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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 89/167

3:00 p.m., December 20, 1989

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	C. Enoch
	G. C. Noonan
	D. Powell, Temporary
Dai Q.	
T. C. Dawson	C. S. Warner
	B. S. Newman, Temporary
	J. Prader
	L. Hubloue, Temporary
	S. M. Hassan, Temporary
E. A. Evans	S.-W. Kwon
	R. J. Lombardo
L. Filardo	G. García, Temporary
	G. Montiel, Temporary
	N. Kyriazidis
	A. Fanna, Temporary
	A. M. Othman
	M. B. Chatah, Temporary
	N. Morshed, Temporary
M. Fogelholm	A. Gronn, Temporary
M. R. Ghasimi	O. Kabbaj
G. Grosche	H.-J. Scheid, Temporary
J. E. Ismael	T. Sirivedhin
	L. E. N. Fernando
A. Kafka	L. M. Piantini
	G. Bindley-Taylor, Temporary
J.-P. Landau	J.-L. Menda, Temporary
Mawakani Samba	J.-C. Obame, Temporary
	M. Al-Jasser
	G. P. J. Hogeweg
K. Yamazaki	K. Ichikawa, Temporary

L. Van Houtven, Secretary and Counsellor
M. J. Miller, Assistant

Also Present
IBRD: K. Ikram, D. M. Leipziger, Asia Regional Office; W. Grais, Europe,
'iddle East and North Africa Office Regional Office. African Department:
L. Bornemann, Deputy Director; E. A. Calamitsis, Deputy Director;
R. Andely, S. J. Anjaria, C. Briançon, M. de Zamaroczy, G. Devaux,
. H. Diogo, J. Khallouf, T. K. Morrison. Asian Department:
Narvekar, Director; H. Neiss, Deputy Director; B. Banerjee,
ngartner, M. J. Fetherston. Exchange and Trade Relations Department:
', Deputy Director; A. Basu, C. V. A. Collyns, R. M. Schramm,
'man-Valavi, R. L. Zandamela. IMF Institute: I. Otani. Legal
nt: W. E. Holder, Deputy General Counsel; R. H. Munzberg, Deputy
ounsel; T. M. C. Asser, E. Aguire-Carrillo, H. Elizalde,
'otte, A. O. Liuksila. Middle Eastern Department:
ewski. Research Department: E. Borensztein, P. Isard.
partment: J. W. Lang, Jr., Deputy Secretary; A. Tahari.
artment: D. Williams, Deputy Treasurer, D. Gupta. Advisors
ectors: N. Adachi, F. E. R. Alfiler, M. Eran, Z. Iqbal,
A. Raza. Assistants to Executive Directors:
. Christiansen, H. E. Codrington, T. T. Do, S. Gurumurthi,
Hepp, A. Iljas, L. I. Jácome, C. J. Jarvis,
apetanovic, J. A. K. Munthali, A. Rieffel, S. Rouai,
e, M. J. Shaffrey, N. Toé, J. C. Westerweel.

1. EXECUTIVE DIRECTOR

The Chairman bade farewell to Mr. Jalan on the conclusion of his service as Executive Director.

2. ENLARGED ACCESS POLICY - EXTENSION AND ACCESS LIMITS FOR 1990

The Executive Directors considered a staff paper on the enlarged access policy and access limits for 1990 (SM/89/220, 10/27/89; Sup. 1, 11/1/89; and Sup. 2, 11/28/89).

The Deputy General Counsel explained that the draft decision was being presented to the Board in the context of the reference in the communiqué of the Interim Committee, to the effect that the enlarged access policy should be maintained for 1990 and reviewed in the light of the outcome of the Ninth General Review of Quotas. The draft decision was similar to the decision the Board had taken the previous year, which had made the link between the review of access limits and the outcome of the quota review more explicit, by stating that the effective date of the review should not be later than the effective date of any increase in quotas under the Ninth General Review. However, there was no such reference to the effectiveness of the quota increase in the Interim Committee communiqué, and the question that had been raised in the discussion in the Committee of the Whole on the Ninth Review of Quotas was whether it would be preferable to specify a precise date, namely, June 30, 1990 for the review of the enlarged access policy.

Mrs. Filardo said that that would imply that even if an agreement were reached on an increase in quotas in January 1990, the present access policy would apply until the end of June 1990.

The Deputy General Counsel explained that in the absence of a decision by the Board at present, the enlarged access policy and the Board's authority to approve stand-by arrangements and extended arrangements with enlarged access would lapse. If the Board decided to extend the enlarged access policy through 1990, but make it subject to a review before midyear, the access limits would remain unchanged from January 1990 until the end of 1990 at the latest, unless a decision otherwise was taken.

Mr. Dawson commented that he believed that the date of March 31 would be more appropriate, because the Board was operating on the assumption that the quota discussion would be completed by the end of January or early February 1990, perhaps after a special meeting of the Interim Committee. The enlarged access policy could then be examined after a few months.

Mr. Grosche said that he had understood that one of the reasons for postponing a review of the enlarged access policy until midyear was so that the Interim Committee's discussion of May 1990 could be taken into account, which, he recalled, would deal with the world economic situation and the debt situation, as well as the quota increase. The future enlarged access policy could be formulated with the Interim Committee meeting's conclusions and the advice of the Ministers in mind.

Mr. Kafka said that the present discussion seemed to lend weight to his suggestion that the enlarged access policy be extended, subject to review when the Board believed that it was appropriate. It did not appear to him that setting a date by which time the review would be completed was particularly helpful. Moreover, to set a date might suggest to outsiders that the Board had in mind more than it actually had in that respect.

Mr. Grosche said that he could not go along with Mr. Kafka's suggestion because it would change the character of the decision on the enlarged access policy. Past precedent had always been to set a date by which time the decision would lapse unless the Board decided otherwise.

Mr. Chatah said that the decision the Deputy General Counsel had suggested would extend the enlarged access policy for all of 1990, unless the Board decided to abrogate it at the time of the midyear review. It might be more in keeping with the language of the Interim Committee communiqué to specify that the review would take place not later than four weeks following the adoption of the resolution of the Board of Governors on the quota increase.

The Deputy General Counsel said that the exact date for the review was up to the Board to decide. He had referred to the date of June 30 because that date had been put forward in the discussion that morning in the Committee of the Whole on the Ninth General Review of Quotas.

Mr. Hogeweg said that he had understood the consensus in the morning discussion to have been in favor of extending the enlarged access policy until June or July 1990, after which time it would lapse, unless the Board agreed to extend it. The most recent suggestion appeared to be to extend the decision for 12 months, but with the provision that it could be reviewed by a certain date.

The Deputy General Counsel stated that it would be legally possible to extend the decision for a certain period, past which time it would lapse unless the Board decided otherwise. The other approach would be to assume that the decision would extend for a period of 12 months, but with a review at a certain time, at which time the decision could be taken either to terminate the enlarged access policy, to extend it, or to modify it in light of the discussion on quotas.

Mr. Grosche said that he had been among those who had suggested a shorter period of time before the review, in order to force the Board to take into account the new developments that might be analyzed by midyear. He could also go along with the text as it stood, with the understanding that the Board would examine the enlarged access policy in the light of the outcome of the discussion on quotas and other matters, such as debt, for example.

Mr. Al-Jasser observed that regardless of what decision was taken at present, he understood that any Executive Director could call at any time for a review of the decision, especially in the light of developments in the quota discussions.

The Deputy General Counsel stated that provision could be made for ad hoc reviews by the Board, if it so agreed. In any event, one provision of the decision on the enlarged access policy specified that the policy would be reviewed annually.

Mr. Al-Jasser said that the last paragraph of the decision also made it possible to review the decision in the light of the developments in the quota discussion. That being said, he would support Mr. Grosche's proposal to extend the decision until June 30, 1990. If in March 1990 it appeared that a review was warranted, it could be done then.

Mr. Hogeweg said that he also would prefer to extend the decision for less than one full year. The Board needed to be forced to take into account other factors when it reviewed the decision. He could agree therefore to extending the decision until June 30, 1990, after which it would lapse unless the Board decided otherwise. As the Chairman had suggested in the morning discussion at the Committee of the Whole on the Ninth General Review of Quotas, that timing would also allow the Board to examine the access policy for the remainder of 1990 and for the following year as well.

Mr. Enoch said that he could go along with what Mr. Hogeweg had said, that the decision be extended until June 30, 1990, with the understanding that it would lapse at that time unless the Board decided otherwise.

Mr. Dawson wondered whether the decision the Board might be called upon to make in June 1990 might be expected to extend through the balance of 1990, or to the point of activation of the next increase in quotas.

The Acting Chairman said that that would have to be determined at the time of the review.

Mr. Dawson wondered whether there were any limits on the period of extension of the decision. He wondered whether the Board would be able to vote to extend the decision for a further 18 months. Would the general requirement that the enlarged access policy be reviewed annually still apply, or could the Board override that provision and extend enlarged access for a period longer than one year without any review?

The Deputy General Counsel said that the original decision on the enlarged access policy had established a certain period for its application--to December 31, 1984. The decision also made extensions possible, but did not give any specific period for the extension. Another provision specified that the policy and the access limits under it would be reviewed annually, although no specific date was given. That review had normally been undertaken in August, but there was no legal impediment to the Board deciding in June 1990 to extend the enlarged access policy for 18 months.

Mr. Chatah commented that the draft decision the staff had presented would need to be changed if the Board were to agree to extend the decision until June 1990.

Mrs. Filardo commented that she understood that the policy would remain in effect through 1990, and that the Board could decide to change it, if it felt it was appropriate, in June 1990.

The Acting Chairman said that whether the enlarged access policy would be extended past June 30, 1990 would have to be decided at the time of the review to be held not later than June 30, 1990. That was in line with what the Managing Director had proposed at Committee of the Whole on Review of Quotas Meeting 89/16, namely, to extend the enlarged access policy and the access limits until the end of June 1990, and review them not later than that date in the light of the outcome of the discussions on the quota increase and the Interim Committee's discussion of the world economic outlook.

Mrs. Filardo commented that that implied that if the increase in quota were less than about 50 percent, access would be reduced between June and December 1990.

The Acting Chairman said that there were no such implications about the amount of access, which the Board would decide at the time of the review not later than June 30, 1990. He took it, therefore, that the Board agreed to extend the decision on the enlarged access policy until June 30, 1990. The Board would review the decision not later than that date.

The Executive Directors took the following decision:

The Fund, having reviewed the Decisions on the Policy on Enlarged Access and the limits on access to the Fund's resources under that Policy and under the Buffer Stock Financing Facility of the Fund, and confirming that the Policy on Enlarged Access will be reviewed in the light of the outcome of the Ninth General Review of Quotas, decides that:

1. In paragraph a. of Decision No. 7599-(84/3), as amended, "1989" shall be replaced by "June 1990."

2. (a) In the third sentence of paragraph a. of Decision No. 7600-(84/3), as amended, "1986, 1987, 1988, and 1989" shall be replaced by "1986, 1987, 1988, 1989, and the first six months of 1990."

(b) In paragraph b. of Decision No. 7600-(84/3), as amended, "1989" shall be replaced by "June 1990."

The review of the Policy on Enlarged Access and access limits thereunder in the light of the out-come of the Ninth General Review of Quotas shall be completed not later than June 30, 1990.

Decision No. 9326-(89/167),adopted
December 20, 1989

3. PHILIPPINES - 1989 ARTICLE IV CONSULTATION; EXCHANGE SYSTEM; AND EXTENDED ARRANGEMENT - REVIEW AND MODIFICATION

The Executive Directors considered the staff report for the 1989 Article IV consultation with the Philippines and the first review under the extended arrangement for the Philippines approved on May 23, 1989, along with a request for a waiver and modification of the extended arrangement (EBS/89/229, 12/1/89; and Cor. 1, 12/15/89). They also had before them a background paper on recent economic developments in the Philippines (SM/89/256, 12/5/89).

The staff representative from the Asian Department made the following statement:

Following the failed coup attempt in early December, a staff team visited Manila during December 11-14 to discuss with the authorities the likely economic implications of the recent events and corrective policy measures. The staff team met with President Aquino, the Secretaries of Finance and Planning, the Governor of the Central Bank, and other senior officials. The Government reaffirmed its continued full commitment to the objectives and policies of the economic program for 1990 and stressed its preparedness to take additional measures as may be required; the staff appraisal contained in EBS/89/229 (12/1/89) does not need to be changed.

In large measure, the immediate disruptive effects of the coup attempt on the economy have by now been overcome. The stock and foreign exchange markets have reopened under circumstances of relative stability, international transactions have been fully resumed, and supply bottlenecks have been removed. On December 5 the Government imposed price ceilings on eight basic commodities (rice, milk, sugar, chicken, pork, flour, kerosene, and liquid propane gas) for the Metro Manila area effective through December 31, 1989. To prevent potential economic disruption and dislocations, a national state of emergency was declared on December 6, which enables the Government to take over or direct private businesses, delivering public service or otherwise affecting public interest. The provision of somewhat broader emergency powers for the President is being considered by Congress.

At this early juncture, it is difficult to gauge the full economic implications of recent events. A principal risk arises with regard to the possible impact on investment and thus on growth and the path to medium-term viability. While press reports have attributed second thoughts to some foreign investors, the authorities noted that first indications from a number of large foreign investors were for a continuation of their plans. One area of likely shortfall is the tourism sector, which had been growing rapidly. While there is thus a possibility that GNP growth in 1990 might be lower than programmed, particularly in the first half of the year, the authorities at present consider the 6 percent target of the program as still attainable. They are fully aware that to achieve this growth target, reduce inflation to the program target of 8 percent by end-1990, and ensure sustained strong foreign investment and prevent capital flight, the policies incorporated in the program will need to be implemented vigorously. In particular, fiscal restraint, a prudent monetary stance, and an improvement in external competitiveness remain core elements of their program. In addition, they recognize the need to boost investor confidence and to strengthen structural policies. In this regard, there are plans to accelerate trade policy reform and the current review of foreign investment regulations.

Regarding monetary developments, commercial banks faced large cash withdrawals by the public in the first days of December and currency issue by the Central Bank increased substantially as a result. Furthermore, the inability to conduct open market transactions during the disruption of activity in the financial district led to an additional sizable infusion of liquidity from maturing treasury bills. The consequent increase in base money during the period is estimated at about P 9 billion (over 10 percent); however, the impact on total liquidity was dampened by the rise in the currency/deposit ratio. Cash withdrawals by the public have since subsided, and on December 8 open market operations resumed. As a result, base money declined by about P 7 billion during the second week of December, reversing most of the earlier increase. While observance of the indicative end-December base money target may prove not to be possible, it is the authorities' firm intention to ensure that monetary developments return fully to the program path by early 1990. The volume of open market operations has already been increased.

The official foreign exchange market, which reopened on December 6, witnessed a moderate depreciation of the peso from an exchange rate of P 22.23 per U.S. dollar prior to the coup attempt to P 22.32 per U.S. dollar on December 14. The premium in the unofficial exchange market has remained small (about 1 percent), and central bank sales of foreign exchange in the official market have been negligible ($1 million). However, the authorities feel that the substantial net purchases of foreign exchange by the Central Bank assumed under the program for the month of December will be difficult to achieve in the immediate circumstances, and that therefore the indicative target for net international reserves (NIR) for end-December may be missed. Nevertheless, the authorities are committed to achieving the end-March performance criterion for NIR. Stock market prices fell by about 8 percent on the first day of trading (December 11), followed by further moderate declines in subsequent days, resulting in a cumulative drop of some 15 percent through December 14.

In the fiscal area, the authorities remain fully committed to the programmed reduction in the consolidated public sector deficit from 4.4 percent of GNP in 1989 to 2.9 percent in 1990. Excluding the costs of reconstruction (which are not yet known but are not expected to be substantial), the estimated net effect of the coup attempt on the public finances in 1990 is an increase in the deficit of about P 2 billion (0.2 percent of GNP). Outlays for compensation of the armed forces and increased veteran benefits are likely to be about P 1.7 billion higher than programmed. In addition, there is the possibility of a delay in Congressional approval of discretionary revenue measures; if these measures were to go into effect in April instead of at end-1989 as originally envisaged, revenue in 1990 would be reduced by about P 1 billion. These changes would be partly offset by savings deriving from a deferment of less essential capital expenditures. Moreover, to keep the fiscal program on track, the Government is considering additional tax measures, which would beimplemented around mid-1990. These measures would be mainly in the area of business taxes, user charges, and a reduction of investment tax credits. In addition, the present program includes a P 2.0 billion contingency to deal with unforeseen events. The authorities stressed that the substantial increases in prices of petroleum products on November 30 (averaging 25 percent, slightly lower than indicated in EBS/89/229 but sufficient to eliminate current oil price losses) underscore their intention to reduce substantially the public sector deficit. They emphasized that they remain committed to continued oil price flexibility and to maintaining the present structure and level of taxation of petroleum products.

With regard to trade policy, the Government has, as provided for under the program, identified additional 45 import items (mainly spare parts) in December for which prior approval requirements will be replaced by tariffs.

The Government intends to implement the agreement reached recently with foreign commercial banks. The debt buyback operation, involving the redemption of $1,312 million of debts at a discount of 50 percent, is expected to be closed as scheduled on January 3, 1990. Present commitments for new money amount to somewhat over $600 million, but the Government hopes that further commitments will be received up to the time of the signing of the agreement, now planned for early February. The preparations for a second round of debt operations are continuing.

In sum, the immediate economic consequences of the coup attempt have not been as severe as might have been expected a priori. Moreover, the authorities have acted quickly to mitigate any adverse consequences and to bolster public confidence. Possible longer-run consequences cannot be forecast with any precision at this stage. What is of critical importance now is that the authorities demonstrate decisive economic leadership, hold firmly to prudent financial policies, ensure that the efficiency and competitiveness of the economy is strengthened as necessary, and within the framework of such policies also deal boldly with the problem of widespread poverty. It is encouraging that the authorities have declared their firm intention to pursue the policies and targets for 1990 set out earlier and, indeed, to do so with renewed determination. Given the uncertainties that are likely to persist for some time, it is crucial in the period ahead to adhere to the basic principles of sound economic and financial policies and take bold and urgent steps to deal with the underlying social and economic problems of the country.

The staff representative added that the Advisory Group of commercial banks was meeting on that date to discuss in advance operational matters. The Chairman of the Group, with whom he had spoken recently, expected that endorsement of the financing package that had been agreed earlier with the Philippines would be reconfirmed and he had confirmed that no bank had withdrawn or reduced the amount of its new money commitment.

Mr. Evans made the following statement:

On behalf of the Philippine authorities, I would like to express appreciation of the staff's untiring efforts and professional assistance in presenting a fair and comprehensive assessment of Philippine developments. The authorities agree with the thrust of the staff appraisal.

As the staff report conveys, major progress has been achieved on both structural adjustment and macroeconomic reforms. An economy which, just four years ago, was characterized by extreme debt difficulties, recession, financial instability, and government monopolies is now experiencing robust growth in an environment of substantially reduced government intervention, greater financial stability, and much improved economic efficiency. The private sector has responded favorably to the authorities' efforts, and the authorities, in turn, have been encouraged to pursue more vigorously the objectives set forth in their medium-term development plan. Though there were some temporary setbacks in 1989, the Philippine authorities expressly and firmly remain committed to the objectives and policies of the economic program for the coming years.

Performance in 1989 was mixed. While the authorities sustained the growth and investment momentum and succeeded in attracting foreign direct investment (including reversal of flight capital), this progress was accompanied by worsening inflation and a larger than expected current account deficit. The deviations from program targets can be traced to some delays in the implementation of oil pricing policy and higher domestic demand fueled by larger than expected minimum wage adjustments. The fiscal effects of these developments resulted in a larger than programmed public sector deficit, exacerbated by higher public debt service incurred in controlling the monetary effects of that deficit.

Monetary policy, which was relaxed temporarily to accommodate the strong private credit demand and the growth momentum apparent in the first semester, was subsequently tightened as signs of inflation and inflationary expectations were building up. Meanwhile, the growth momentum generated strong import demand for capital and intermediate goods, thereby widening the current account imbalance.

The policy slippages in mid-1989--since corrected--were directly related to the need to maintain a domestic consensus around the basic program objectives. Both the minimum wage increases and the delay in implementing necessary oil price increases flowed from dissatisfaction at the speed with which improving growth performance was being reflected in generalized improvements in living standards. By the latter half of 1989, the monetary and fiscal policy slippages had been corrected, although not without incurring considerable electorate reaction.

