expect further fiscal tightening through additional compression of current expenditures. In this regard, we welcome the Nigerian authorities' move to restructure expenditure and their intention to shift the focus of their fiscal adjustment efforts to revenue mobilization in order to enable them to allocate more resources to the social sectors. We welcome in particular the creation of the special fund to finance various programs, such as job creation for unemployed graduates, the provision of supplies of medicines to hospitals and clinics, and maintenance of public transportation. However, in view of the magnitude of the social needs, the amount of the special budgetary allocations appears modest, and we urge the authorities to devote more resources to that purpose, if the revenue mobilization efforts permit this. At the same time, donors could help in funding specific programs geared at protecting the most vulnerable groups.

As to the performance on the inflation and exchange rate fronts, the Nigerian authorities are understandably frustrated by the slow progress being made despite the implementation of a restrictive fiscal policy and the tightening of monetary policy. We share the authorities' view that the price increases and the depreciation of the exchange rate are mutually reinforcing. This is one of the major drawbacks of the system of continuous depreciation of the exchange rate in the official exchange market to catch up with the rate in the parallel market, which is itself a moving target. It creates a vicious circle in which the depreciation of the exchange rate translates into higher domestic prices, which, in turn, contribute to further depreciation. Moreover, such a system encourages speculation against the national currency, since economic agents continuously anticipate further depreciation. It is fair to recognize that, in the case at hand, excess liquidity in the system has nurtured the speculation by making available the necessary resources. The circle has to be broken, and we concur with the authorities that reducing the excess liquidity in the system would ultimately dry up the sources of the speculation and lead to a stabilization of the naira exchange rate. We also agree that the structural aspect of the problem should not be overlooked. Indeed, an improved supply situation in the economy would help arrest the continuous deterioration in the value of the naira.

We note with concern that, despite the debt relief obtained from both the Paris and London Clubs, foreign debt service, at ₦ 17 billion, claimed more than 50 percent of federal government revenue in 1988. It is even more worrisome to note that, before debt rescheduling, the debt-service ratio will exceed 70 percent of exports of goods and nonfactor services in 1989 and 1990 and stay well over 50 percent in the period to 1993. Against this backdrop, we cannot but agree with the staff that this situation points to the need for Nigeria to receive more generous debt relief than it has received in the past. Like the Nigerian authorities, we feel that, given the country's IDA-qualifying per capita income, there is a case for considering its eligibility for the Toronto initiative. In any event, Nigeria's external debt situation underscores the need for substantial debt reduction to be undertaken with concessional resources. Such an operation would ease Nigeria's debt overhang and free the much-needed resources to achieve sustained economic growth in order to give hope to the Nigerian people and enhance their support for the adjustment process.

I support the proposed decisions.

Mr. Serre made the following statement:

Considerable progress has been made in implementing the stabilization and structural adjustment measures agreed under this program. The strong commitment demonstrated by the authorities as well as the favorable increase in the price of oil exports have greatly contributed to offset the uncertainties which surrounded the adoption of the program last February. However, as the staff underlined, inflationary pressures remain heavy, and difficulties persist in managing the exchange rate policy with a view to reducing the spread between official and parallel markets. As the staff reports make clear, close monitoring of this program is needed in order to reassess further developments and to adopt policies in line with the underlying economic situation. In this respect, two recent developments deserve to be emphasized: the lack of consistent economic indicators has caused substantial setbacks in readjusting overall policy implementation; and difficulties encountered in the external sector have been due mainly to the delayed implementation of the revised exchange rate system at the beginning of 1989, which induced the emergence of a parallel market. Thus, given the sensitivity of this program to both internal and external shocks, we urge the authorities to be aware of the downside risks associated with allowing imbalances.

I will now comment on the different aspects of the program, dealing successively with macroeconomic policies, the external sector, and the medium-term prospects of the economy.

Despite the high rate of inflation, the Nigerian authorities are to be commended for having met most of the indicative targets for the end of December 1988 and the performance criteria for the end of March 1989. We also welcome the better growth results observed in 1989 in the oil sector and in the other sectors of the economy.

However, in the context of inflationary and exchange rate pressures, budgetary policy should remain an important tool in the adjustment process, especially as additional measures are requested to cope with changes in the economic environment. If the momentum of adjustment is to be maintained, there is very little room for complacency in this area, given the weight of the debt service. The authorities should now pay more attention to raising and streamlining government revenues. Despite their impact on transportation costs, increasing domestic petroleum prices should be useful at this stage, and we would appreciate some comments from the staff on this aspect of fiscal policy. On the expenditure side, the assistance provided by the World

Bank and other donors during fiscal year 1989 offers an opportunity to reorient non-oil sectors of the economy in a durable manner through the financing of investment expenditures and through quick disbursing sectorial lending.

As to policy, we welcome the measures undertaken three months ago to reduce the liquidity of the financial system. Nevertheless, we share the staff's concerns regarding the potential risk of reducing confidence in the system. Decisive action needs to be taken in this area to address present weaknesses. Moreover, the attainment of positive real interest rates is an indispensable part of the whole process of restoring a sound financial and banking system through a market-oriented scheme.

With respect to the external sector, we agree with the staff that additional measures should be required to complement the recent actions undertaken in the monetary area. Improving the situation will depend mainly on the authorities' ability to control speculation and on repatriation of resources held abroad. Are there further indications from the staff on the level of repatriation flows?

On a broader basis, this program has stayed on track because of exceptional conditions defined by the Paris Club as well as strong external financial support. A close monitoring of balance of payments developments is of the utmost importance. We hope that bilateral agreements will make debt reconciliation possible, given the modifications that occurred in the international environment, particularly higher interest rates. In this respect, we welcome the creation of an escrow account. Furthermore, the high level of the overall balance deficit, together with the persistence of large financing gaps until 1994, will remain a cause for concern. Finally, the uncertain oil price prospects is a major constraint on the successful outcome of this program.

This leads me to the medium-term prospects of the economy. During the discussion on Nigeria in February 1989, this chair underlined the fact that this program was a transitional one that aimed primarily at reducing financial and external imbalances. Nigeria needs to diversify its economy by expanding the non-oil sectors and pursuing strong structural reforms. Appendix II of the staff report, which is devoted to relations between Nigeria and the World Bank, provides useful information on this matter. Some comments from the staff on the impact of these various operations on the medium-term outlook of the program, particularly the balance of payments prospects, would be appreciated. Finally, in the process of diversifying the economy with regards to the scarcity of budgetary resources, we urge the authorities to limit public investment to projects with the greatest return.

In conclusion, further efforts are needed to keep up the momentum of the adjustment program, given the precarious medium-term outlook, particularly as the forecast balance of payments equilibrium for 1995 is based only on optimistic assumptions about further developments in international oil prices. In demonstrating their willingness to move ahead, the authorities deserve the support of the international financial community. In addition, we welcome the fact that special attention has been devoted to social measures in the Government's budget. There is no doubt that, at this stage, the program needs to be supported by the population. We support the proposed decisions.

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

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/89/120 (9/8/89) and EBM/89/121 (9/11/89).

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and by Advisors to Executive Directors as set forth in EBAP/89/213 (9/7/89) is approved.

APPROVED: May 2, 1990

LEO VAN HOUTVEN
Secretary