Meanwhile, important gains have been achieved in restructuring the economy toward greater efficiency: government agricultural monopolies have been dismantled, and have not been replaced by private monopolies; privatization of nonfinancial public corporations is proceeding ahead of schedule; the financial sector reform has already resulted in a successful sale of 30 percent of the stocks of the government-owned commercial bank to the public, and substantial operational profits for this bank; the reform of the government-owned development bank is almost complete, and a reform program was initiated in 1989 to strengthen the whole commercial banking system; the Central Bank is also being cleared of its involvement in agricultural credit allocation, and is gradually transferring quasi-fiscal losses to the National Government; the continuing trade liberalization program has proceeded as scheduled, with only a few remaining quantitative restrictions to be eliminated and replaced by tariffs; land reform, which is an important element of the authorities' economic restructuring efforts, is being rephased to take account of some legal impediments in the treatment of public land. It remains the firm intention of the authorities to implement as expeditiously as possible the comprehensive agrarian reform program; structural improvements in the fiscal system have also increased tax elasticity and facilitated administrative reforms, which, in turn, have bolstered the tax effort.

Substantial progress was achieved in 1989 in securing external financing for the adjustment program. Debt relief from Paris Club creditors amounting to P 1.7 billion was obtained immediately after the Fund Board approval of the extended arrangement. Soon after, new loan commitments under the Multilateral Assistance Initiative/Philippine Assistance Plan for $3.5 billion for 1989/90 were secured from official bilateral and multilateral sources. The authorities have agreed with commercial bank creditors a voluntary and market-based financing arrangement involving provision of new money in the form of new money bonds (which will be excluded from future restructuring and the new money base), debt and debt-service reduction, and restructuring of existing bank debt at terms more favorable than earlier arrangements.

The buyback component firmly in place is to be executed in early January 1990, consequent on Fund and Bank approval of essential support under the debt strategy. For the new money bond issue, a one-month extension (to mid-February) has been decided. The extension should permit the Advisory Committee and the Philippine Government to encourage additional contributions to the present $600 million new money commitments. The Advisory Committee will meet in New York on December 20, 1989 to, inter alia, discuss procedures for the extension.

The authorities have taken vigorous steps to normalize operations following the recent coup failure. On the political front, the Philippine Congress has provided the President with temporary emergency powers to ensure a speedy return to normalcy. Important statements of support have been obtained from the country's major trading partners, including the United States, Japan, the EEC and ASEAN, and Pacific countries.

On the financial front, Central Bank action to support banks experiencing mild runs prevented a system-wide disturbance. Consequently, interest rates remained stable, as reflected in the movement of short-term treasury bill rates. The stock market's decline in reaction to the attempted coup was much smaller than had been anticipated. While it is still premature to assess the coup's effect on medium-term investments (positive statements have been obtained from major foreign investors), the authorities have decided to accelerate their review of investment incentives with a view to greater market openings. Other measures to prevent disruption of trade and tourism were implemented with the aim of restoring immediately the momentum that had been obtained before the political disturbance.

While these recent developments necessarily increase uncertainty, and must result in some short-term blips in program performance, the Philippine authorities fully agree with the staff that the 1990 program objectives--including the March 1990 performance criteria--are achievable, albeit with heightened difficulty. What scope might have existed, when the program was agreed in early November 1989, to outperform the policy targets, has now evaporated. Indeed, any such attempt now could well spark detrimental policy reversals not too far down the road.

Notwithstanding that, the authorities remain firmly committed to the program as indicated by their recent actions. On the fiscal front, domestic petroleum prices were increased to reflect international oil prices on December 1, 1989, and the corresponding adjustment of electricity rates has been made. In addition to following up previous steps to improve tax administration, the authorities have submitted to Congress for approval several proposals for tax increases and new tax measures. Combined, the second phase of tax administration improvement and new revenue measures are expected to generate an additional 1 percent of GNP for 1989. The authorities have also decided to abolish the Oil Price Stabilization Fund (OPSF) around the third quarter of 1990, as soon as arrears to the OPSF are cleared, thus eliminating one of the major sources of the higher fiscal deficit in 1989, and a perennial political headache.

In the monetary area, it remains the intention to address policies to the reduction in inflation to around 8 percent by end 1990. The expansion in liquidity necessitated by the December disturbance will be reversed during the first quarter of the year. Maintenance of external competitiveness remains a key policy objective. The peso has remained stable--i.e., has continued to depreciate at an orderly pace--and the difference between the parallel and official rates has remained minimal. In any event, the Central Bank will be guided in its exchange rate policy both by the requirement of competitiveness and by the international reserve target under the economic program.

As indicated earlier, the Philippine authorities remain firmly committed to the achievement of stable and sustained growth within the framework of the Fund program. They would like to express their appreciation to those who have been sensitive to their difficulties and necessary domestic priorities. At the same time, they are seeking the full support of the Board to be able to continue implementing the economic adjustment program. An essential component of the program is the debt operation with commercial banks, for which the authorities have requested a limited acceleration of set-asides under the Fund guidelines for debt reduction. Without approval of that element, the whole program would fail. In recognition of that, the authorities agree to abide by the early repurchase requirements recently agreed by the Board, notwithstanding that those requirements postdate their letter of intent.

With the economic performance remaining basically on track and the financing from commercial banks very much in progress, I endorse the staff's judgment that the Philippine authorities' requests for the second drawing under the extended arrangement and the acceleration of funds set aside for debt reduction for 1990 deserve the full support of the Board.

Mr. Kyriazidis stated that the staff had presented a rather unsatisfactory picture of the economic situation in the Philippines. The growth and investment objectives of the program had been basically achieved, but only at the expense of all other program goals, such as the inflation target, the current account target, and the public deficit target. Furthermore, action on some important structural reforms, such as land reform, seemed to be behind schedule.

It was regrettable that performance under the program had been so disappointing, Mr. Kyriazidis went on. In fact, the Philippines was the first case in which a Fund program approved under the new debt strategy guidelines had gone virtually off track in such a short period of time. Furthermore, by proposing substantial modifications of the extended arrangement, the staff implicitly recognized the failure of the authorities to pursue a program which could not in any case be considered as exacting by any standard.

It was clear that the inability of the authorities to pursue the badly needed fiscal adjustment was at the root of the present situation, Mr. Kyriazidis commented. The increasing public deficit had fueled the upsurge in inflation, and had caused the sizable deterioration in the current account. Moreover, the permissive stance of fiscal policy, coupled with a restrictive monetary policy in the second part of the year, had caused an unwarranted appreciation in real terms of the peso, which, together with large wage increases in the private sector, had affected negatively the competitiveness of Philippine exports.

In order to put the program back on track, it was necessary to implement a fiscal policy geared--at least--to the initial targets, so as to remove the extra burden recently put on monetary policy, Mr. Kyriazidis stressed. The recent change in domestic oil prices was a step in the right direction. Furthermore, an adequate exchange rate policy seemed to be necessary to support an adequate level of export growth.

It was regrettable that the increase in the public sector deficit was connected with higher expenditure on items which were under the direct control of the authorities, namely, wages and subsidies, and that no appropriate countermeasures had been taken when the size of the fiscal slippage had become apparent, Mr. Kyriazidis continued. The importance of achieving a stricter control of recurring items of current expenditure needed hardly to be emphasized.

The staff indicated that the unexpectedly large increase in the civil service wage bill had occurred because of the implementation of the wage standardization scheme, which had been intended to correct unjustified wage disparities among different categories of employees, Mr. Kyriazidis recalled. He could understand the authorities' preoccupation with achieving a more balanced structural remuneration within the public sector, and the provision of the correct pecuniary incentives to important categories of public workers, but the pursuit of those social goals should not have been allowed to put in jeopardy the policy of strict control of current expenditure, which was a basic component of the entire fiscal package. Under the present circumstances, even strict adherence to the executive order which limited the hiring of public workers to health, education, and revenue agencies, could only restrain, but not prevent, further increases in the total public sector wage bill.

It was regrettable that the increase in subsidies, resulting mainly from the deliberate oil pricing policy of the authorities, had been among the causes of the increased consolidated public sector deficit, Mr. Kyriazidis stated. It was unfortunate that the higher deficit of the OPSF had resulted in the accumulation of sizable domestic arrears, which would put a heavy burden on the 1990 budget. In that regard, he welcomed the fact that the OPSF would be included in the public sector borrowing requirement under the new program. Nevertheless, it was not clear to him why the OPSF had not been included in the program from the very beginning.

With respect to the modifications of the program, Mr. Kyriazidis went on, the staff appeared to be proposing that the slippage which had occurred in 1989 be only partially rectified. The new objectives of the program, both in the external and the fiscal fields, appeared less ambitious than those set in the original program. A government deficit equal to 1.7 percent of GNP was set for 1990, whereas the original program had envisaged a deficit equal to 0.9 percent of GNP, for example.

While the abandonment of the objective of maintaining expenditure at the level of 17.6 percent of GNP in 1990 could be explained by the impossibility of fully compensating for the slippage in wage expenditure which had taken place in 1989, and by the increase in interest payments expected in 1990, the reduction in the revenue target from 16.7 percent to 16.2 percent of GNP could only be explained partially by the reduced nontax revenues, Mr. Kyriazidis pointed out. Total revenues under the revised target were expected to increase in 1990 by 0.5 percent of GNP, whereas the original program had envisaged an increase of 1.1 percent of GNP. He would welcome the staff's comments on what had caused them to revise downward the expected increase in the ratio of revenues to GNP.

In the external sector, Mr. Kyriazidis went on, less ambitious targets had been set for 1990 under the revised program, basically as a result of the higher income elasticity of imports, and in spite of higher than originally envisaged services and transfer receipts, and a higher current account deficit to GNP ratio, which would also be reflected in the lower reserve to import ratio. As a consequence, the elimination of the financing gap in 1990 that was envisaged would be made possible only through larger rescheduling and bilateral flows.

On the whole, the proposed changes made the program even weaker than it had been at the time of the approval of the original arrangement, Mr. Kyriazidis remarked. One might wonder whether the program still fit the Fund's guidelines on the debt strategy. Furthermore, large financing gaps remained in the medium-term, even if they were smaller than originally envisaged. In light of the reluctance shown by the banks to provide new medium-term funds to the Philippines, it was unlikely that future financing gaps would be filled by bank credit. Therefore, financing gaps in the medium-term could only be closed by an adequate flow of foreign direct investment, by the return of flight capital, and by adequate bilateral flows. However, whether a sufficient flow of capital--both private and official--to support the program would be forthcoming depended ultimately upon the authorities' commitment to stabilizing the economy's macroeconomic environment, and to implementing adequate financial policies. He wondered whether the Fund program, as it stood at present, ensured the achievement of those goals. The positive conclusion of the discussions with the commercial banks represented the achievement of what appeared to be a necessary, but not a sufficient, condition for medium-term stability.

Fund and Bank financing had played a crucial role in making possible the agreement between the Philippines and commercial banks, Mr. Kyriazidis observed. At present, the agreement with the banks was among the few positive and tangible results the Philippine program had achieved. However, if the intention was to make the Philippine program more than an exercise in financial engineering, the country would have to strengthen considerably its adjustment efforts, certainly beyond what was presently envisaged. He therefore attached great weight to adequate assurances that the program would be significantly strengthened, particularly in the fiscal sector, by the time of the next review.

At the time of the first request for an arrangement, his chair, together with others, had decided to abstain, Mr. Kyriazidis recalled. That decision had been difficult and painful. However, he had the same feelings at present, given the fact that the amended program was weaker than the one that had been approved in May 1989. One would loathe to envisage having to apply the decision on early repurchase expectations--which had just been taken--at the time of the review of the Philippine program.

The importance of the case went well beyond its country dimension, Mr. Kyriazidis concluded. It represented a crucial episode in the debt strategy. Therefore, he felt obliged, before making a final decision, to sense the opinions of the Board. He wished therefore to reserve his position until his colleagues had had an opportunity to provide their insights.

Mr. Yamazaki made the following statement:

> We share Mr. Evans's view that the economic performance of the Philippines, as well as the financing package agreed with commercial banks, certainly justify the Philippine authorities' request for the second drawing under the extended arrangement, and the acceleration of set-asides for 1990. We support the proposed decisions.
>
> Having said that, we certainly recognize the uncertainties and risks involved in the program. In particular, as Mr. Evans has mentioned, the margins incorporated in the program when it was formulated in early November might now have been lost. However, it should be noted that the authorities have continued to express their firm commitment to the program, as well as their willingness to adopt additional measures, if necessary. Thus, the Fund should encourage the authorities to sustain their adjustment efforts,

aimed at the continued recovery of the economy from the heavy debt burden.

Nonetheless, we regret that the authorities are facing the same challenges they faced at the beginning of the arrangement. In fact, the difficulties that the authorities have to overcome could be even more serious. The policy slippages in mid-1989--although since corrected--have widened the domestic and external imbalances. Therefore, it is crucial that the authorities persevere with the 1990 program. Since this is virtually the first case in which the Fund is providing its own resources for a debt reduction operation, we urge the authorities to recognize that the performance under the program will have significant implications not only for the Philippines itself, but also for other heavily indebted countries that have already embarked on, or are about to embark on, far-reaching economic adjustment while taking advantage of debt and debt-service reduction.

In this context, we attach particular importance to the management of fiscal policy. We strongly hope that the recent political turbulence will not delay the adoption of discretionary revenue measures. Should slippages occur, it would be essential for the authorities to implement contingency measures without delay, as they have already committed themselves to. Furthermore, in the long run, it would be essential for the authorities to make bolder efforts to increase tax revenue beyond the currently planned minor revamping of revenue measures, since the relatively low tax revenue/GDP ratio seems to illustrate the deep-rooted inefficiency of tax administration. Since, in our view, the tax base seems to be large enough, an overall review of tax administration would be essential, despite the encouraging progress that has been made so far. In this context, we would like to know whether the staff plans to provide further technical assistance to improve tax administration.

On the expenditure side, the establishment of discipline is crucial. In particular, we urge the authorities to resist any pressure to increase wage compensation for government workers, notwithstanding the recent political upheaval. It is also crucial to adjust the prices of petroleum products in order to reduce the public sector deficit. We encourage the authorities to expedite the schedule.

The role of monetary policy should also be emphasized. In this connection, it is important that the central bank be freed from the burdens arising from treasury operations.

We have nothing to add to Mr. Evans's statement on the exchange rate policy. However, it is a matter of concern that the indicative target for net international reserves for end-December may be missed. Therefore, it could be essential for the authorities to monitor the situation closely and take appropriate corrective measures, if necessary.

The recent political developments have certainly made it difficult to project the balance of payments situation even in the near future. However, we have been encouraged by the recent capital inflows. We are inclined to think that ongoing major projects will sustain the increase of direct investment, and that the influence of the recent political upheaval might be minimal.

On the financing package, we welcome the early agreement reached with the commercial banks, and the fact that the cash buyback transaction will be held on January 3, 1990, although it is somewhat disappointing that the issuance of the new money bonds will be delayed. We are also encouraged by the staff's report that the package remains on track--in particular, that no bank has withdrawn its new money offer. Furthermore, we would like to urge the authorities to expedite their negotiations with commercial banks on the second stage of the debt and debt-service reduction.

Mr. Dawson stated that he agreed strongly with some of the comments of Mr. Kyriazidis, especially regarding the authorities' record of performance in 1989, which had indeed been mixed. Nevertheless, he would tend to interpret that performance in a bit more positive light, since the authorities had acted--albeit slowly--to correct the slippages stemming from the oil price subsidy and loose monetary policy in the middle of the year. The authorities should be commended, rather than criticized, for having responded so forcefully, although with some delay.

The Board also needed to be sensitive to the added burden which the recent political difficulties had placed on the authorities, Mr. Dawson pointed out. Although it was true that some of the targets that had been established for 1990 could be considered as a step backward from the program that had been originally envisaged in May 1989, the authorities appeared to have recognized the problems that had occurred in 1989, and were committed to avoiding their recurrence. The staff report and Mr. Evans had drawn attention to that commitment.

For 1990, vigilance in strengthening fiscal policy measures would be essential, since the full impact of the public sector wage increase would be felt during 1990, which would have to be kept under close scrutiny, Mr. Dawson noted.

He was pleased to learn that the Philippines' external creditors had maintained their commitment to the buyback and new money packages, Mr. Dawson commented.

His chair might have preferred a debt reduction package for the Philippines that was structured a bit differently as between debt reduction and debt-service reduction elements, Mr. Dawson went on. However, he noted that the authorities envisaged debt-service reduction in the second phase of their debt reduction program. He looked forward to that being incorporated into the debt reduction operation for 1990 even though that had not been mentioned in the staff paper.

He strongly supported the staff's recommendation for approval of the waiver and modification of the extended arrangement, Mr. Dawson concluded. Any decision otherwise might send the wrong message, not least to the authorities themselves, who had been trying to set the economy back on a sound footing, and with more success than might have been expected under the circumstances.

Mr. Obame made the following statement:

> Since the recent developments in the Philippine economy have been well documented by the staff and Mr. Evans, and since I am in broad agreement with the staff appraisal, I will make only a few remarks on fiscal and external policies, and on the structural reforms which we find will be critical for the achievement of the program's medium-term objectives.
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> Following the disappointing fiscal performance observed in the first part of the program period, I find the authorities' intention of strengthening fiscal policies for the 1990 program appropriate. Those policies are expected to contain the expansion of domestic demand, while contributing to the achievement of the fiscal targets. In this regard, I note that the authorities remain committed to reducing the consolidated public sector deficit from 4.4 percent of GNP in 1989 to 2.9 percent of GNP in 1990, through wide-ranging fiscal measures combining a balance of new revenue measures, expenditure restraint, and a further strengthening of tax administration.
>
> On the revenue side, I note that tax revenues are projected to increase significantly, owing mainly to the introduction of discretionary revenue measures, including, inter alia, an increase in excise taxes on consumption products (cigarettes, alcoholic beverages, and soft drinks), and the broadening of the coverage of the value-added tax. The authorities' efforts aimed at improving the flows of information between government agencies, and computerizing value-added tax transactions at the Bureau of Internal Revenues (BIR), are welcome steps, which should improve the efficiency of tax administration. On the expenditure side, I also note that the authorities intend to reduce in 1990 the expected increase in civil service employment by about 3.9 percent through the containment of the wage bill. Furthermore, other expenditures

have been made subject to tight budgetary ceilings. All these measures, and the recent steps taken toward deregulating domestic prices of petroleum products in particular, will go a long way toward improving the overall financial position of the public sector.

The widening of external imbalances that was recorded underscores the need to strengthen external policies and ensure strong export growth through a policy of economic diversification. I welcome the authorities' recent efforts in removing most of the impediments to foreign investment, through trade and investment liberalization and reforms. These efforts, however, need to be pursued, and even accelerated, so that the Philippines could attract the much-needed foreign direct investment flows that its Asian neighbors and partners are taking advantage of. Moreover, the authorities' early ratification of the Articles of the Multilateral Investment Guarantee Agency (MIGA) would be helpful in attracting such external flows.

If ensuring strong export growth is a prerequisite for strengthening the country's external sector position, it appears also that actions aimed at reducing the external debt and debt-service burden and at mobilizing appropriate financing are equally crucial for the viability of the program per se. With respect to external debt, we are pleased to note that the authorities are well advanced with their operations of debt buyback and interest support for debt-service reduction. We agree with the authorities that the successful completion of these operations with commercial banks could facilitate the achievement of the investment and growth targets of their medium-term economic program.

The information provided by the staff on the status of the implementation of structural reforms under the program is encouraging. The reform of the public enterprise sector and of the financial sectors seems to be progressing broadly as programmed, but I note that slippages have occurred in agrarian reform. This is indeed a source of concern, because the distribution of land to the population is one of the ways of alleviating poverty in the Philippines. Therefore, we expect that the reform will not be too delayed, and that the authorities will take steps to rectify the slippages.

The staff and Mr. Evans have underlined the efforts that the authorities intend to make under the program to achieve their medium-term objectives. While emphasizing the critical role that fiscal and external policies and appropriate external financing would play in this respect, we wish also to point out the importance of a stable social and political environment for the success of any economic program. Indeed, recent events in the Philippines could have raised doubts as to whether or not the implementation of the current program was sound. However, the information provided by the staff and by Mr. Evans is reassuring, and I therefore support the proposed decisions, including the release of the set-asides.

Mr. Prader made the following statement:

The Philippine economy displays impressive prospects for long-term economic expansion, and the potential for reducing the hardships of poverty which presently affect a great majority of the large population is equally impressive. During the last several years, substantial progress has been made on both fronts. However, performance in 1989 was mixed, as Mr. Evans has phrased it.

The growth and investment objectives for 1989 have been broadly attained, an outcome which contrasts sharply with the worsening of most other macroeconomic variables: acceleration of the inflation rate to 13.5 percent, stagnation of the savings/GNP ratio, marked degradation of the current account, and a substantial overrun of the fiscal deficit target.

These disappointing outcomes are largely, if not wholly, the result of two major policy errors; first, the more than substantial 40 percent increase in the minimum wage, which the staff finds equivalent to an average nominal wage increase of about 25 percent, and the accompanying 25 percent to 30 percent increase in average civil service remuneration; and second, the asymmetrical adjustments of domestically administered oil prices to world price developments.

Mr. Evans explains these policy slippages as directly connected to the need to maintain the domestic consensus around the basic program objectives. Be that as it may, such a connection does not seem to be the fundamental reason for the slippages, which are rooted rather in the authorities' difficulty of finding appropriate remedies for the worrisome problem of poverty, and appropriate ways of implementing the long promised land reform, which is still behind schedule. The lack of progress on the land reform issue also contrasts with recent progress in the fiscal and monetary fields, where policy slippages have finally been more or less corrected.

From the macroeconomic standpoint, the Philippine economy's prospects now look less certain than they did last May, at the start of the extended Fund program consisting of debt and debt-service reduction operations. Programs which include this kind of Fund-supported operations are supposed to be characterized by the strength of the economic policy measures, in particular. The strength of the economic policy measures is especially important at the present juncture, because the need for adjustment is just as pressing as ever.

The staff has done an excellent job of highlighting the past policy slippages and precisely identifying the corrective actions which must be taken from now on. These include the cor-rection of domestic oil prices, on which it is heartening to note that the authorities have already reacted appropriately. I can entirely agree with the staff appraisal of the present situation of the Philippine economy, and with its conclusions as to the policy directions and the precise policy measures now to be taken. I would urge the authorities to implement this policy matrix strictly and thoroughly, in order to demonstrate clearly their command of the situation. Recent developments, both economic and political, call urgently for such a demonstration. Special emphasis should be given to measures for strengthening the political and social consensus for the adjustment program, both domestically and internationally.

Most urgent, from the domestic standpoint, is addressing the problem of widespread poverty and the long overdue land reform, but these efforts must not of course compromise the fiscal adjustment target. Most urgent, from the international standpoint, is to boost investor confidence in the economy by a prompt overhaul and relaxation of the Omnibus Investment Code and the Board of Investment procedures.

I fully agree with and endorse the staff's policy recommendation. I have one question concerning the reduction of the investment tax credit, which is one of the additional tax measures that was proposed after the failed coup attempt to keep the fiscal program on track. This measure, although reasonable enough from the fiscal standpoint, could easily prove an obstacle to such other desirable objectives as the encouragement of domestic investor confidence, achievement of the growth target, and avoidance of a further weakening of export competitiveness. The staff's comments on this point would be welcome.

Whether the report is right in saying that the balance of payments outlook is now better than before remains to be seen. On the outlook itself, I have three questions. First, the export performance projections for 1990-92 retain the average volume growth target of 10.5 percent. It is clear that this projection assumes an improvement in the present level of export competitiveness, but seems too high even if the assumed improvement is fully realized, especially over the next 12 months--over which time a 12 percent increase is expected.

Second, substantial net inflows of foreign direct investment are assumed, and the report adds that these have been estimated conservatively. Since the actual direct investment inflow for 1989 fell far short of the programmed amount, on what basis does the revised program adjust this flow upward from the assumptions of the initial program?

Third, the income elasticity of imports has also been adjusted upward, to about 1.5, which is the main reason for the higher current account deficits estimated for the rest of the program period. But the report gives very little information on the reasons for such changes in the economy, stating simply that this structural change was made in the light of the experience in 1989. Could the staff be more explicit on this point?

The Board is now confronted with the Philippines' request for accelerated purchases of set-aside amounts. I am not sure we should approve this request, since, according to the Fund's guidelines, the phasing of set-aside purchases should be in line with program performance. The major policy errors of the recent past, and their consequences, therefore seem to call for maintaining the normal phasing of these set-aside amounts for now. It will be easier to approve such a request at a later stage, perhaps in conjunction with the Board's consideration of a Philippine request for augmented interest support.

Of course, these remarks have a wider application than just to the case before us today: they are intended to be general, and reflect this chair's view that similar situations should be avoided in the future. We should come back to this point when the guidelines on the Fund's involvement in the strengthened debt strategy are reviewed. The constellation of events before us today is quite unfortunate, and appears to leave us no alternative but to endorse the proposed requests. First, the payment date for the debt buyback, already agreed to, is January 3, 1990. Second, the Fund's disbursement of set-aside amounts is needed to trigger the disbursements of other institutions, and a refusal of today's request would leave the Philippines practically without the resources to accomplish the buyback. Third, in Mr. Evans's frank assessment, without approval of that element, the whole program would fail. This leaves us no choice but to approve the proposed decisions, however reluctantly.

Our agreement is based mainly on three expectations. First, that debt and debt-service indicators will show substantial improvement over the medium term. Second, that total Fund credit will fall during the period of the extended arrangement. And third, and most important in the present context, the Philippines' excellent record of discharging its obligations to the Fund gives reason to expect an equally diligent maintenance of these obligations in the future.

Mr. Grosche stated that at the time the Board had approved the present extended arrangement for the Philippines, he had been among those Directors who had voiced concerns regarding the financing of the program. He had also wondered whether the pursuit of an ambitious growth target without strong measures in place for higher public savings, might not compromise price stability and balance of payments viability. As it had turned out, his concern seemed to have been well founded.

He welcomed the fact that an agreement had been reached recently with foreign commercial banks, Mr. Grosche went on. At the same time, he could not but be disappointed that the total financing from the package--new money, in particular had fallen short of the amounts envisaged. Also, the necessary rephasing of the reserve targets of the program was most unfortunate. It implied not only that there was a thinner cushion against adverse external developments, but also that the Fund's money was put at an even greater risk.

The staff report revealed some developments which he believed warranted close attention, with a view toward countering major program deviations in a timely manner, Mr. Grosche stressed. He had in mind in particular inflationary developments and the deterioration of the external current account, both of which were closely linked to insufficient savings in the public sector.

It was certainly reassuring to note from the paper that the authorities recognized the crucial importance of greater price stability and external viability for sustaining growth at high levels, Mr. Grosche commented. He welcomed their decision to tighten policies. However, he feared that the policy measures that were being contemplated for 1990 might be too modest to ensure a return to the program path. To aim at an inflation rate of 8 percent for 1990 was clearly not ambitious enough. He was also concerned that the scope for monetary and credit expansion remained on the high side, especially bearing in mind the still substantial liquidity overhang which appeared to exist in the economy. In any case, a sufficiently restrictive monetary stance would help to stimulate gross national savings, which in 1989 were expected to fall substantially short of earlier expectations. It could also make an essential contribution to improving further the external capital account.

Similar, and perhaps additional, concerns arose in the fiscal policy area, Mr. Grosche went on, where revised estimates for 1989 indicated not only that insufficient progress had been made, but that even a reversal of adjustment gains achieved in 1987 and 1988 might have come about. He wished therefore to strongly endorse the intention to tighten the fiscal stance and to keep the 1990 consolidated public sector deficit in line with the original program target.

The importance of credible fiscal action could hardly be overemphasized, Mr. Grosche remarked. It not only had an immediate bearing on resource availability to the private sector, but also on the cost of those resources, and the overall savings performance of the economy. It also related to the need to restore business confidence as a prerequisite to sustainable growth. While that confidence seemed to have been affected first and foremost by the existing political uncertainties, it would be bound to suffer even further if the authorities were to allow significant program deviations to occur.

In May 1989, he had already raised some doubts concerning the envisaged export growth, which he had considered to be on the high side, Mr. Grosche recalled; he continued to have doubts. The strong export growth envisaged for 1990 would require the adoption of aggressive export policies, as well as an easing of supply constraints. That in turn would require the maintenance of an adequate degree of external competitiveness. He therefore believed that the authorities would be well advised to take into account the staff's advice regarding exchange rate policy. He would add, however, that such a policy should be regarded as a second best approach, the first one being tight domestic financial policies.

With respect to the structural reform process, the agrarian reform was in his view a crucial element of the whole reform package, Mr. Grosche observed. Like the staff, he felt that much stronger efforts would be required in that area.

Despite his serious concerns, he could support the proposed decisions, Mr. Grosche concluded. He expected the authorities to fully live up to the confidence that the international community was displaying in supporting their policy commitments. He could also go along with the staff's recommendation to approve the authorities' request regarding an acceleration of the release of set-asides, in order to make the bank package succeed. Unfortunately, he shared Mr. Prader's view that the Fund had no other choice.

Ms. Powell made the following statement:

> We are concerned with the slippages in the Philippines' program in 1989. Although all but one of the end-September performance criteria were met, it is clear that the slippages were more serious than this suggests. Substantial wage increases, a more expansionary stance of financial policies, and the failure to adjust oil prices in line with world prices, contributed to strong domestic demand growth and a significant acceleration of inflation. The trade and current accounts were also weaker than had

been anticipated earlier. Even though growth was slightly below the target of 6.5 percent, the results suggest that, as well as policy slippages, this target was probably overly ambitious.

The authorities have taken a number of measures to bring the situation back under control, and we welcome these steps, in particular, the tightening of monetary policy and the adjustment of oil prices.

They have also continued to make progress on structural measures.

We can agree to the request for a waiver, as the ceiling on monetary base growth was exceeded by only a slight amount, and monetary policy has been tightened. We are also prepared to support the proposed modifications of the end-March 1990 performance criteria, albeit with some reluctance, as we have serious reservations about the program.

Our reservations essentially relate to two major concerns. The first is that, notwithstanding the slight reduction in the growth target for 1990--to 6 percent from the original 6.5 percent--we continue to believe that this may well be an overly ambitious target. We are not convinced that a program based on growth targets of 6 percent next year, and 6.5 percent in the following two years, is consistent with the necessary reduction in inflation that would allow for sustained growth. We also doubt whether it is consistent with external viability. Given the inflationary pressures in the economy that have built up as a result of the large wage increases, and the boom in construction and real estate, inflation may not moderate as planned.

Our second concern relates to the possible economic impact of the attempted coup. According to the staff, the immediate consequences of the coup attempt are not as severe as might have been expected a priori, and the staff has not suggested modifications to the program. We would agree that it is difficult, at this stage, to gauge the economic implications of recent developments. Nevertheless, the possible impact of the coup attempt has heightened our concern about the adequacy of the program. Although we hope we are wrong, it could have more serious consequences for the short and medium term than the authorities and the staff are apparently assuming at present. In particular, one must question the assumptions built into the program regarding direct foreign investment and return of flight capital. There could also be delays in other financing flows, and, as the staff notes, an impact on tourism revenue.

Until the impact of the coup attempt can be assessed more fully, a high degree of uncertainty surrounds the program, particularly with regard to the possible impact on investment, and hence on medium-term growth and external viability. We agree with the staff that it is absolutely essential that the authorities show decisive economic leadership. In particular, there can be no weakening in their intention to follow prudent financial polices, and they must move ahead rapidly with measures to strengthen the efficiency and competitiveness of the economy. However, given the uncertainties, we also feel that it is critically important that the authorities monitor the situation closely and be prepared to take corrective measures, should the assumptions underlying the program prove to be overly optimistic. We would be very concerned if the authorities were to adopt stimulative measures because of concern that growth was falling short of the target. This could add to inflationary pressures, and make what could well be a less favorable than projected external position even worse.

Looking more specifically at financial policies, we are pleased to note, from the staff statement, that the infusion of liquidity during the coup attempt has been largely reversed. We would urge the authorities to continue with measures that will bring monetary policy in line with the program, as soon as possible. We very much welcome the measures being taken by the authorities to eliminate the losses of the Central Bank, and enable it to conduct an independent monetary policy. On fiscal policy, we are concerned that increased expenditures, as a result of the attempted coup, together with possible delays in Congressional approval of revenue measures, could make meeting the fiscal target more difficult. Our concern is all the greater, given that foreign savings may be less available than has been assumed, thereby increasing the need for higher domestic savings. The authorities have made progress in improving tax administration and in closing loopholes, but need to continue with this process of fiscal consolidation by controlling expenditures, particularly wages, and, if necessary, by introducing additional revenue measures.

The authorities are to be commended for the progress they have made on needed structural reforms. However, we would agree with the staff on the need to move ahead more quickly on agrarian reform, and for better targeting of expenditures that are designed to alleviate poverty. Recent developments would appear to have made progress in these areas all the more urgent.

Despite our considerable concern about the strength of the program in the current circumstances, and the possibility of a significantly less favorable balance of payments outcome than projected, we can support the request for an acceleration of the 1990 set-asides. The debt buyback will, over time, provide considerable savings to the Philippines, and should help to build confidence.

Mr. Landau made the following statement:

Today's discussion clearly has revealed the authorities' commitment to restore the economy to a path consistent with the medium-term macroeconomic objectives of the extended arrangement. The performance of the economy in 1989 has been mixed. On the one hand, the real economy's resilience has been remarkable; indeed, GNP growth was around 6 percent for the third year in a row, investment was buoyant, reaching about 20 percent of GNP, and export diversification away from traditional products continued, with a strong increase in exports of manufactures. We are also encouraged by the significant amount of private capital repatriation. On the other hand, large wage adjustments and significant slippages in public finances have stimulated a too rapid growth of domestic demand, fueling inflation and leading to a serious degradation of the current account deficit.

My authorities are well aware of the difficult internal circumstances of the Philippines. However, we must keep in mind that any further slippages of the magnitude of recent ones would certainly jeopardize the strong growth adjustment process, which has been led over the past two years by a strong recovery of investment. Therefore, the modified program before us constitutes the minimal requirement for the return of the Philippine economy to a sustainable growth path.

I am in broad agreement with the staff's recommendation on fiscal policies. The subsidization of oil prices has been one major cause of the recent slippages, and I fully agree that the subsidy should be eliminated. The deregulation of oil prices and the envisaged increase in power tariffs are of great importance.

On the expenditure side, a strict control over current expenditure seems warranted, particularly with respect to the wage bill, after the large wage increases granted this year. We welcome the news that the 1989 target for public investment has almost been reached, implying a significant improvement in the authorities' capacity to reach their objective in this area.

We are encouraged by the good performance which has been registered so far this year on the revenue side. However, we wonder why, given this positive outcome, the target has been revised downward for 1990. This seems inconsistent with the measures the authorities intend to take to further strengthen tax administration, and broaden the scope of the value-added tax. A more ambitious target in this area would certainly have been welcome.

I generally agree with the staff appraisal on monetary and exchange rate policy. Fiscal developments have clearly complicated the handling of monetary policy. The authorities have rightly reacted in strengthening monetary policy, which has induced an increase in real interest rates and a further real appreciation of the peso. The present mix could put undue pressure on investment and export growth, and should be reoriented through fiscal adjustment.

Foreign investment is vital to ensure both an adequate level of investment and equilibrium in the balance of payments. Recent events have done nothing to help in this regard. I would welcome any further staff comments.

We are encouraged by the staff's assessment of the medium-term prospects. The international financial community has responded quickly to the Philippine authorities' commitment to sound macroeconomic policies and structural reforms. Furthermore, discussions with commercial banks have proceeded rapidly, and the final package should be signed next month. The projections clearly show that the debt-service ratio will decrease significantly in the years ahead.

On the whole, provided that the authorities avoid further slippages and stand ready to take any measures which might be necessary, financing gaps should be reduced as compared with the original program projections.

We can support the proposed decisions.

Mr. Lombardo made the following statement:

During 1989, the Philippine economy continued to make progress toward the objectives of the medium-term strategy. The strong growth in real GNP and the investment performance during 1989 were certainly encouraging, and a clear consequence of the implementation of sound financial policies and fundamental structural reforms during the past years. Particularly welcomed is the substantial progress made in terms of medium-term external viability, and in securing external financing necessary for the economic program. However, despite these positive developments, some weakening in financial policies was observed during 1989, resulting in higher price inflation and a wider external current account deficit.

All the performance criteria for September 1989 under the extended arrangement have been met, with the exception of the ceiling on the monetary base, which was slightly exceeded. Given the efforts and the progress that have already been made, and the authorities' commitment to return to the program path, we can support the proposed decisions on the review, waiver and modification of the extended arrangement, as well as on the exchange system. In particular, we support the decision regarding the disbursement and acceleration of set-asides to assist the financing of the buy-back operation agreed to with commercial banks.

We are in general agreement with the thrust of the staff's appraisal and recommendations, and have only some few specific comments on the areas of fiscal and monetary policy.

The large increase in minimum wages and the large subsidy for oil consumption seem to be behind the weakening in financial policies and the unexpected growth of domestic demand observed during 1989. The large subsidy for oil consumption and the over-run in current expenditures associated with the salary increase and higher interest payments resulted in a higher public sector deficit, despite buoyant tax revenues. In this regard, we welcome the authorities' intention to return in 1990 to the original fiscal target, through a balanced combination of revenue measures and expenditure restraint, as indicated in the policy memorandum. Elimination of the subsidy for oil (amounting to close to 1 percent of GNP in 1989) and deregulation of oil prices are certainly crucial policy actions in the right direction.

Furthermore, actions to reduce and eliminate the Central Bank's losses in the medium term are especially needed, not only to reduce the consolidated public sector deficit, but also to permit the conduct of an independent monetary policy. In this regard, we encourage the authorities to adopt the needed measures, in particular, the transfer to the National Government of liabilities incurred by the Central Bank in functioning as a fiscal agency, and the rationalization of interest rates paid for National Government deposits in the Central Bank.

The experience in 1989 shows that one of the weaknesses of monetary policy was the difficulty in selling treasury bonds, and of mopping up liquidity in the economy through other instruments of monetary policy. We wonder whether the diversification into, and issuance of, new instruments by the Central Bank could play a role in this regard, making the implementation of monetary policy more flexible.

A more flexible application of monetary policy could also have a positive effect in reducing the monetary impact of the debt to equity conversion operations. The revival of such a scheme--as planned--could be helpful not only to achieve a reduction in external debt, but also for the transfer of technology and repatriation of capital flight.

We fully share the staff's view on the need to have a more balanced combination of fiscal and monetary policy in order to reverse the recent loss in competitiveness. In this regard, the authorities' firm commitment to implement the needed fiscal adjustment, while reducing the pressure on monetary policy, in order to facilitate a depreciation of the peso, is most welcome. An adequate level of competitiveness is certainly a necessary condition to ensure the strong export growth and diversification that the external viability objective requires.

I commend the Philippine authorities for the progress they have already made in securing the external financing necessary for the medium-term program. We note the loan commitments obtained from official bilateral and multilateral creditors, the agreement reached with the Paris Club, and the completion soon of a financial package with commercial banks. The broad support received by the Philippines from the international financial community is an encouraging recognition of the serious effort that the country is making in addressing its economic and social problems.

Mr. Enoch made the following statement:

The last six months have been difficult ones for the Philippines. The fiscal and current account deficits are now projected to be substantially larger than the program targets, inflation has increased sharply, and some of the important structural measures planned by the Government appear to have run into the sand. This is not the sort of commitment that is necessary under an extended arrangement, after 15 years of protracted use, nor that under a program within the new debt strategy. As Mr. Kyriazidis has noted, this is the first such program to have gone off track. While an agreement has been reached with the commercial banks, they have not been prepared to lend new money in the amounts that it was originally thought would be essential to the viability of the program. Earlier in December 1989, the situation was confused further by an attempted coup. As the staff says, at this early juncture, it is difficult to gauge the full economic implications of the coup attempt, but it can hardly have improved an already difficult situation. It should certainly make the Board pause before approving a substantial front-loaded loan.

The program for 1990 seeks to address these problems, and in the staff's view is sufficient to correct them. The question is whether the authorities can implement this program, especially since some of the slippages from the 1989 program targets were the result of a failure on the part of the authorities to implement essential measures.

This applies particularly in the area of fiscal policy, where most of the authorities' problems stem from excessive wage settlements in the public sector and the maintenance of subsidies on domestic oil prices. If the program is to be successful, it is absolutely crucial that the authorities address these issues. In particular, the authorities must hold the line on salaries. On oil prices, the measures which the authorities have now taken are welcome, but I agree with the staff that it is essential that they continue to adjust domestic prices to reflect changes in international prices and the exchange rate. The political difficulties attendant on moving the oil price are characteristic of a situation in which prices are not freely determined.

On the revenue side, the authorities have proposed a number of important measures to Congress, but Congress has yet to decide on them. I would hope that these measures can be implemented swiftly, although this must be far from certain. If they are not, then the authorities will need to consider alternative means of improving the fiscal position.

In the area of monetary policy, the authorities have asked for a waiver of one of the performance criteria for September 30 under the program--that of the ceiling on base money. I can go along with this waiver on an exceptional basis, as the limit was only slightly exceeded. However, the underlying factor--which is of considerable concern--is the increase in the rate of inflation. It is essential that the authorities bring this under control, and their willingness to implement an interest rate policy which involves significantly positive real interest rates is an encouraging sign in this respect. But if the authorities' anti-inflationary policy is to be successful, fiscal policy must take up more of the strain. I welcome the recognition of this in the staff paper.

The appreciation of the real exchange rate in 1989 is also a source of considerable concern, given the prospects for the balance of payments over the medium term, and the repeated focus of past Board discussions on slippages in this area. I would agree with the staff that greater weight should be given to exchange rate policy, and that the authorities should aim to reverse quickly the recent loss in external competitiveness. I would be interested to hear how firm are the authorities' assurances in this area.

In the area of structural policies, many measures have already been taken. I would commend the authorities for their rigorous action in the field of privatization. But it is very disappointing that land reform, which is the centerpiece of the authorities' structural measures, appears to have stalled. I hope that more progress can be made on this over the next year.

A great deal more effort will be required from the authorities if this program is to be successful. But even if the authorities do take all of the necessary measures, there may be problems in financing the program. In this chair's view, the financing assumptions in the original program were optimistic; those in the latest paper are even more so. For example, export growth is expected to be 15.5 percent per annum from 1991 onward, and forecasts of direct investment have been revised upward in every future year. Even if this was central before the coup attempt, it would not be so in its aftermath. The commercial banks, which originally would have been expected to contribute $1.7 billion toward the financing gap, will now be contributing much less.

Virtually the only aspects of the financing which have definitely improved are inflows in the form of bilateral aid and more generous than expected rescheduling from the Paris Club. Of course, this amounts to a further shift of the financing burden, and transfer of risk from the private to the official sector, given the shortfall in the commercial banks' contribution. The coup attempt can only have damaged the prospects for capital inflows, and even on the basis of the assumptions regarding capital inflows in the paper, the target of building up gross reserves to three months of imports has been deferred, from 1989 in the original program, to 1991. Financing gaps, of course, remain in the outer years of the program. In the light of all of this, one would have to say that the financing of the program remains precarious.

The debt buyback which has been agreed with the commercial banks should, of course, improve the Philippines' financial position in the long term. I have a few comments and questions about this part of the proposed decision, however.

First, I am disturbed by the delay in the agreement on new money from the commercial banks. Conducting the buyback operation first means that the Fund and the World Bank will be making their contributions somewhat ahead of the commercial banks. While the assurances about new money given by the staff at the beginning of the meeting provide some comfort, it is nevertheless of concern that the banks could still back out if there are adverse developments. I would be grateful for staff confirmation of this. Second, I assume that the Philippines will have adequate resources to effect the buyback. It would have been helpful if more information on this could have been given in the staff paper.

I note that the staff paper refers to the Philippines using some of its own reserves to finance the buyback, and that the reserves used in this transaction would be replenished over time by the use of remaining set-asides from the Fund and the Bank. I presume that this means that only potential additional resources would be available to finance the kind of second-stage debt reduction operations which are referred to in the paper. Perhaps the staff could elaborate on this.

There are a number of features in the review which seem to be a cause for some concern. The program has clearly gone off track in policy terms in 1989. Although the 1990 program does contain the kind of measures that are needed to bring it back on track, the authorities will need to pursue them resolutely, and will also need a certain amount of luck, especially with respect to the financing of the program. We are also concerned about the extent to which the Fund and the World Bank are now out in front of other creditors, especially when the accelerated set-aside resources are taken into account.

I would be interested in the staff's response to Mr. Kyriazidis's question about the possibility of strengthening the program, especially on the fiscal side, at the time of the first review.

Mr. Ismael made the following statement:

So far in 1989, the adjustment program for the Philippines, which was approved by the Executive Board in May 1989, has been on track in regard to the growth and investment objectives. However, both the inflation rate and the current account deficit have worsened, and some slippages in policy implementation have occurred. This does not come as a complete surprise, considering how ambitious the program is, and the events that have occurred since. It is still too early to determine for sure the extent to which the recent disturbances may have damaged the chance of achieving the program targets. However, it would be prudent in any case for the authorities to be prepared for the worst.

I commend the authorities for their competent handling of what could have become an economic crisis. I agree with them that fiscal restraint, a prudent monetary stance, and improved external competitiveness should remain the core elements of their program.

The fiscal policy measures planned for 1990 comprise expenditure restraint, new revenue measures, and a further strengthening of tax administration. These are steps in the right direction, and should be pursued with determination. A tighter fiscal policy will help ease some of the burden of monetary policy. The latter must remain cautious, and be adapted quickly to any change in circumstances. The present policy of permitting interest rates to find their market level should continue to be followed.

The large increase in wages which became effective in 1989 for both the civil service and the private sector appears somewhat excessive. I urge the authorities to exercise greater restraint in the future in this area. Negative effects are likely on the Government's fiscal position, the inflation rate, and export competitiveness, which the Government can ill afford to risk. I am inclined to wonder whether a reliance on fiscal and wage restraint will be sufficient to maintain external competitiveness; a more flexible and active exchange rate policy may be appropriate.

Reasonable progress has been made in the area of structural adjustment, including tax reform, oil pricing policy, reform of government corporations, and financial sector reform. I commend the authorities for their strong commitment to continue with their reforms, and I urge greater attention to agrarian reform, which appears to be lagging. A greater diversification of crops will help provide a cushion for external price fluctuations. The successful abolition of the OPSF by the third quarter of 1990--although overdue--would be a bold step, and could serve as an example for other countries which have found a similar move to be politically difficult. The price controls imposed on some commodities in the aftermath of the coup attempt would hopefully be eliminated as well.

I note that the debt operation with commercial banks is an essential component of the adjustment program. I urge official and commercial bank creditors to continue playing an appropriate role in the required financing. For their part, the authorities should continue to pursue prudent economic and investment promotion policies in order to attract direct foreign investment.

I also urge the Philippines' trading partners to help by opening up their markets, so that the country will be in a position to earn foreign exchange to service its debts.

I endorse the authorities' request for the release of set-asides in order to finance the debt buyback. I am also prepared to endorse the Fund's continued support, including the waiver that has been sought. I commend the Philippine authorities for their commitment, and urge them to persevere with the program. I can therefore support the proposed decisions.

Mr. Ghasimi made the following statement:

In spite of political disturbances, an unfavorable external environment, and severe financial impediments, the Philippine economy has shown a satisfactory economic performance in recent years, resulting in a rather high annual rate of economic growth of about 6 percent during 1987-89. It is quite clear that the shift from a consumer-led to an investment-led economy, manifested in a high level of investment--estimated to account for 20 percent of GNP in 1989--has contributed to this satisfactory economic growth in recent years. It is indeed heartening to note that such an economic recovery has been accompanied by further indications of a repatriation of capital flight, a decline in external debt, and the containment of the current account deficit at a rather low level of GNP.

It is quite clear that considerable challenges will confront the authorities in the future, as a result of the susceptibility of the economy to both internal and external shocks. In such a situation, it can hardly be denied that the attainment of sustainable economic growth, along with the achievement of more balanced internal and external conditions, depends upon not only firm commitment in implementing the appropriate adjustment measures, but also a favorable and conducive external environment and the extension of considerable financial support from the international financial community.

In fact, the preliminary results for 1989 indicate that, in many areas, the achievements so far have been positive. However, the performance of the economy with regard to inflation and the appropriate level of national savings has not been satisfactory. Despite the improvement in tax collection, the government deficit was somewhat larger than previously envisaged, because of higher current expenditures.

Looking to the future, we are pleased to note that the macroeconomic framework for 1990-92 proposes and accommodates the necessary corrective policy measures to reduce the prevailing internal and external imbalances. The further expansion of investment that is anticipated over the period 1990-92, and its financing mainly through higher levels of domestic savings, are definitely steps in the right direction.

Financial sector reform continues to be an essential element of the structural policies in the Philippines. In this respect, the legislation to enhance bank supervision procedures will be crucial to improve the management of the banking system and the allocation of bank credit according to economic criteria.

The public corporate sector, which expanded very rapidly during the 1970s and early 1980s, contributed to and, in a sense, complicated the task of the Government in trying to reduce both the current account and public sector deficits during the 1980s. The authorities' structural reform program to privatize and strengthen financial institutions and enhance their management and operations was definitely a step in the right direction. The authorities should be encouraged to implement the measures necessary to enhance the efficiency of the public enterprise sector.

We also welcome the second phase of the authorities' comprehensive program to strengthen tax administration, especially the acceleration of the computerization of the value-added tax system and the training program.

In the foreign trade sector, recent trends show that the expansion of exports of manufactured goods from the Philippines has played a crucial role in the successful recovery of exports since 1986. However, as noted by the staff, a considerable part of this increase has been due to the expansion of small domestic value-added activities. In this respect, and given the recent rising trend of urban unemployment--from 11.9 percent in 1988 to 12.6 percent in 1989--the authorities must now decide whether to expand the domestic value added in the export of manufactured good at the risk of confronting higher degrees of protection for the more processed goods in the markets of the developed countries.

We support the proposed decisions, including the acceleration of the set-aside for debt reduction for 1990.

Mr. Al-Jasser made the following statement:

Commendable progress has been made in implementing structural reforms and adjustments in the Philippines. In particular, tax administration has been streamlined, government intervention has been significantly curtailed, and higher exports of manufactures have been registered. However, the internal and external disequilibria worsened in 1989, as excessively expansionary financial policies, lax incomes policy, and delays in the adjustment of certain administered oil prices caused domestic demand to grow sharply. Inflation picked up, and the Philippine peso appreciated substantially in real effective terms. In the process, and despite larger-than-expected capital inflows, the balance of payments weakened, and the buildup of gross official reserves fell far short of the program target. Moreover, the delay in the implementation of the land reform program is to be regretted.

It is helpful to note that the authorities recognize the need to correct past deviations from the adjustment path by reining in the growth of domestic demand and restoring external competitiveness in 1990. Their emphasis on moderating demand growth through public sector expenditure restraint and the much-needed upward adjustment in domestic oil prices to international levels is appropriate. Clearly, the success of the renewed initiative will depend critically on a stronger and more determined implementation of these policies. It also presupposes the availability of adequate financing from commercial banks. It is very disappointing that commercial banks have so far fallen behind expectations with respect to the provision of new money. It is important that the Fund exert as much moral suasion as possible on commercial banks to fulfill their obligation of meeting the Philippines' financing needs.

Perhaps the most important issue relates to the implications of the recent attempted coup for the ability of the Government to strengthen adjustment efforts. I am happy to note from the staff's statement that the short-term effects of the abortive coup may be minimal. However, the medium-term effects may be more important. The export performance in 1990 may fall short of expectations, and the much-needed inflow of foreign direct investment and flight capital may not materialize. These events clearly imply that while reforms can no longer be delayed, the needed further stringency consistent with poverty alleviation and an early and broad-based growth would not be easy. That is why it is essential that the world community strengthen the ability of the Philippine Government to continue on the agreed adjustment path. In this context, a more comprehensive analysis by the staff of the implications for the period ahead would have been helpful.

I am in favor of releasing the accrued set-asides and the requested accelerated release of set-asides for 1990 to facilitate the buyback of commercial bank debt. Since the financing that is expected from the Fund and the World Bank might not be able fully to meet the authorities' requirements, it would be desirable if the bilateral contributions were to be forthcoming without delay. The debt-equity swap, which has so far helped in reducing the external debt by over $800 million, should be continued, and applied vigorously. It is incumbent upon the authorities to continue pursuing other avenues to reduce debt, and to shift toward acquiring nondebt foreign liabilities, such as foreign direct investment. In this context, I urge the authorities to move quickly toward ratifying the MIGA convention, and also to take concrete steps to rationalize the regulations and incentives applying to foreign direct investment.

I support the proposed decisions.

Mr. Dai made the following statement:

It is encouraging to learn from the latest information provided by the staff that, despite the present difficult situation in the Philippines as a result of the recent political turbulence, the authorities have reaffirmed their full commitment to the objectives and policies of the economic program for 1990. Although, as the staff indicates, the immediate economic consequences of the coup attempt were not as severe as had been expected, the determination demonstrated by the authorities in overcoming the disruptive effects, and in promptly restoring economic and business order, is commendable.

According to the staff report and Mr. Evans, the performance of the Philippine economy over the past year indicates that the main objectives of the adjustment program remain broadly on track. It is estimated that real GNP growth for 1989 will reach about 6 percent, and total investment will rise to about 20 percent of GNP. On the external front, payments problems have been avoided, despite a heavy burden of debt and debt service. Progress in the areas of structural policies has also been generally in line with the objectives of the program, except for land reform, which has fallen behind schedule. Nevertheless, in light of the recent acceleration of inflation and the widening of domestic and external imbalances, it is obvious that much remains to be done in 1990 and beyond. I am in broad agreement with the thrust of the staff appraisal.

On the overall economic situation, although the pattern of domestic demand that has developed in the past few years has helped to produce a sound growth of output and to return the balance of payments to an acceptable level, it cannot be sustained over a long period of time without bringing adverse consequences to the economy. As a result of substantial wage increases in both the private and public sectors, which have bolstered private consumption over the past year, excessive growth of domestic demand continues to place pressure on prices and on current payments. By the end of the year, the inflation rate is expected to accelerate further, to some 13 1/2 percent, and the current account deficit would continue to widen, due to a large increase in imports--outpacing export growth--and a significant deterioration in the terms of trade. In order to cope with demand pressures, monetary policy, which was lax at midyear, has been tightened recently.

Although this tightening appears to be necessary in the short run, the impact of the resulting higher interest rates on investment and on the exchange rate should be monitored carefully.

On the financial policy front, although by the latter half of 1989 the monetary and fiscal policy slippages had already been corrected, the policy mix of a relatively lax fiscal policy and tight monetary policy during the year has put upward pressure on the exchange rate, adversely affecting external competitiveness. In this regard, the staff is correct to emphasize fiscal policy as a key area in which strong measures need to be taken to further reduce the budget deficit. Nevertheless, in light of the social impact that is often associated with such austere policies, the fiscal adjustment measures would need to keep a good balance between expenditure restraint, new revenue measures, and a further strengthening of tax administration. Given the difficult situation facing the authorities after the recent political turbulence, it is important for the authorities to pursue fiscal restraint in a prudent manner, particularly when some of the structural reforms have yet to be complete.

It is encouraging to see that substantial progress was achieved in external financing in 1989, and that the outlook for uncovered financing gaps after 1990 would be smaller than originally projected. But, it is noted that total financing from the commercial bank package, in particular the new money element, has fallen short of the amounts envisaged. As pointed out by the staff, this support from the international banks would be crucial not only to the success of the entire debt reduction package for the Philippines, but also to the country's economic growth and financial stability. It is to be hoped that progress in this regard will be made, in light of the negotiations and agreement between the Advisory Committee and the Philippine Government.

Given the fact that the economic performance of the Philippines is basically on track, and given the firm commitment of the authorities to carry on with economic adjustment despite the recent domestic turbulence, it is appropriate to approve the authorities' request for the second drawing under the extended arrangement, the acceleration of funds set aside for debt reduction for 1990, the waiver of the nonobservance of the performance criterion on the monetary base for end-September 1989, and the modification of performance criteria for March 1990. I fully support the proposed decisions.

Mr. Fernando made the following statement:

We are in general agreement with the thrust of the staff appraisal, and the recommendation. The debt reduction operation will require a contribution from all the parties concerned if it is to be meaningful and successful. In particular, from the Fund the use of Fund resources and provision of policy advice will be needed, and from the country itself, a contribution in terms of resources and adjustment will be required. We are encouraged by the results of the first round of the debt reduction exercise. The impact of the exercise has to be judged in terms of whether it was the most efficient way of using scarce resources. While the evidence provided in the papers suggests that this condition has been satisfied, the lasting benefits of the exercise will be seen only over time. This underscores the need for a strong and sustained commitment to economic adjustment and reform policies, particularly in the light of some negative perceptions about political stability. The economic message to the private sector should be stronger than it was before. Such an adjustment path should also lead logically to a declining reliance on domestic debt to finance government operations. The authorities' actions to correct the recent slippages are welcome.

The authorities' strategy is to reduce the debt burden on a lasting basis through a blend of growth and direct actions to reduce the outstanding stock of debt and debt service. Conceptually, this is indeed sensible, as such a strategy enhances future prospects. But inevitably, questions arise as to the sustainability of the high level of investment and the growth rate. Growth and industrial product exports have a high import coefficient. In this context, the relationship between the growth rate and debt reduction operations, on the one hand, and financing gaps, on the other, is obvious. A question which might be addressed is whether the financing gaps that were induced by the growth-oriented debt strategy have caused the banks to question whether they should have a role in filling them. This is even more relevant in the context of the apparent shortfall in new money pledges. In any event, a high value should be attached to improving the efficiency of existing investments through adequate maintenance expenditure--an aspect usually not that attractive to policymakers, as opposed to new projects--as well as through strengthening the competitive forces in the economy.

In the light of the developments affecting the objective of regaining access to private credit markets, it might be observed that markets would show a greater willingness to lend to the private sector than in the period when sovereign lending was the rule. Lending decisions are thus obviously going to be more difficult. We should expect a more rigorous screening of projects, in both the private and public sectors. We cannot overemphasize the contribution that a stable macroeconomic environment, an appropriate incentives structure, and a viable public investment program can make to facilitate such screening.

There should be no doubt that monetary policy will attach the highest priority to dampening inflation. Inflation can reverse all the gains in the external sector, including from debt reduction. Indeed, it is a healthy sign that the gap between the official and parallel exchange markets is very small, and this should not be reversed. But, inflation can disturb this, while also requiring a rate adjustment to restore competitiveness. We note the proposals that have been made and the actions that have been taken to restore competitiveness through a nominal depreciation, but we would like to see less pressure on the exchange rate from inflation, as we recognize that exchange rate actions have other objectives, including in support of trade liberalization. The low domestic value added of manufactured exports would also seem to urge caution in relying on the exchange rate to offset domestic policy slippages. Thus, we would like to see a strong monetary policy.

Of course, the question of high interest rates acting as a brake on private investment is relevant, but could be addressed in a number of other ways, such as, inter alia, measures to further reduce bank intermediation costs, measures to increase the efficiency of the financial sector through greater competition, and measures on the labor front. Control of and timely attack on inflationary tendencies through monetary action can also dampen any risk of capital flight, through maintenance of positive real interest rates.

We take note of the official community's strong endorsement of the Philippine program. Higher-than-expected official capital inflows have mitigated the external financing gap, which is accommodating growth-driven import expenditures and the target level of reserves. The authorities should take advantage of the margin thus provided to consolidate program implementation--for export performance to cover the import needs, and for a lower level of government involvement, which could act to reduce government claims on official external reserves. We support the proposed decisions, including the release of set-asides for June and December 1990, as the negotiations for the first round of debt reduction are drawing to a close.

Mr. Hogeweg made the following statement:

The staff report was written before the recent political upheavals. I was struck by Mr. Evans's statement that the slippages which occurred in mid-1989 were directly related to the need to maintain a domestic consensus around the basic program objectives, and that the correction of these slippages by the latter half of the year had caused a considerable reaction from the electorate. I take this to mean that the Philippine authorities feel that they are operating on the edge of what is politically feasible. I would stress that political feasibility is not a constant which is to be taken as given; it can be influenced by the authorities' actions. However, together with the recent coup attempt, this raises a doubt as to the ability of the authorities to pursue their policy intentions for the remainder of the program, which aims at restoring the original development path. In the meantime, the damage of the slippages is not undone as quickly as the corrective tightening of the policies themselves. The public sector borrowing requirement has been brought to a higher level, and the current account position is weaker than before. If, as the staff suggests, a higher level of imports is needed to sustain the targeted growth rate, I might conclude that perhaps the growth objectives are too ambitious. I note that Mr. Evans ascribes part of the widening of the current account imbalance more directly to the higher domestic demand fueled by the slippages. However that may be, I feel that the program has been weakened by the slippages that have occurred. This is all the more regrettable, since the political tolerance for adjustment is now in part used to undo the damages of slippages. That does not bring the country much further.

In addition, there now is the impact of the recent coup attempt to be dealt with. It is indeed premature to assess the effects of the coup attempt on investment and private capital flows, both of which are essential pillars on which Philippine economic developments rest. I am sure that different judgments can be made on the issue; after recent discussions with the authorities, the staff appears to be remarkably sanguine. I really do not know what to believe, but at the very least, some important additional measure of uncertainty has been added to the program, which struggles now to regain its envisaged path.

Official financing of the Philippine program is developing beyond expectations. As a result, in spite of the increased external imbalances, the financing gaps now seem smaller than before. I have mixed feelings about that, especially when seen in combination with the outcome of the financing package with the commercial banks, which provides less new money than envisaged, and it seems questionable whether the one-month extension of the signing of the package will generate significant additional amounts. However, the banks have offered larger amounts of debt for the buyback scheme than the Philippines can finance at present, given the separations between debt stock and debt-service reductions. I think, however, that the buyback part of the bank package is a positive market-based example of how debt reduction operations can work.

Apart from the program review, the waiver, and the modifications of the extended arrangement, the Board is also asked to agree to acceleration of set-asides becoming available through 1990, and to approve the release of the set-aside amounts to help finance the buyback operation. This is the first time that the Board is called upon to decide on the release of set-asides, and I feel therefore that we should be very careful. The staff feels that the proposals fit in with the guidelines approved last May. At the time of approval of this program, I had a major difficulty with respect to the financing assurances, and the fact that a medium-term scenario illustrating the way the envisaged debt reduction operation would decisively help the country to attain external viability and renewed spontaneous market access was absent. The absence of that, at that time, means that now, a clear yardstick to measure the efficiency of the use of those resources is also lacking, and I must conclude that the strength of the program on which the operations are based has been weakened since its approval.

I would urge the Philippine authorities to be very much aware that they should, at the very least, adhere firmly to the program as it has been amended, and, if at all possible, do better, especially in the fiscal area. That is the only way to maintain confidence, which will be crucial for their success. Although there are clearly big risks involved, I am willing to go along with the proposed decisions, precisely because I believe that Fund support is essential to prevent a loss of confidence--which might be fatal at this juncture. As to the set-asides, I very much appreciate the authorities' explicit agreement with the Fund's recent decision on early repurchase expectations, which covers both the case of misuse of set-asides, as well as program derailment. This facilitates our support for the front-loading which is involved, which seems to be very much needed to finance the operation. Front-loading should, however, remain the exception, rather than the rule. I believe that these funds should be disbursed at the moment they are actually needed to effect the intended transactions; like Mr. Enoch, I wonder what exactly is the relationship between these transactions and the signing of the package in February 1990, and what separate timing implies for the position of the Fund.

Mr. García stated that the overall performance of the Philippine economy over the previous four years had been without question favorable and encouraging. Major progress had been achieved in reducing macroeconomic disequilibria and improving resource allocation. As a consequence, inflation had been kept under control, and real GDP had grown at rates slightly more than double the rate of population growth. The return of flight capital and the bolstering of foreign investment were further evidence of the effects of that excellent performance. The progress was even more encouraging if it was compared with that of other countries with similar problems at the time the Philippines had begun its adjustment efforts in 1986, and taking into consideration the fact that progress had been made in a context of social and political instability.

There had been some weaknesses in program implementation during the first half of 1989, Mr. García pointed out. However, according to the staff and Mr. Evans, the authorities were committed to maintaining the program on track. He encouraged the authorities to continue with the pace and strength of the adjustment process, particularly on the fiscal front and with respect to external competitiveness, in order to avoid losing the progress that had been made so far. He was however well aware of the internal difficulties the authorities were confronting.

He concurred with the staff appraisal and fully agreed with the points that had been raised by Mr. Evans, Mr. Garcia concluded. When the extended arrangement with the Philippines had been discussed by the Board in May 1989, the major concern had been with respect to the uncertainty of the financing gap. At present, the outlook was different, as there was more evidence that the financing gap might be covered. In that respect, he welcomed the contributions that had been made by several bilateral donors, and the commitment of the Paris Club to ease the financial burden of the Philippines. However, he regretted the reluctance of commercial banks to make a commitment to contribute on a lasting basis, even though the Philippines was making great efforts to correct the past mismanagement of the economy. That notwithstanding, the agreement that was expected to be signed in January 1990 with the commercial banks would be an important step in the direction of covering part of the remaining financing gap and reducing the debt overhang. As Mr. Evans had stated, the acceleration of a limited part of the set-asides was an essential component of the program, and the Philippines deserved the Fund's full support for that operation. He supported the proposed decisions.

Mr. Bindley-Taylor stated that he was in broad agreement with the staff appraisal. He also had been heartened by the rate of economic growth in the Philippines, but he regretted the slippages of 1989. Those slippages had been caused by an overrun in the fiscal deficit and a certain amount of monetary expansion, which had contributed to inflationary pressures and widened the current account imbalance. He was heartened by the fact that the authorities had responded to those slippages, albeit at a relatively slow pace. The policy measures in the revised program, if implemented vigorously, would ensure that the program stayed on track, and that the benefits of adjustment would be realized.

He urged the authorities to pursue fiscal adjustment, particularly wage restraint, measures to enhance revenue, and the elimination of domestic price supports, Mr. Bindley-Taylor went on. What was even more important, he urged financial reform, especially to free the central bank from treasury operations that encumbered it at present.

With respect to structural reform, Mr. Bindley-Taylor continued, he wished the authorities to renew the drive for agrarian reform, and to continue the privatization process of certain state enterprises. The relaxation of controls on foreign investment would certainly help in that connection. He noted that in the external sector, the strong export growth that was projected in the program was predicated upon export competitiveness. He therefore urged the authorities to redress the recent loss in competitiveness through their own form of exchange rate action.

While it was clear that the authorities were attempting to strengthen their adjustment efforts, and the Fund was preparing to lend its support to the program, he was concerned that the commercial banks had been hesitant in their response, and that was certainly to be regretted, Mr. Bindley-Taylor concluded. He supported the proposed decisions.

Mr. Fogelholm made the following statement:

> The case of the Philippines is certainly a most problematical one, particularly in light of recent developments, which have compounded the uncertainties. Last time we discussed the Philippine program in the Board, this chair was of the opinion that the program was too growth oriented, and did not sufficiently stress adjustment. This first review clearly shows that this criticism on the whole was well founded. On the one hand, growth has indeed been rapid, with investments being the engine. Performance criteria have also been met, with only one minor deviation. On the other hand, it is fair to say that the program has not led to the sought-for internal stabilization of the economy, or improvement in the external accounts.
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> All in all, the basic problem still lies in an excess of demand, which makes the maintenance of the internal and external balance increasingly difficult. Unfortunate policy decisions, such as the unduly large minimum wage increase, have contributed to this outcome. It is obvious that further corrective action must now be taken, and it is imperative that the redesigned program be implemented more strictly.
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> The program for the following year can still be considered to be too ambitious, and placing too much emphasis on growth. It

could well prove to be impossible to maintain the growth target at 6 percent while simultaneously aiming at a reduction in the rate of inflation and the current account deficit, given the supply constraints in the economy and the deterioration in competitiveness. Also, the staff seems to have similar doubts about the sustainability of the growth target, judging by the stress it puts on the need to keep the realism of the growth objective under close review.

The route back to a more balanced economic development in 1990, in line with the program, will undoubtedly demand a coordination of efforts in many different areas. Generally, a more restrictive economic policy is required, including a clear shift in the policy mix, with the emphasis moving from monetary to fiscal policies, if the twin goals of dampening demand and improving competitiveness are to be achieved. We are also afraid that the long lasting effects of the increase in the minimum wage, both on employment and on inflation, might have been underestimated in the staff paper, and that the correction of imbalances will require more time than anticipated. Thus, wage restraint will now be more than necessary, and the foreign exchange rate policy will have to be kept under close review in light of developments in external competitiveness.

Further structural measures are also essential to improve the environment for utilizing fiscal and monetary policy independently. In this connection, I am pleased to note that the structural policies have, by and large, been implemented in line with the program. In particular, I note that more effective tax administration has resulted in a substantial increase in tax revenues. However, in one crucial area, that is, in land reform, the program has fallen behind schedule. Recent events clearly indicate that a swift resolution is needed, and that more resources have to be allocated to this purpose.

The financing situation is apparently still unresolved, and the planned debt reduction operation is subject to further delay, according to Mr. Evans. However, this situation seems to have arisen because of a renewed attempt to increase the commitments for new money from the commercial banks. Nevertheless, it is disturbing to note that in the present projections, the financing gap for 1990 is only being closed through a reduction in the reserves.

Furthermore, it is quite possible that the current account outlook may prove to be even more precarious than portrayed in the staff report. Some Directors have already noted the optimistic export growth assumptions, and it is also possible that foreign direct investments will--at least temporarily--be severely affected by recent events, which, of course, also might induce capital flight. All in all, it would seem that the program risks have definitely increased.

Against this background, it is with concern that we view the proposal to disburse accelerated set-asides for the upcoming debt reduction operation. One possible solution to alleviate these concerns would be to disburse only a part of the set-asides for 1990 now, and the remainder after the next review. Such action would signal that accelerated set-asides presuppose stable adjustment and realistic financing prospects also for the near future. It is not at all certain that these requirements can be completely fulfilled in the prevailing circumstances. Nevertheless, we acknowledge the compelling need to alleviate the debt burden and the consequent need for enhancements.

The authorities should be encouraged to continue with their adjustment efforts. Moreover, we would like to underline the importance of the staff being prepared to react quickly if any element of the program begins to deviate from the expected path.

With this pronouncement of great concern, this chair can approve the proposed decisions.

Mr. Morshed stated that recent developments in the Philippines were a major cause for concern, as they added to the vulnerability of an already fragile economy. It was perhaps too early to assess the impact on foreign direct investment, capital flight, and the attitudes of commercial banks, all of which could have a significant effect on the macroeconomic situation. It could be assumed, however, that the internal disturbances would have served to affect adversely the risk in the program. The implications for the design of a Fund-supported program thus disrupted were that a fine balance would have to be struck between stronger economic measures to reduce program risks and sensitivity to the political constraints to adjustment.

He welcomed the continued commitment of the authorities to the program, and to the correction of fiscal and monetary policy slippages in particular, Mr. Morshed went on. He generally endorsed the thrust of the staff report. Fiscal stabilization measures would be central to the program, measures relating to public sector expenditure restraint in particular. At the same time, there was a need for monetary restraint and for the elimination of central bank losses incurred in supporting the Government's fiscal policies. Maintenance of a competitive exchange rate and continued structural reform were also necessary ingredients in the comprehensive policy package. He associated himself with the remarks of Mr. Fernando on debt reduction operations and access to private capital markets.

He wished to endorse the suggestion made by a number of speakers that measures directed at poverty alleviation in the program be better defined and strengthened, Mr. Morshed concluded. While continued economic growth was an integral part of an adjustment program, it was also essential that the benefits of growth improve the quality of life--directly or indirectly--for the weaker segments in the society, so that growth could be sustained over the medium term.

The staff representative from the Asian Department said that, with respect to the authorities' fiscal policy, the increases in the minimum wage and in public sector wages which the Government had submitted to Congress had been entirely consistent with the program, and the program expectations had been based on them. In that event, however, Congress doubled the amount of the increase suggested by the Government. The largest fiscal slippages had occurred in the domestic oil price subsidies, over which the Government had more influence, however. Regarding the corrective measures for 1990, priority needed to be attached to the consolidated public sector deficit, so that it would return to the program path that had been originally envisaged.

Over the previous few years, the staff had attempted to increase the coverage of the consolidated public sector deficit to capture more entities that were outside of the national government, in addition to the loss making enterprises, the staff representative remarked. There was at present an economically meaningful and broad coverage in consequence. Even though, as Mr. Kyriazidis had pointed out, the deficit of the national government in 1990 was somewhat higher than originally programmed, this reflected to some extent the effect of the oil price policy in 1989, which required settlement of overdue claims by oil companies over the course of 1990. The key point was that the consolidated public sector deficit would return to the program path. The overall effect of the corrective fiscal measures that would be taken was equivalent to well over 2 percent of GNP, including the oil price adjustment. Some of those measures remained to be approved by Congress--the increased taxes on alcohol and cigarettes, for example.

The downward revision of the total revenue target of the national government for 1990 was due entirely to a technicality, the staff representative pointed out. The downward revision could be attributed mainly to the measurement of nontax revenues, where there would be a shortfall, because the Government would no longer receive interest payments on certain loans that it had extended to public enterprises. Those interest payments had been financed through subsidies, and, by converting the loans into equity, the Government was doing away with both the subsidies and the interest payments. Thus, the national government's subsidy payments, as well as nontax revenues, were seen to decline substantially, leading to a decline in total revenue. However, tax revenue, which was the key concern and where the policies had their greatest effect, could be seen to conform to the original program target.

Fiscal adjustment was the cornerstone of the program for 1990, the staff representative stressed. The program envisaged accordingly a reduction in the growth of total domestic demand to 5.3 percent in 1990, compared with 7.7 percent in 1989. That also bore greatly upon the likely balance of payments outturn.

There was no question that the failed coup attempt would have some fiscal implications, the staff representative remarked. The fiscal program had contained a small margin of about 0.2 percent of GNP to deal with contingencies, which unfortunately was surely gone. Nevertheless, the authorities had under consideration various measures that could be put into effect to bolster the fiscal position, either through administrative action or Congressional approval. Those included some reduction in investment tax credits, which it was believed could be afforded because of the current investment boom. The question arose as to whether those tax credits were really needed.

Foreign direct investment had been on an upward swing and had had a beneficial impact on the economy until recently, the staff representative continued. The smaller gross flows of foreign direct investment were due entirely to the fact that fewer debt equity conversions had taken place. Other forms of investment had increased very rapidly--portfolio investment, in particular. Foreign investment applications and approvals had increased twofold to threefold in 1989. The most recent political developments might have an impact on foreign investment over the next few months, and much would depend on the strength of the authorities' policy response in that regard. Nevertheless, the estimates of foreign direct investment had originally been quite conservative for 1990, given the extent of that investment in 1989.

The authorities nevertheless realized that more needed to be done to encourage foreign direct investment, the staff representative related. A review of the investment regulations was presently being undertaken--a politically touchy subject. The authorities were considering relaxing the 40 percent limit on foreign ownership of certain companies, although there was no such limit on export industries and investment in so-called pioneer areas, which encompassed those areas of manufacturing and exporting which represented the Philippines' future. Some administrative measures could be taken to improve--and in some cases, do away with--the approval machinery. An examination of discouragements to investment would be the focus of the next review for the second year program.

Following the recent political turmoil, there was an increased recognition on the part of the Government on the need to address such socially important issues as land reform, the staff representative commented. The land reform program was important but highly sensitive politically. Although a great deal of preparatory work had been done, the transfer of privately owned and publicly owned land to new beneficiaries had fallen behind schedule. A new Secretary of Agrarian Reform had been appointed in the summer of 1989, and it was to be hoped that she would act more energetically and avoid past problems. The Government had moved in the direction of compulsory land acquisition, with pilot programs in certain areas of the country. The staff agreed that the agrarian reform measures should be implemented more rapidly.

Questions had been raised about the realism of the export projections, the staff representative recalled. Although export growth rates were projected to be fairly high, export growth in 1989 had in fact been quite high as well, especially in the important areas, such as manufactures. Volume growth in 1989 had been 17 percent, notwithstanding the shortfalls in the traditional export sector that were adversely affected by special supply and demand factors. Manufactured exports had grown rapidly, and given the Government's undertaking to reverse the losses in external competitiveness, there was no reason to believe that, with continued strong foreign demand, the export targets for 1990 and subsequent years would not be achieved. Also, because of better weather conditions, the staff anticipated an improvement in traditional exports, such as coconut oil and other agricultural products. On the whole, therefore, assuming that the right policies would be in place and that the exchange rate would not serve as a discouragement, the export targets seemed achievable.

The increase in import elasticity which the staff had incorporated into its analysis had come about because of the staff's experience in 1989, when the high import elasticity of investment had come as a surprise, the staff representative remarked. Investment was very import elastic, and since the staff expected investment to remain buoyant, it was realistic to expect a somewhat more rapid growth of imports.

Questions had been raised about the growth targets in the program, the staff representative went on. The Philippines had grown at an annual rate of about 6 percent for the previous 3 1/2 years. Foreign direct investment remained strong, and there did not appear to be any supply side constraints that would prevent growth of that order of magnitude from continuing. Nevertheless, the latest coup attempt might result in some shortfall in growth in the short run, and in making its projections the Government had accepted the possibility that growth in 1990 might be lower than it had been in 1989 and before. At the time of the next review of the program, the staff would look at the growth projections for 1990 and beyond very carefully, to see whether they were indeed realistic. If the staff concluded that somewhat lower growth projection would be warranted, the appropriate revisions to the program would have to be made.

Improvement of tax administration in the Philippines was a key issue, the staff representative stated. Although the tax system and the nominal tax rate schedule were fundamentally sound, there were problems in the area of tax compliance--especially with respect to the income tax. The staff would also provide technical assistance in the area of the value-added tax.

The short-term impact of the coup attempt had been remarkably well absorbed, the staff representative observed. There had been virtually no impact on the exchange rate, no evidence of capital flight, and the margin of the black market exchange rate over the official rate had remained almost constant. The infusion of cash into the system shortly after the coup attempt was currently being reversed. There was a very firm program of monetary retrenchment, and it could be expected that monetary policy would return to normal by early 1990.

Stimulatory measures on the fiscal side in response to the most recent events would be inappropriate given the need for fiscal adjustment, the staff representative commented. It was reassuring that not only the Government, but also the Congress, held the view that the Philippines must remain on the path of fiscal adjustment.

The question had been raised as to whether the Central Bank should issue additional paper in order to absorb liquidity, the staff representative recalled. In the past, there were two kinds of paper--treasury bills and central bank bills--which the Central Bank considered to be a problem, because of market segmentation. Thus, the issuance of central bank bills was discontinued, and treasury bill issues in excess of the Government's own financing need are the main requirement to absorb excess liquidity. Making the Treasury realize that it was at the root of the problem of the Central Bank's large net negative income position was an important step. Therefore, the current program provided for the gradual transfer of debt service from the Central Bank to the Government. The redirection of the negative net income position of the Central Bank would greatly assist the implementation of monetary policy in the forthcoming period.

The change in the mix of policies that was envisaged for 1990, along with greater fiscal restraint, should allow lower interest rates, and therefore a gradual depreciation of the peso within the floating exchange rate system, the staff representative noted. The aim of the Government's direct intervention in the foreign exchange markets had been to reverse the deterioration in external competitiveness by the early part of 1990, the staff representative continued. The target on net international reserves for December 1989 might not have been achieved because of the coup attempt, because the program had provided for substantial purchases by the Central Bank in that month in the foreign exchange market, which probably had not been possible under the circumstances. Nevertheless, the Government was firmly committed to compensating for that in the early part of 1990, so that the performance criteria for March 1990 would be met.

The debt buyback operation, which the Government had a legal obligation to engage in, was scheduled for January 3, 1990, which had been chosen because some loan repayments were to become due on January 5, the staff representative stated. Two types of resources would be provided for the buyback: the set-asides from the Fund, of $120 million, and a World Bank loan for set-asides of $150 million, which would be taken up by the Bank Board the following day. The Fund's positive decision would enable the disbursement also of a regular purchase of $90 million and a loan from the Export-Import Bank of Japan for import financing of $300 million, in parallel with Fund lending. The provision of resources before January 3 would be very important, because otherwise the buyback would not go ahead as planned, and the Government would be put in the position of having to abrogate a legal obligation. Any new money from the commercial banks would also effectively be cancelled. The new money agreement had already been delayed for technical reasons, because the Advisory Committee believed strongly that the free riders should be brought on board, and the Committee wished to have more time to pursue them. Consequently, a date in February 1990 had been envisaged for signing the new money agreement; disbursement would follow subsequently. Sixty percent of the new money would be provided once the technical work following the signing had been completed. Another 20 percent would be made available around the middle of 1990, and a final 20 percent at the end of the year. Those last two tranches of new money would be linked to the Fund purchases under the program.

The second stage debt operations that the Philippines had foreshadowed would essentially involve interest support, directed primarily at those banks which had remained on the sidelines in the present package, the staff representative concluded. The timing, size, and modalities of the operations were uncertain. The program of debt-equity conversions first needed to be put in place before the second stage operations could occur. It also depended on the preference of the banks.

The Deputy Director of the Exchange and Trade Relations Department stated that the general decision on early repurchases in connection with the debt operations had become effective by lapse of time the previous evening. The staff was circulating an addendum to the proposed decision on the Philippines which would give effect to the provisions of the general decision which had become effective the day before. The precise figure of $1312 million for the amount of the buyback had been included, because that was the amount that had been contracted, and under the circumstances the staff did not wish to provide an approximation or range, which might have given rise to doubts about what had actually been intended. In the future, such precision would probably not be necessary, and the present case should not be taken as a precedent. He wished to assure Mr. Evans that minor immaterial deviations in what was ultimately actually executed would not give rise to the initiation of a proposal by the staff or the management under the early repurchase decision. Such a proposal would only be made if something fundamentally at variance with the purpose of the operation arose.

Mr. Evans said that like the Philippine economy in 1989, the comments of his colleagues had been very mixed, which was not unexpected. He had found much criticism of performance, which had not surprised him. Mr. Kyriazidis's impressions of the extent to which the program had gone off track had been addressed by the staff, and, beyond a quibble on a detail or two, he had no problems with the substance of what he had said.

With respect to the new money package, he understood that the $600 million which was already committed--which was locked into the arrangement with the commercial banks--would not be put at risk by the delay in concluding the arrangement, Mr. Evans went on. The delay was intended to increase the final amount that would be committed.

A number of Directors had observed that the timing of the debt buyback in the present case left the Board with little choice as to the decision it would need to take, Mr. Evans concluded. That lack of choice was also inherent in the type of procedure in which the Fund was involved, where the Fund was requiring--and desiring--the debtors and the banks to reach agreement within a specified time. The Fund was requiring that the Board review the agreement before it could finally go ahead, and very tight time limits were set up. In such cases where a program was to be reviewed under pressure of time, the Board indeed often had very little choice, because the whole financing package would fail unless the program was approved. However, putting it in those terms was taking it out of context, in his view, because the authorities themselves also had very little choice in coming to a decision as to whether or not to proceed with the buyback. He made that point advisedly, from watching the process of the Philippines, and noting the close contact between the authorities, the staff, and the management over the past several months. The staff and the management had made it clear to the Philippine authorities that they had no choice but to put their program back on track, and to take certain measures before a paper could go to the Board. Therefore, although, in the end, it became a matter of presenting a case for the Board to approve about which it had little choice, a prerequisite for the paper itself was a program which the authorities had accepted, along with the authorities' prior measures. In the case of the Philippines, the measures had been taken even before the paper had come to the Board, and in that respect, the authorities had been put in the situation of having no choice either. Such a dynamic was probably unavoidable in situations like the present one.

Mr. Enoch said that in light of the comments of Mr. Evans and the staff, he could support the proposed decisions, with the addendum that had been just circulated. Like other Directors, he had been assisted in that decision by the authorities' acceptance of the Board's recent early repurchase decision. He urged the authorities to pay close attention to the points that had been raised by Directors during the discussion, and to justify the support which the Executive Board had shown them by implementing the proposed program in full.

Mr. Kyriazidis said that he had noted that his concerns had been echoed by a number of other speakers. He had also taken note of the arguments Executive Directors had made supporting approval of the proposed decisions. As he did not wish to strike a discordant note, he was willing to go along with the proposed decisions. He was particularly grateful to Mr. Evans for his assurance that the concerns of Executive Directors would be brought to the attention of the Philippine authorities.

The Acting Chairman made the following summing up:

Directors observed that the economic results of the Philippines in 1989 were mixed. Although the economy had continued to grow strongly and investment had gained momentum, inflation had accelerated, and domestic and external imbalances had widened.

Directors expressed their disappointment with the serious policy slippages that had underlain those negative developments. The potential adverse economic impact of the recent coup attempt also gave cause for concern. Directors therefore stressed that at the present juncture, it was crucially important to restore confidence in the economy and to build on the progress that had been made since 1986. In that context, they urged the authorities to demonstrate the political will to adhere to the program supported by the extended arrangement. A number of Directors believed that the policy objectives set for 1990 were not ambitious enough, and thus encouraged the authorities to stand ready to take such additional measures as might be required.

Directors emphasized in particular the importance of policies to curb domestic demand expansion and improve external competitiveness, as well as strengthened implementation of structural reforms. They also called attention to the fact that, in the light of the additional uncertainties resulting from recent events, the pursuit of unrealistic growth objectives could undermine the financial and inflation conditions that would be necessary to support sustained growth.

Directors expressed disappointment at the increase in inflation in 1989. That increase was attributable, they observed, to a rapid growth in domestic demand that was fueled by excessive credit expansion in the first half of the year, large wage increases in the private sector, and an increase in the fiscal deficit associated with the civil service wage increases and the substantial subsidy arising from the OPSF. They welcomed the tightening of monetary policy in the third quarter of the year, and emphasized the need to maintain monetary policy on a steady anti-inflationary course and to let interest rates find their market levels.

Directors also encouraged the speedy and full implementation of measures to eliminate over time the losses of the Central Bank. They underscored the critical need for a major strengthening of fiscal policy, and of public sector savings. In that connection, they welcomed the recent adjustments in the domestic prices of petroleum products, and encouraged the authorities to move ahead quickly with the envisaged deregulation of petroleum prices. They considered it essential to press on with the efforts to improve public sector resource mobilization through further strengthening of tax administration and implementation of new revenue and public enterprise pricing measures as envisaged in the program, and any further revenue measures that might be needed to assure achievement of the 1990 fiscal target.

Directors stressed the need to contain expenditures, by holding the line more firmly on public sector wages and employment, in particular. Directors commended the authorities on the progress that had been made in trade liberalization, financial sector reform, and reform of public corporations, including the privatization program. However, they noted with concern the delays in the program of agrarian reform, and encouraged the authorities to address urgently the factors constraining its implementation. Directors emphasized that continued progress with structural reforms in all of those areas would be of the utmost importance for promoting balanced and sustained economic growth.

Directors observed that the targeted improvement in the balance of payments was a central element of the program, and was dependent on the pursuit of appropriate domestic policies and on the continued support of the international financial community. They emphasized that the gains of recent years in the growth of nontraditional exports, inflows of foreign investment, and the return of flight capital should not be allowed to erode. Doubts were voiced about the realism of the projections in each of those areas. Moreover, the recent loss in external competitiveness should be reversed quickly, and the international reserve position of the Central Bank should be strengthened, speakers commented. Those considerations should guide exchange rate policy, which would be supported by the shift in the mix of monetary and fiscal policies toward greater fiscal restraint. In addition to the continuation of trade liberalization measures, Directors encouraged the authorities to make foreign investment regulations less restrictive, and called for early implementation of the revised debt equity conversion scheme.

Directors commended the Philippine authorities for their efforts to reach agreement on a new financing package with commercial bank creditors. However, they expressed disappointment that the new money element had fallen short of expectations, as the medium-term prospects would be within reach only if the banks provided a substantial share of the external financing the

Philippines would require. Directors noted that the debt buyback schedule for 1990 would help to alleviate the debt and debt-service burden and enhance prospects for investment and economic growth. They welcomed the authorities' intention to carry out a second stage of debt operations that would include an option for interest reduction.

In sum, a number of Directors found themselves deeply concerned about the adequacy of the Government's policy performance, but expressed the hope that continued Fund support, along with other external support, would provide the authorities with an additional impetus to strengthen policies and establish a stronger basis for lower inflation and sustained economic growth. Directors wished to be reassured by the time of the next review that such a strengthening of policies had taken place.

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

The Executive Board then took the following decisions:

Exchange System

The Fund approves the restrictions on payments and transfers for current international transactions that remain pending the finalization of the bilateral agreements with Paris Club creditors until the completion of the next review under the extended arrangement or June 30, 1990, whichever is earlier.

Decision No. 9327-(89/167), adopted
December 20, 1989

Extended Arrangement - Review and Modification

1. The Philippines has consulted with the Fund in accordance with paragraph 4(c) of the extended arrangement for the Philippines (EBS/89/59, Sup. 3, 6/1/89) in order to review progress in implementing the program supported by the extended arrangement and establish suitable performance criteria.

2. The letter dated December 1, 1989 from the Secretary of Finance and Governor of the Central Bank with annexed Supplementary Memorandum on Economic Policy, 1989-92 will be attached to the extended arrangement and the letter dated March 20, 1989 with annexed memorandum shall be read as supplemented and modified by the letter dated December 1, 1989 with annexed memorandum.

3. Accordingly,

(i) the ceiling on the borrowing requirement of the monitored public sector referred to in paragraph 4(a)(i) of the extended arrangement shall be as specified in Table 2 of the Supplementary Memorandum on Economic Policy annexed to the letter dated December 1, 1989;

(ii) the ceiling on base money referred to in paragraph 4(a)(ii) of the extended arrangement shall be as specified in Table 2 of the same memorandum;

(iii) the floor on net international reserves of the monetary authority referred to in paragraph 4(a)(iii) of the extended arrangement shall be as specified in Table 2 of the same memorandum;

(iv) the limits on the approval of nonconcessional loans with 1-12 year maturities, including the sublimit on the approval of nonconcessional loans with 1-5 year maturities, referred to in paragraph 4(a)(iv) of the extended arrangement shall be as specified in Table 2 of the same memorandum; and

(v) the limit on outstanding short-term external debt referred to in paragraph 4(a)(v) of the extended arrangement shall be as specified in Table 2 of the same memorandum.

4. The Fund decides that no further understandings are necessary and that the Philippines may proceed to make purchases under the arrangement, notwithstanding the nonobservance as of September 30, 1989 of the ceiling on base money referred to in paragraph 4(a)(ii) of the arrangement.

5. (a) The Philippines has requested that the Fund make available, in accordance with paragraph 2(b) of the arrangement, the equivalent of the set-aside amounts involved in the reductions which, pursuant to paragraph 2(b) of the arrangement, (i) were made in the purchase already made under the arrangement and (ii) are to be made in the purchase scheduled to become available on December 15, 1989 under the arrangement.

(b) The Philippines has also requested that the Fund make available, in accordance with paragraph 2(c) of the arrangement, the equivalent of the set-aside amounts involved in the reductions to be made, pursuant to paragraph 2(b) of the arrangement, in the purchases scheduled to become available under the arrangement during 1990, with corresponding adjustment to the phasing and discontinuance of the setting aside of amounts for debt reduction with respect to the purchases scheduled to become available under the arrangement during 1990.

(c) In the light of these requests and the representation of the Philippines, the Fund has reviewed the financing of the Philippines' program supported by the extended arrangement, and determines that the debt reduction involved is consistent with the objectives of the program and that the purchase of the amounts referred to in subparagraphs (a) and (b) above is needed for the making of payments in connection with the Philippines' debt reduction operation.

(d) Accordingly, the Fund decides that

(i) The amounts referred to in subparagraphs (a) and (b) above shall be available to the Philippines under the arrangement;

(ii) Paragraph 2(a) of the extended arrangement shall be modified to read: "Purchases under this arrangement shall not exceed, without the consent of the Fund, the equivalent of SDR 94.37 million until December 15, 1989, the equivalent of SDR 235.92 million until June 15, 1990, the equivalent of SDR 306.70 million until December 15, 1990, the equivalent of SDR 377.48 million until June 15, 1991, the equivalent of SDR 471.85 million until December 15, 1991, and the equivalent of SDR 566.22 million until April 30, 1992."

(iii) Notwithstanding paragraph 2(b) of the extended arrangement, the purchases scheduled to become available under the arrangement during 1990 shall not be reduced.

(e) For purposes of Decision No. 9331-(89/167) adopted December 19, 1989, the amounts referred to in subparagraphs (a) and (b) above are to be used by the Philippines in a purchase for cash, within 60 days of this decision, of an amount equivalent to $1,312 million of debt to commercial banks at a discount of 50 percent.

(f) Paragraph 5 of the extended arrangement shall be modified to read: "The Philippines will not make purchases under this extended arrangement during any period of the arrangement in which the Philippines has an overdue financial obligation to the Fund or is failing to meet a repurchase expectation pursuant to the

Guidelines on Corrective Action in respect of a noncomplying purchase or pursuant to Decision No. 9331-(89/167), adopted, December 19, 1989.

Decision No. 9328-(89/167), adopted
December 20, 1989

4. <u>TUNISIA - REVIEW UNDER EXTENDED ARRANGEMENT</u>

The Executive Directors considered the staff paper on the second review under the extended arrangement for Tunisia approved on July 25, 1988 (EBS/89/231, 12/4/89; Sup. 1, 12/5/89; and Sup. 1, Cor. 1, 12/18/89).

Mr. Ghasimi made the following statement:

The Tunisian authorities welcome this renewed opportunity to review with the Fund the progress achieved so far under the extended arrangement. They continue to find the regular discussions with the Fund, as well as recommendations by the Executive Directors, very constructive and helpful. They would also like to convey to the Executive Board their appreciation for the valuable technical assistance provided to them by the Central Banking and Fiscal Affairs Departments.

Indeed, developments in Tunisia in 1988 and during the first half of 1989 highlighted the importance of macroeconomic policies and their timely modification to accommodate the changing circumstances. It has now been rightly acknowledged that appropriate macroeconomic policies are all the more critical for an economy undergoing significant internal deregulation and substantial external opening, while still remaining vulnerable to exogenous factors.

In the early months of 1989, the Tunisian authorities were confronted with two main challenges. On the one hand, the rapid monetary expansion in 1988 necessitated adoption of a restrictive monetary stance so as to absorb the excess liquidity emanating from the balance of payments surplus. On the other hand, the much awaited investment recovery made it somewhat difficult for the authorities to induce a rise in interest rates, which were in fact kept at a relatively low level.

This accommodative monetary stance was, however, not really easy to sustain, as by midyear it became evident that the balance of payments was under growing pressure. Aside from the impact on domestic credit, and subsequently, international reserves, of a policy of low interest rates, the pressures on the balance of payments were compounded by the effects of a continuation for the second consecutive year of a severe drought, as well as by the larger-than-anticipated fall in nontraditional tourism receipts.

The risks of overheating of the economy and of building pressures on the balance of payments prompted the authorities to forcefully tighten monetary policy, and adopt a more active monetary management for the second half of 1989 and early 1990. The monetary program for this period includes a substantial reduction in the volume of liquidity auctioned weekly by the Central Bank on the money market; increases in the money market interest rate, from the low level of 8.6 percent at the beginning of the year, to 11.3 percent in early December; issuance of treasury bills for a total of D 165 million between October and December 1989, of which D 140 million is to be directed to nonbank holders. Despite some start-up delays associated with the introduction of this new instrument, particularly with regard to its marketing to the public as a financial instrument, it is the authorities' firm intention to widen rapidly the secondary market for treasury bills. In this connection, the latest available information indicates that an amount of D 157 million of treasury bills was auctioned, of which D 52 million was subscribed by the public. The authorities also introduced a temporary reserve requirement equivalent to 100 percent of any increase in excess of 4 percent in short-term bank deposits, between September and December 1989. This reserve requirement is additional to the existing reserve requirement of 2 percent on bank deposits introduced in May 1989.

The authorities are monitoring closely monetary developments, particularly the expansionary impact on liquidity stemming from developments of the net foreign assets of the banking system, as well as the sale of treasury bills to the public. Their aim is not only to comply with the monetary target for the end of 1989, but, more importantly, to introduce the necessary flexibility in the conduct of monetary management, without, however, deviating substantially from the main objectives of the adjustment program, namely, achieving external viability, as well as sustaining noninflationary economic growth.

Although monetary policy received a great deal of attention from the authorities in 1989, other important issues were not neglected, particularly in the areas of tax reform and rationalization of subsidies. Since these and other elements of the program were sufficiently detailed in both the letter of intent and the staff report, I will confine myself to highlighting some of the major accomplishments.

With regard to tax reform, it should be noted that after introducing the value-added tax in 1988, and concurring with the advice of a recent Fund technical assistance mission, the authorities are now finalizing a fundamental reform of direct taxation. In establishing the new system, the authorities were guided by the objective of achieving greater simplification and coherence of direct taxation. Indeed, they consider that with the further liberalization of the economy, rationalization of the tax burden should support the efforts of sustaining private initiative and achieving more efficient resource allocation. They also believe that the new system should be more equitable, and help to rehabilitate tax compliance in order to reduce tax evasion, which is generally associated with inefficient tax systems. It is worth mentioning that prior to the introduction of the reform, the authorities embarked upon several initiatives designed to improve tax administration. Furthermore, they will closely monitor the new system, and stand ready to introduce the necessary corrective measures so as to minimize any adverse impact of the reform on the budget.

With regard to subsidies, the authorities are carrying forward a profound reform of the operations of the Caisse Génerale de Compensation. This reform, supported by technical assistance from the U.S. Agency for International Development and the World Bank, is being monitored by the recently created Higher Council on Price Compensation, chaired by the Prime Minister. While reaffirming the need for continuing subsidies for the poorest segments of the population, the authorities aim at achieving a better targeting and rationalization of the operations of the compensation system. These structural measures will be supported by price increases designed to reduce the overall cost of subsidies. In this connection, the first adjustment in prices was implemented in August 1989, and resulted in increases ranging from 6 percent to 32 percent.

Finally, Directors may note that the Tunisian authorities have not made any purchases under the extended arrangement in 1988 and 1989. They have also indicated that they do not intend to use the Fund's resources for the time being. The issue of purchases under the current extended arrangement will be considered further by the authorities on the occasion of the next program review.

Mr. Menda made the following statement:

From 1986, Tunisia's authorities initiated an impressive set of economic reforms. We are pleased to note that despite the adverse consequences of exogenous factors, recent economic performance has been broadly satisfactory. We are particularly pleased to note that private investment has responded, although with some delay, to the changed economic environment, which will contribute to the good performance of the external sector. We also note that, as a result of careful debt management, the debt-service ratio was reduced once again.

Nevertheless, some slippages have occurred in recent months. We are reassured by the fact that the authorities responded, although with some delay, to the situation of overheating and of external pressures experienced this year. Furthermore, Mr. Ghasimi's statement clearly demonstrates the commitment of Tunisia's authorities to sound macroeconomic policies and structural reforms.

At present, there is no other option for the authorities but to continue their adjustment effort. I broadly share the staff's views.

We cannot but emphasize the crucial role of fiscal policy in Tunisia's economic performance. We ask the authorities to pay particular attention to the fiscal deficit. The deficit will be large in 1989 and has only been stabilized with the supplementary finance law passed in October.

On the expenditure side, we encourage the authorities in their willingness to reassess their subsidy policy, in particular by focusing on the more vulnerable categories. This is all the more important given the deficit of the Caisse Générale de Compensation. My authorities fully agree with the staff that this problem is worrying and requires long-lasting solutions. We are aware that the authorities have already taken some courageous measures, and we fully understand that the present system constitutes a cornerstone of Tunisia's safety net. However, given the burden on public finances, ways have to be found to tackle the problem and gradually eliminate subsidies.

We are pleased to note that the authorities have reached their objective on the revenue side and that the implementation of the value-added tax has been satisfactory. We encourage the authorities to pursue this course of action by introducing personal and income tax reforms in a timely fashion. We agree with the staff that the authorities should closely monitor tax receipts to ensure the revenue neutrality of the tax reform, and stand ready to take any needed additional measures in case of further slippages.

Concerning monetary policy, we welcome the corrective measures which have been taken by the authorities. We strongly encourage them to remain vigilant in formulating their interest rate policy, which should be a major instrument in orienting the economy. Further liberalization of the financial sector seems warranted, and in particular, the elimination of the remaining restrictions on interest rates. We also encourage the authorities to continue the development of a broad-based market in government paper, which should contribute to a better implementation of monetary policy. In the present circumstances, the utmost attention has to be given to monetary policy, because it has to rely more on new instruments, in particular.

The authorities must be commended for the broad range of structural reforms which have already been implemented. Fiscal reform and reform of the financial system remain well on track. However, I would like to emphasize the need to pursue liberalization and the opening of the economy, and to accelerate the pace of reforms in these areas. The removal of price controls, along with a reduction of consumer subsidies and import liberalization measures, are of the utmost importance in stimulating private investment in competitive sectors.

The Tunisian authorities have undertaken far-reaching economic reforms. As the staff rightly points out, the authorities are now faced with problems of fine-tuning, which require appropriate commitment and perseverance. My authorities fully support them in their endeavors, and support the proposed decision.

Mr. Ismael made the following statement:

Despite unfavorable exogenous developments--the prolonged drought and the sharp decline in tourism receipts--the overall performance of the Tunisian economy so far this year has been broadly satisfactory. I am pleased to note, in particular, that the strong performance of exports has helped to contain the adverse impact of exogenous developments on the external position, thereby assisting the process of adjustment and economic recovery. On the domestic side, inflation pressures arising from the investment recovery and the relaxation of price administration on consumer staples have also been contained satisfactorily.

It is indeed heartening to note that private investors are beginning to gain confidence, and to respond strongly to the authorities' adjustment measures, which have been supported since 1988 by an extended arrangement with the Fund that is now under review. In this regard, I note with satisfaction that the buoyancy in investment has been concentrated in export-oriented sectors, auguring well for the authorities' efforts to diversify the economy and the export base over the medium term.

Nevertheless, I agree with the staff that although the economy has shown greater resilience, it remains vulnerable to unexpected adverse exogenous developments. Partly as a result of these factors, I note that most of the macroeconomic targets set under the program for this year are unlikely to be achieved. With the benefit of hindsight, it can be said now that the targets might have been too optimistic.

I believe that these factors, together with the authorities' accommodative monetary stance--resulting from their primary concern not to disturb the still-fragile economic recovery--have contributed to the authorities' failure to observe the performance criteria on net foreign assets of the Central Bank and domestic credit.

Exogenous factors aside, I believe that the authorities' response to the growing signs of external pressures and the risks of economic overheating has been commendable, done as it was in a way that the momentum of the economic recovery was not broken. I am pleased to note in this respect that, while attempting to strengthen monetary management through the introduction of treasury bills, the authorities have adopted a tighter stance of monetary policy by reducing substantially the volume of liquidity and increasing money market interest rates.

On the fiscal side, I welcome the introduction of corrective fiscal measures under the supplementary finance law to compensate for higher expenditures. For the year to come, it seems that the draft budget is quite realistic, and I agree with the staff that both the revenue and expenditure sides need to be monitored more closely, because of the vulnerability of both sides, and the structure of revenue and expenditure.

Let me express my appreciation to the authorities for their efforts, under difficult circumstances, to keep the structural elements of the program broadly on track. I endorse the proposed decision.

Mr. Al-Jasser made the following statement:

The Tunisian authorities have exhibited determination and resourcefulness in strengthening and modifying the policy package in order to bring performance back on track under the extended arrangement. This has been a three-pronged operation: a significant tightening of monetary policy, enhanced fiscal efforts, and the maintenance of external competitiveness. Monetary growth has been tightened significantly in the second half of 1989 in order to rein in the sharp monetary expansion in 1988. Effective reserve requirements have been increased, and the sale of government treasury bills will keep liquidity in check. Interest rates have consequently been allowed to move upward. It is important that the authorities stand ready to take additional measures, if necessary, to contain liquidity growth within the newly agreed limits.

Expenditures were cut in the last quarter of the year, and new tax and nontax measures were taken to contain the budget deficit at a level close to that originally envisaged. As the staff paper indicates, the draft 1990 budget intends to continue the restrained fiscal policy stance, despite, as the staff rightly emphasizes, vulnerabilities on both the expenditure and revenue sides. It is good to note that, notwithstanding the likely short-term negative revenue effects, the authorities have continued to pursue the reform of the direct taxation system. It is to be hoped that the authorities will take any necessary steps if the potential revenue shortfall exceeds present expectations.

In view of these measures and the authorities' demonstrated determination to implement additional steps, if necessary, I have no hesitation in supporting the proposed decision modifying the performance criteria on domestic credit and net foreign assets of the Central Bank for end-1989.

Quite apart from the issue of the adequacy of measures to meet modified criteria and to return to the adjustment path under the extended arrangement, Tunisian policies need to be evaluated in a longer-term context. The economy remains quite vulnerable to exogenous disturbances, despite the recovery in investment and a strong performance of the export sector. Self-sustaining growth must pick up, in order to ensure a reduction in unemployment and to strengthen the ability to withstand disturbances. For this, there is a need to diversify the production and export bases, which will require a continued and heightened policy vigilance. The authorities should speedily reduce distortions in financial intermediation and discontinue, as soon as possible, the preferential lending interest rates and other restrictions on a freer operation of the money market. In the same vein, it is crucial that the benefits of trade liberalization and increased import competition are not neutralized through the operation of the proposed import safeguard system. As this chair stressed at the last Board discussion on Tunisia, I wish to emphasize again that steps need to be taken to encourage foreign direct investment, so that the shortage of indigenous investment can be offset by foreign investment.

Mr. Enoch made the following statement:

Tunisia has had an impressive track record with Fund-supported facilities since 1986, although it is somewhat disappointing that the Board is being asked to modify two performance criteria under the extended arrangement. I have little difficulty in supporting the proposed decision, in view of the authorities' intended modifications to their policy, and this chair's confidence in their commitment to the overall program.

The first review of this program alerted the Board to the problems associated with the persistence of the drought into this year, and the sharp drop in foreign exchange inflows from neighboring countries. The exogenous nature of these developments seems fully to justify an amendment to the net foreign assets performance criterion. However, the quarterly progress of net assets is akin to that of a roller coaster. I would welcome staff comment on why the particularly strong third quarter is expected to be followed by such a rapid decline to the end of the year. The letter of intent seems to point to buoyancy in the whole of the latter part of the year.

Exogenous influences have been compounded by import growth, which is due at least in part to a relaxation of monetary conditions, rather than import liberalization measures--which have slowed. This relaxation has in turn created the need for a program modification in respect of credit growth.

Approval of the credit benchmark modification is therefore predicated on the authorities' recognition of the need for a significant monetary tightening. The need for tight monetary policy is underscored by the upward revision to inflation projections shown in the staff paper.

What is essential now is that steps to tighten monetary conditions are made effective by improvements in financial intermediation, and I fully endorse the staff's emphasis of this point. Foremost among these improvements must be the elimination of preferential interest rates and the lending rate cap, especially as the arrival of a foreign bank branch should serve to promote more competition within the financial sector. Within this, a broadening of the short-term government paper market should help in a shift from direct to indirect means of monetary control.

Most other structural measures are progressing well, but I would urge the authorities to allow no further slippage from the timetable for import liberalization. The deviation the from the program in respect of subsidy expenditures is serious, because of the effect it is having on the fiscal position. The admirable restraint in other forms of current expenditure has been swamped by the overrun in consumer subsidies. I welcome the initial steps taken to raise prices of subsidized goods; but I urge the authorities to stick with their commitment further to reduce subsidies, and if possible to accelerate their envisaged timetable. On the revenue side of the budget, the authorities are persisting in their bold tax reforms, but the delay of the petroleum tax increase was unfortunate, and I welcome the indication that it is to be implemented shortly.

There is no doubt that the Tunisian authorities remain committed to the program, and their willingness to adjust to developments was clearly demonstrated in the implementation of this year's supplementary finance law. I also note the authorities' intention to assure that by the end of the program period the debt-to-GDP ratio will be within the original program parameters.

Despite difficulties, the authorities have refrained from making purchases under the program this year, and I welcome Mr. Ghasimi's statement that the authorities do not intend to make purchases until the third review is completed. This shows admirable restraint and a determination to make the necessary policy adjustments.

I support the proposed decision, with confidence in the Tunisian authorities' commitment to sound adjustment.

Mr. Fanna made the following statement:

The Tunisian authorities have recently confronted a typical economic policy dilemma; on one hand, a strong recovery of private investment is taking place, together with a sustained growth in demand for consumer goods. On the other hand, this pressure on resources is negatively affecting the trade balance, with a consequent loss of foreign reserves. The authorities have initially accommodated the much-awaited investment recovery, accepting a higher than programmed credit growth and a decline in interest rates. They decided to take action to contain demand pressures only in the second half of 1989, mainly through a tighter monetary policy.

The present recovery of private investment is of the utmost importance, since the unemployment rate is still worryingly high, and the economy continues to exhibit signs of vulnerability to exogenous shocks, as recent developments caused by the drought in the agricultural sector confirm. At the same time, I do not foresee immediate problems on the external front. Consequently, I fear that the tightening of monetary policy could lead to a too large and unwarranted surge of interest rates that could slow down the favorable pace of investment.

Financial markets in Tunisia still contain some rigidities. I am aware of the importance of the structural adjustments on these fronts that have to be undertaken under the program. These adjustments are aimed at reaching a higher degree of efficiency in financial markets, in order to improve the effectiveness of monetary control through indirect instruments.

I wonder what the appropriate timing is for eliminating the still-existing rigidities in financial markets, however. Indeed, maintaining fixed key lending rates in some sectors of the economy may still be appropriate. In other words, I wonder if there exists, at present, a trade-off between reaching efficiency in financial markets and maintaining favorable developments in real markets, namely, in investment performance. If such a trade-off exists, priority should be given to favoring the developments in real markets, thus delaying structural adjustments in financial markets.

In order to discern whether such a trade-off exists, it would be useful to have some elaboration from the staff on a number of issues. For example, it would be interesting to know what is the percentage of bank credit at preferential rates, which sectors of the economy benefit from these rates, and whether these sectors are those experiencing the present expansion of investment performance. What is the meaning of the one-third adjustment of the preferential rate to the money market interest rate, given that the latter can fluctuate freely? Indeed, while the former has been raised by 0.8 percent, the spread between the two has widened. Moreover, it would be helpful to know how much the present recovery of investment depends on credit, and how much on funds generated internally by firms.

If interest rate rigidities were to partially accommodate the recovery of investment, then clearly, trade balance developments could worsen. However, there are some qualifications to make. In 1989, exports of agricultural products were affected negatively by the unforeseen prolongation of the drought, which--optimistically--should soon end. Moreover, imports of consumer goods, which grew strongly in 1989, should slow down following the developments in financial markets. Indeed, the recent re-establishment of a Treasury bill market aimed at directing the bulk of the issues to nonbank agents should have the effect of shifting financial resources from consumer goods to financial savings.

These developments could compensate for the expansion of capital goods imports that would inevitably accompany a further expansion of investment, without creating too many tensions on the external front. In this regard, I would like the staff to confirm that the possibility remains that the financing gaps in the balance of payments will eventually be covered. Given the past performance with respect to the repayment of foreign debt and the relatively low debt to GDP ratios, it seems that the Tunisian authorities are in a relatively favorable position for obtaining foreign credit, if needed. If this is true, this should diminish fears that it would be impossible to finance the balance of payments, even before a policy designed to accommodate the present recovery of investment and the expansion of capital goods imports that that might entail.

I support the proposed decision.

Mr. Othman made the following statement:

The performance of the Tunisian economy under the medium-term adjustment program on which the authorities embarked last year has been quite satisfactory in most respects. The authorities' policy response in the middle of this year to the demand pressures was particularly welcome, as it again demonstrates the authorities' commitment to maintaining a stable macroeconomic environment as a necessary condition for improving the growth and employment prospects. We are also encouraged by the steady implementation of structural reforms, in the areas of the tax system and public enterprises, in particular. Although there is still some uncertainty regarding the budgetary impact in 1990 of the reform of direct taxes, the fact remains that the tax reforms provide a more efficient and more equitable system of domestic source mobilization. We have also taken note of the authorities' readiness to introduce corrective measures in the event of an adverse impact of tax reform on the budget. The authorities also need to be vigilant in monitoring and controlling spending by the Caisse Générale de Compensation (CGC)--or subsidy fund. This is not to minimize the importance of maintaining affordable prices of basic foods for the lower-income groups. To the contrary, we believe that alleviating the adjustment burden on the most needy is an important requirement for the sustainability of the reform process. It is also important, however, that such spending be well targeted at the intended groups. We therefore welcome the consideration being given to reform to be put in place in 1990, which aims at reducing the financial costs and distortion of the system.

We note that the pace of import liberalization has been somewhat slower than initially targeted. However, I am not sure that this was altogether unexpected or undesirable, given the balance of payments situation which prevailed this year. With the current account deficit significantly more than programmed--for the reasons explained by the staff--I am not sure that a stepping up of import liberalization would have been useful. Actually, during the first review last May, the staff recommended an acceleration of import liberalization only if the balance of payments situation were to strengthen. In any event, I note that the authorities expect to step up the pace in the coming months, which would be consistent with the expected improvement in the balance of payments.

However, I note that the balance of payments projections for 1990 are based on an import volume growth of only 3 percent, which is due to the tapering-off of the effects of the exceptional circumstances of 1988-89. Nevertheless, this figure seems to be on the low side, and perhaps the staff can elaborate a little more on their assumptions regarding imports of capital goods, which in 1989 grew by 24 percent in volume terms, particularly in light of the indication of a pickup in investment activity.

Let me express our satisfaction with Tunisia's performance under the extended arrangement, which the authorities have so far treated only as a stand-by credit--stand-by in the original sense of the word. We support the proposed decision.

Mr. Hubloue stated that, as Mr. Ghasimi had suggested in his statement, appropriate macroeconomic policies were all the more critical for an economy undergoing significant internal deregulation and substantial external opening, while remaining vulnerable to external shocks. The monetary policy corrections which the Tunisian authorities had introduced in the second half of 1989 had proved how strongly they were committed to that principle. It was especially encouraging that, after two years, private investment had begun to respond favorably to the new policy climate, and that that response was concentrated in the export sector. While he could understand that the authorities' initial policy reaction to the overheating of early 1989 had been rather cautious, for fear of undermining the recovery, he would point out that the chances of a durable improvement in investment performance were now brightened by the comprehensive monetary measures which had been introduced recently. He hoped that those measures would be strengthened by actions along the lines of what had been suggested by Mr. Fanna.

With respect to tax reform, Mr. Hubloue continued, Mr. Ghasimi had submitted that the rationalization of the tax burden should support efforts to sustain private initiative and to achieve a more efficient allocation of resources. He fully agreed with the view that tax reform should be an essential component of programs aimed at liberalizing and privatizing the economy, even though they might create some uncertainty on the revenue side of the budget in the short term. Although the staff recommended that in such a situation the authorities should stand ready with additional tax measures to offset any revenue shortfalls, such a course was not always the most appropriate one under all circumstances. If the shortfall resulting from the present reform was a permanent one, he could agree that additional revenue enhancements would be called for. However, if the shortfall was expected to be only temporary, additional revenue measures could blur needlessly the structural objectives of tax reform. In the case of a temporary shortfall, more appropriate solutions might be to accept a temporary deviation from the program's original budget targets, or to accelerate temporarily the envisaged reductions in expenditure.

The operations of the Caisse Génerale de Compensation imposed a burden on the budget and on the economy at large, Mr. Hubloue concluded. He welcomed the fact that the reform of Tunisia's subsidy system was being given the highest priority by the Prime Minister, and that decisive measures in that regard were to be taken during 1990. Tunisia's extended arrangement with the Fund could not be considered successful unless a durable reform of the system of subsidies was introduced, before the expiration of the present arrangement. The measures that had already been taken generally went in the right direction, in aiming for an increase in the intervention price and a better targeting of subsidies to the poorest segments of the population. The successful accomplishment of that reform, in a socially acceptable way, would have effects which would extend far beyond the case of Tunisia, as it would set an example for other countries, the economies of which suffered from unsustainable subsidies and pricing systems. He supported the proposed decision.

Mr. Noonan made the following statement:

> I start from the position that it is Tunisia's future growth, and particularly its export performance, that will under-write the country's ability to service its foreign borrowings. The extent to which its future output and exports will grow depends on many determinants, but among them, productive capacity must rank as of major importance. I have therefore focused on Tunisia's recent and current investment performance as a guide to that capacity. In doing so, I do not wish to imply that other determinants, such as competitiveness, are not just as important. Rather, my objective is simply to draw attention to what may be a weakness on the investment side in the commendable progress otherwise being achieved by the authorities under their adjustment program.
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> On looking at the performance of the Tunisian economy over a number of years, including some years before the present program, I have been struck by the extent of the decline in the relative share of investment in total domestic expenditure. Expressed as a proportion of GDP, investment fell from 32 percent in 1984 to 19 percent in 1988. Indeed, it would seem that, if 1986 is

excluded, all of the external adjustment which has been brought about in Tunisia has been achieved at the expense of aggregate investment. A similar pattern is evident on the fiscal side, where capital expenditure has borne the brunt of the adjustment to both a reduced overall deficit and a decline in revenue and grants, the two being expressed as a percentage of GDP.

The recent growth in exports was far greater than that anticipated in the original program. One view of that rapid growth might be that it was the result of liberalizing measures adopted under the adjustment program, having the effect of unleashing the productive potential of preprogram investment. If there is substance in that view, the current investment ratio of just over 19 percent of GDP, which is low in the historical context, must give cause for some concern.

It is unlikely that improvements in the efficiency of new investment would be of such a magnitude as to offset the substantial decline in total investment. Moreover, the authorities seem anxious to have a higher investment ratio.

Demand pressures, including a substantial rise in government expenditure on food subsidies, forced the authorities in mid year to adopt corrective measures. The measures included raising interest rates and mopping up liquidity from the nonbank sector. Those particular measures might have been expected to exert a dampening influence on any emerging private sector investment recovery. The staff appraisal, however, concludes that following two years of a wait-and-see attitude, private investors finally appear to be responding strongly to the changed policy environment and incentives for investment.

In view of my concern that investment may have been asked to carry too much of the burden of adjustment to date, I would be interested in having clarification of whether the strong private sector response referred to by the staff preceded the midyear policy corrections, and, if so, whether there is any evidence that that investment response was adversely affected by the corrections.

I appreciate that the various recent reforms of the taxation system and the continued drought imposed constraints on the extent to which the authorities could have gone further by way of fiscal measures in making their midyear corrections to the economy. Nevertheless, I would like to have the staff's view on whether it would have been reasonable, notwithstanding those constraints, to have expected the authorities to have given a greater role to fiscal measures in making their midyear corrections, especially if that would have reduced any adverse impact on private sector investment.

Although I have raised some queries on the investment performance, the progress otherwise being made under the structural adjustment program warrants, in my opinion, continued support for that program, and for the proposed decision.

Mr. Gronn made the following statement:

It is regrettable that there have been deviations from the performance criteria, and that the overall adjustment process in Tunisia seems to have weakened. To put the program back on a sustainable track, the authorities must make a strong commitment to the implementation of appropriate policies.

However, there have also been positive developments. The tax reforms, corrective measures in monetary policy, and measures to improve the efficiency of the pricing system, are all on the positive side. Discontinuation of the exchange rate guarantees and steps to liberalize imports have also contributed to enhance the competitiveness and to open up the economy.

On the negative side are the slippages in the economic adjustment efforts, which will have to be corrected resolutely. It is worrisome that the current account deficit target will be exceeded quite substantially this year, despite the corrective policies already in place. To look ahead, the basis for the export projections would seem to be uncertain with regard to receipts from tourism and other exports. Also, continued liberalization of imports could weaken trade performance, and thus add to the pressure on the exchange rate. In these circumstances, and given that demand policies could prove to be inadequate, exchange rate flexibility would seem to be appropriate.

The tightening of monetary policy this year and in 1990, as described by Mr. Ghasimi, is highly appropriate and welcome. A more flexible interest rate should indeed be encouraged as an essential ingredient of a more effective monetary policy. The elimination of preferential lending rates to priority sectors should also be expedited, to improve the efficiency of resource allocation.

Two items need attention with regard to fiscal policy. First, the authorities are at present in the midst of a comprehensive tax reform that makes revenue collection rather uncertain. While these reform initiatives are welcome, developments need to be closely monitored, and the authorities should stand ready to take further fiscal measures if required. I would not, however, overemphasize revenue neutrality in connection with the tax reforms, as fiscal tightening seems to be a key factor in sustaining the adjustment program. Enhanced tax coverage and improved tax collection alone might have been adequate to facilitate some reduction in the tax rates to stimulate private sector activity.

Second, while a re-examination of subsidies on a broad scale is welcome, it is somewhat unclear when these measures will become effective. Moreover, I would urge the authorities to speed up the reform efforts in the public enterprise sector. Increased profitability and efficiency in these enterprises could both enhance competitiveness and strengthen fiscal performance.

With respect to incomes policy, I understand that no nominal public sector wage increases are expected, apart from those resulting from changes in the tax system. Continued restrictive policies in this area would seem to be appropriate. However, in light of the fact that consumer prices are expected to increase by 7-8 percent, this would entail a further drop in real incomes. I note, in this context, that the authorities intend to target food subsidization more closely to alleviate the most severe price effects upon the poorest segments of the population. This is a move that I welcome.

I support the proposed decision.

Mr. Kwon made the following statement:

The Tunisian authorities have performed reasonably well so far under their extended arrangement with the Fund. Although some performance criteria have been missed, the authorities have taken corrective monetary and fiscal measures which should put the program back on track. Overall, the staff paper gives the impression that the authorities remain fully committed to the program, and are willing to take remedial measures where necessary and to continue to implement structural reforms. The pace of the latter has been a little slower than expected in one or two areas, but good progress has been reported in others, including in the public enterprise sector.

Overall, the situation in Tunisia could be characterized as one of steady, though not spectacular, progress. Given the policy corrections implemented by the authorities, I have no problems with the proposed decision, as the modifications requested do not appear to be significant. However, there are some areas where I feel that more could be accomplished.

In the financial sector, there are still controls on interest rates, including the cap on lending rates and preferential rates for some sectors. The authorities' unwillingness to remove these distortions appears to relate to concern over the level of competition in the financial sector, and in this connection I share the views expressed by previous speakers, particularly the point raised by Mr. Fanna. It is not clear what is being done to encourage more competition in the financial sector, but it would appear that a good start could be made by removing the remaining controls on interest rates and allowing them to be determined by the supply and demand for funds. This will also help direct investment funds to the most productive projects, an important point, given the importance attached to the level of investment by the authorities.

Given the recent unfortunate experience with a too accommodating monetary policy, we might welcome the acknowledgment by Mr. Ghasimi as to the necessity of appropriate macroeconomic policies for an economy in the throes of deregulation. Monetary policy appears to be now on the right track, with some success having been experienced in selling treasury bills to the public sector, and the authorities should aim at maintaining a consistent stance.

On the fiscal side, I cannot add much to the staff's comments. The reform of direct taxation is to be welcomed, but I would like to know more about the rationale for taxing agriculture and fishing at a much lower rate than other activities. I would be appreciative if the staff could comment on this. Reform of the Caisse Générale de Compensation (CGC) is essential. The staff recommendations are along the right lines, and work on a reform package for the CGC should be given a high priority. The budget deficit for 1989 must not be allowed to exceed the recently upwardly revised estimate.

On the external side, we might join the staff in urging the authorities to bring the process of import liberalization into line with the initial targets of the program, and use macroeconomic policy to achieve their current account objectives.

Ms. Montiel made the following statement:

During 1989, Tunisia's economy was adversely affected by exogenous factors which, in the presence of intensified demand pressures, caused a deterioration in the external sector. As

Mr. Ghasimi points out, the authorities, faced with risks of overheating the economy while trying to maintain the momentum of private sector investment, adopted a more active monetary management during the second half of the year, and proposed a 1990 draft budget which reflects a more restrictive fiscal policy.

With respect to the fiscal stance, we concur with the staff on the necessity of breathing new life into the medium-term fiscal adjustment process. In that regard, we welcome the envisaged tax reform, aimed at achieving a more equitable and flexible tax system; however, since in the short run the reform does not ensure revenue neutrality, the authorities should take all necessary measures to correct potential shortfalls in tax revenues, including curbing expenditure. Indeed, the reform of the CGC and of the subsidy system is essential in order to keep fiscal discipline. Although in the 1990 draft budget the consumer subsidies will decrease in nominal terms by 20 percent, the rest of the transfers will increase by 16 percent, leaving the expenditure on transfers and subsidies virtually unchanged in nominal terms. I would appreciate some clarification from the staff on the nature of these transfers.

Regarding monetary and financial policies, although we welcome the recent increase in interest rates and the restrictive liquidity management of the Central Bank on the money market, the improvement in the efficiency of the financial intermediation process requires a greater reliance on market instruments. However, we have some doubts about the effectiveness of the treasury bills as an instrument of monetary policy in the short run. There is no guarantee as to the capacity of this instrument to absorb liquidity in the short run, because of its government financing character and the lack of an established secondary market. We would appreciate some comments from the staff on the possible advantages of central bank paper versus treasury bills as instruments of monetary policy in Tunisia's case. Nevertheless, treasury bills would seem to be helpful in the process of eliminating preferential interest rates, and would stimulate greater competition in the banking system.

The progress the Tunisian authorities have achieved in implementing structural reforms, particularly the reform of the public enterprise sector, deserves our commendation. We support the proposed decision, including the modification of some of the end-1989 performance criteria.

Mr. Scheid made the following statement:

Considering the difficult tasks the Tunisian authorities are facing, we are very pleased with the quite satisfactory overall economic performance they have achieved so far this year. The authorities had to deal with demand pressures, resulting mainly from a rapid monetary expansion in 1988, and with adverse exogenous factors, particularly the continued drought and unexpected shortfalls in tourism receipts. In consequence, the pressure on the balance of payments increased substantially.

Against this background, the Tunisian authorities adopted a number of corrective measures from mid-1989, with a view to tightening the monetary and fiscal policy stance. The results have been encouraging. According to the most recent figures, prospects for the current account and public deficit reduction in 1990 have improved further. We commend the authorities for their strong commitment to pursue appropriate macroeconomic policies, while continuing the process of structural reforms, and their willingness to cooperate closely with the Fund. In particular, we are pleased to note from Mr. Ghasimi's statement that Tunisia, at least for the time being, will continue not to make purchases under the extended arrangement. This is a clear indication of the quality of the program, and it serves as a useful example, underlining the true stand-by character of the Fund's resources.

I broadly share the staff's appraisal with regard to the policy recommendations. Tunisia demonstrates the dangers of a monetary policy that is not kept on an even keel. After having been too expansionary in 1988, the risks that are anticipated on the internal and external sides made a change of gears inevitable. If such a change is being delayed--as seems to have been the case in Tunisia--the correcting measures will have to be relatively harsh, creating risks for the recovery of economic activity and private investment.

It is rather clear that durable investment growth cannot be based on lax monetary policies. The still-high inflation rates over the medium term indicate that the scope for a monetary relaxation is quite limited. Even if the current restrictive course would lead to a temporary deceleration of investment activity, the Tunisian authorities should nonetheless abstain from a "stop-and-go policy," and should not try to fine-tune investment activity by means of monetary policy.

The proper way to enhance medium-term investment and growth prospects is to improve the internal return on investment, by further liberalizing the economy and removing impediments to growth. This is a precondition for reducing the worrisome high level of unemployment, by creating lasting employment opportunities. Substantial progress has already been made in restructuring the economy, but much remains to be done. It is regrettable that the envisaged liberalization of prices and imports is somewhat behind schedule. The authorities should therefore speed up their efforts.

The progress achieved in restricting monetary expansion can only become fully effective if supported by fiscal policy. This underlines the need for closely monitoring public revenue and expenditure. Although the ongoing tax reform in Tunisia has produced commendable improvements in the tax structure and in the efficiency of tax administration, the overall impact on revenues has been quite unclear. At least in the short term, revenue shortfalls cannot be excluded. A strict expenditure control is therefore of critical importance if the budget deficit is to reach the envisaged target for 1990. Since the higher than expected deficit this year was to a large extent due to overruns in the expenditure of the Caisse Générale de Compensation, I welcome the authorities' intentions to streamline the subsidy system, and to lower subsidies steadily. A courageous step was already taken by increasing prices of subsidized consumer goods in August.

I fully agree with the authorities' view that further steps are necessary, and that they have to be based on a broad social consensus. But I wonder how this assessment fits in with the increase in the public sector wage bill, as envisaged in the draft budget for 1990. Even without a general salary increase, the wage bill is expected to be 5.2 percent higher than in the previous budget. Moreover, a special reserve of D 30 million has been set aside to compensate the public sector for negative impacts of the tax reform. I would appreciate some additional comments on this subject.

I can accept the modest modifications in the domestic credit and net foreign asset targets, as requested by the Tunisian authorities. I support the proposed decision.

Mr. Ichikawa made the following statement:

In the first half of 1989, the Tunisian economy was still negatively affected by the major setback of the preceding year in the agricultural sector. It is regrettable that Tunisia has failed to observe some important performance criteria in the process of its economic recovery. However, as the economy is rapidly returning to the original adjustment path, I can support the proposed decision. That being said, the economy is still very vulnerable to exogenous factors, and the continuous improvement of macroeconomic policies is encouraged, in order to keep the economy on the track of appropriate adjustment. In this regard, I have little to add to the staff's appraisal.

In the fiscal area, I welcome the fact that the tax measures of the supplementary finance law have offset the shortfall in tax revenue. However, the further reform of the tax structure is warranted, in view of the weaker than expected revenue performance of indirect taxes on domestic transactions. In this connection, I would appreciate it if the staff could identify the causes of the optimistic forecast on value-added tax revenue in 1989. I also welcome the proposed rationalization of direct taxes, such as the elimination of double taxation in corporate tax. At the same time, however, the authorities should closely monitor tax receipts, as Mr. Menda suggested, to prevent a shortfall in overall revenue. In such an event, additional revenue-enhancing measures might be necessary.

In view of the projected decline in grants, tight control of the budget is warranted. In this connection, a substantial streamlining of the CGC's financial structure is particularly necessary. While I understand that a shock approach might not be productive under current circumstances, the authorities should be encouraged to develop a workable framework of phasing out subsidies and price controls.

On the monetary front, while the recovery of private investment is welcome, the unsustainably high level of credit expansion was a matter of concern. While the steps taken so far to absorb the excess liquidity seem reasonable, I agree with Mr. Enoch that further improvement in financial instruments will be helpful to accelerate the stabilization, while sustaining the growth momentum of the private sector. In this connection, I welcome the authorities' intention to introduce a market-based solution, namely, the sale of treasury bills. However, the effectiveness of such an operation will depend on the quantity of bills actually absorbed by the nonbank sector. In this regard, I share the staff's concern about the relatively low interest rate on the bill. I am interested in knowing what kind of improvements are recommended to secure a desirable distribution of the bills, in the staff's view.

I agree with the staff that the ceilings on lending rates should be removed. This will contribute to the authorities' market-based approach to the overheating problem. The spread between the market and preferential rates should also be closely monitored. A flexible response by the authorities in this area is important.

In the external sector, the widening of the external imbalances in the first half of this year was a source of concern. However, I note in the staff paper that encouraging progress has been achieved in the structural element. The authorities are encouraged to maintain a liberalized trade regime, while strengthening demand management and monitoring the exchange rate closely.

The Tunisian economy is successfully resuming its growth-oriented adjustment, thanks to the authorities' commendable efforts. I am confident that further improvement in macroeconomic policy will support the economy's rapid achievement of the adjustment targets.

Mr. Newman made the following statement:

In recent years, Tunisia has made considerable progress through implementation of a cautious macroeconomic policy and a gradual, albeit wide-ranging, structural reform program, which has increased the market orientation of the economy. The course correction being undertaken as part of the second review is consistent with the objectives of the extended arrangement, and should help put the program back on track. Consequently, my authorities can support the proposed decision and the modification of the performance criteria.

The economy is expected to recover this year and resume growth to near previously targeted levels. However, achievement of sustained growth will require that demand pressures be curbed to avoid increased price pressures. The recent tightening of monetary policies to restrain credit to the economy is a prudent and welcomed step which should prevent undesirable overheating, while permitting the maintenance of an improved investment climate. The effectiveness of monetary policy would be enhanced by a further broadening of the government securities market, and by increased reliance on market-determined interest rates. We are therefore disappointed by the delays in meeting the programmed target for reducing the differential between the money market and preferential rates, and hope that the widening of the differential which took place during the year will be reversed.

The authorities have moved promptly to contain the overshooting of the budget deficit this year, although the draft budget for 1990 projects a deficit as a share of GDP some 20 percent above the program target. Continued effort will be required to improve revenues and restrain expenditures. In particular, we welcome efforts under way to curb the costly consumer subsidy program, by targeting assistance and reducing operating costs. My authorities have considered the comprehensive reform of the tax system as one of the most impressive aspects of the extended arrangement, and believe that its full implementation will improve incentives for domestic saving and investment, as well as strengthen the financial position of the Government. We were disappointed by the delayed implementation of the income tax reforms. Our own experience with tax reform points up the inevitable uncertainties regarding the initial effects on revenue, which highlights the importance of curbing expenditures in order to avoid an unanticipated rise in the budget deficit due to unforeseen revenue shortfalls, or increases that may prove temporary.

The sharp deterioration in the external position this year highlights the continuing need to maintain a restrained demand management stance. While export performance is improving nicely, the staff's medium-term projections suggest that the economy is likely to remain vulnerable to external shocks. In these circumstances, we believe that maintenance of a flexible exchange rate policy will be crucial, and is preferable to a slowing down of the liberalization of the trade sector. Indeed, we continue to believe that a more rapid liberalization of imports and reform of the tariff levels would be feasible and desirable.

Progress is being achieved on a comprehensive structural reform that will make the economy more market oriented. Price reforms are proceeding, although at a slightly slower pace than the very gradual pace contained in the program. We hope that reforms in this area could be speeded up, especially in the area of distribution margins, in order to improve the efficiency of resource allocation. The significant privatization of public enterprises that is under way is welcomed, and should help to reduce the drain on public resources once current financial liabilities are settled.

I understand that at the next review of Tunisia's program, the Executive Board will consider the second year of the extended arrangement. At the time of the initial approval of the arrangement, we had suggested a number of procedural changes to reflect issues which had been discussed in the context of the review of the extended Fund facility. In particular, we raised the possibility of having semiannual, rather than quarterly, performance criteria, and the inclusion of specific structural reforms as performance objectives. We would like to know whether the staff has considered these suggestions in connection with the second year of the program.

Tunisia is making headway in reforming its economy through prudent demand policies and a gradual structural adjustment. The authorities have acted effectively to undertake needed course corrections, as developments warranted, in order to keep the program on track. That they have been able to do so without drawing on Fund resources under the program is truly impressive. We applaud their efforts, and urge them to accelerate this process in the next phase of the extended arrangement.

The staff representative from the African Department said that the Tunisian economy was in the process of ongoing structural reform and structural adjustment. Many of the points by Directors had been discussed with the authorities, especially with respect to the efficiency of financial markets.

The authorities shared the concerns with regard to the importance of greater interest rate flexibility, the scope of preferential interest rates, and the cap on lending rates. The first steps in those areas had been taken early in 1989, and the staff would encourage the authorities to adhere to their target of achieving liberalization in those areas before the end of the program period. However, the financial system was quite segmented, and certain of the preferential treatment and definitions of priority sectors that had been inherited from the past would be difficult to change overnight. A commitment had been made to narrow the gap between the preferential interest rates and the money market rate early in 1989, by raising the preferential interest rate by about 0.8 percent. However, given the requirements of macroeconomic management, the money market rate had had to be allowed to rise, so the gap had not been narrowed as had been hoped.

A number of Directors had commented on the link between interest rates and investment activity, the staff representative recalled. The tightening of monetary conditions and of interest rates would affect not only consumption and consumer goods imports, but investment activity and capital goods as well. The sectors that were given preference--including export activities, agriculture, housing, and investment by small and medium-size enterprises--were sheltered from interest rate adjustment in the money market, and the authorities recognized that it would be wrong to assume that a strict trade-off existed between greater efficiency in the financial markets and preserving the pace of the economic recovery.

There was a relatively strong, but not necessarily stable, seasonality in the balance of payments which made forecasting quite difficult, the staff representative went on. In the third quarter, there was generally a very strong inflow of receipts from tourism and workers' remittances, which tended to taper off in the fourth quarter. There also tended to be a large lumpiness in debt-service payments due toward the end of the calendar year.

The projections for 1990 would be reviewed at the time of the next review of the program. The authorities had reaffirmed the 1990 balance of payments projections, which were consistent with the original program. There had been a number of exceptional developments in 1989 which suggested that a slowdown in imports need not be reflected in a slowdown in economic activity, and it was hoped that consumer goods imports would slow down while capital goods imports would remain at a relatively high level.

There were a number of factors behind the weakness in investment and the fall in the ratio of investment to GDP, the staff representative pointed out. Some of the long-term decline in the ratio of investment to GDP could be explained by the fact that the structural reform had focused on investment in small and medium-sized businesses, economic diversification, and the export-oriented sectors, rather than large-scale industries. That was in contrast with the late 1970s and early 1980s, when there had been large investments in the phosphates and petroleum sectors.

Some speakers had wondered whether the mix of monetary and fiscal policies might have been better, and whether there might have been more scope in 1989 for reliance on fiscal policy as opposed to monetary policy, the staff representative recalled. The authorities had felt that the margin for maneuver on fiscal policy during the course of 1989 had been rather limited. They had adopted a relatively ambitious target on the fiscal deficit to begin with for 1989, and in the first quarter of 1989 it had already become clear that expenditures on consumer subsidies would increase because of the continued drought, combined with continued high world prices for cereals and the very large dependence of Tunisia on cereal imports. Also, the authorities had been in the process of implementing the reform of indirect taxes that had been introduced in 1988, and were in an advanced stage of preparing the reform of the system of direct taxation for introduction in 1990. Attention was therefore focused on monetary policy instruments, because they were regarded as a necessary element of the structural reform. In that connection, it was thought that the introduction of treasury bills, which had been envisaged for some time, and which had been recommended by a past Fund technical assistance mission, could serve to assist in meeting the macroeconomic objectives for 1990. In that respect, a number of comments had been made about liquidity absorption and the effectiveness of treasury bills in that regard. There had been a very rapid monetary expansion in 1988, more than twice the rate that had been foreseen in the program, reflecting the very large balance of payments surplus arising from the boom in tourism and in particular, the increase in tourism receipts from the neighboring countries of North Africa. It had been expected that the favorable impact on the balance of payments of those factors would decline over the course of 1989 but, on the basis of the statistics for the first quarter of the year, it was not known how rapid the effect would be, or whether it would be only temporary. With the benefit of hindsight, one might say that the introduction of treasury bills should have been accelerated. The staff had hoped that they would have been introduced earlier in the year, and that they would have made a substantial contribution to macroeconomic management over the course of 1989. However, treasury bills were a new instrument, and the uncertainties connected with it would have to be accepted.

The interest rate on special savings account deposits was somewhat higher than that on treasury bills at present, and the special savings accounts enjoyed tax benefits, the staff representative stated. It was not certain that treasury bills would necessarily be absorbed by households; they might instead be absorbed up by small or medium-sized enterprises which had done well from the economic boom outside of the agricultural sector. The objectives the authorities had set in respect of the issuance of treasury bills remained attainable.

There had been some initial overestimation of the amounts that would be garnered by the value-added tax. In part, this was because the amounts that were garnered from taxes which the value-added tax had replaced were larger than expected--chiefly owing to the payment of taxes overdue under the old system, the staff representative concluded. As the value-added tax came on stream, the other payments would decline.

Mr. Ghasimi stated that while the Tunisian authorities were encouraged by their achievements since 1986, they considered that further diversification of the economy and the enhancement of nontraditional exports would be needed to compensate for the expected decline in the oil sector. The authorities were well aware of the impact on the budget of the introduction and simultaneous implementation of several structural adjustments, especially in the areas of direct taxation, public enterprises, and subsidies. Their assessment of the needs in those areas, combined with their objective of sustained economic growth and a desire to alleviate the problem of unemployment, presented the authorities with real challenges, which in fact served to reinforce their commitment to further adjustment efforts. Those efforts were well reflected in the medium-term scenario, which encompassed a reduction of both current and budget deficits to 2.3 percent of GDP by 1991, as envisaged in the program.

The question of preferential lending rates had been raised by a number of Directors, Mr. Ghasimi concluded. He wished to emphasize that the authorities were conducting a far-reaching review of the problem in the context of efficient resource allocation. The aim was to reassess the appropriateness of maintaining preferential rates to the priority sectors at a time when the interest rate was expected to play an important role as an indirect instrument of monetary and credit policy.

The Executive Board took the following decision:

1. Tunisia has consulted with the Fund in accordance with paragraph 4 of the extended arrangement for Tunisia (EBS/88/119, Sup. 1, 7/28/88) and paragraph 36 of the memorandum on the economic and financial policies of Tunisia annexed to the letter from the Governor of the Central Bank of Tunisia, the Minister of Planning, and the Minister of Finance, dated June 16, 1988, in order to reach understandings with the Fund on the circumstances in which purchases can be resumed by Tunisia after December 31, 1989, and in order to complete a review of the program with the Fund.

2. The letter dated December 1, 1989 from the Governor of the Central Bank of Tunisia and the Minister of Planning and Finance shall be attached to the extended arrangement for Tunisia and the letters of June 16, 1988, together with its annexed memorandum on the economic and financial policies of Tunisia, and of March 23, 1989, shall be read as supplemented and modified by the letter of December 1, 1989.

3. Accordingly, the performance criteria on domestic credit and the net foreign assets of the Central Bank at end-December 1989, which are referred to in paragraphs 4(a)(i) and (iii) of the extended arrangement, shall be modified as specified in the letter dated December 1, 1989 and its annexed table.

4. The Fund decides that the second review contemplated in paragraph 4(c) of the extended arrangement is completed, and Tunisia may proceed to make purchases under this extended arrangement, subject to performance criteria, after December 31, 1989.

Decision No. 9329-(89/167), adopted
December 20, 1989

5. BURKINA FASO - 1989 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1989 Article IV consultation with Burkina Faso (SM/89/253, 12/1/89). They also had before them a background paper on recent economic developments in Burkina Faso (SM/89/275, 12/18/89).

Mr. Mawakani made the following statement:

The performance of the Burkinabè economy in 1988 was satisfactory in many respects. Real GDP, rebounded sharply from the depressed level recorded in 1987 and grew by about 8 percent, a rate that compares favorably with the annual average rate of the three-year period 1985-87; the rate of inflation, as measured by the consumer price index, although on the rise after two consecutive years of decline, was contained at 4.2 percent; and the overall fiscal deficit, on a commitment basis and including grants, was reduced from 6.7 percent of GDP in 1987 to 4.8 percent in 1988. Moreover, the overall balance of payments position registered a surplus, and official foreign exchange reserves increased to a level that represented 6.6 months of imports of goods and services at the end of 1988. However, the external current account position deteriorated, with the deficit reaching 3.2 percent of GDP and a tight liquidity position of the Treasury led to a further accumulation of payments arrears, both domestic and external.

Overall, while there were developments that the Burkinabè authorities consider to be a cause for concern, there were also positive developments that give them some comfort. In the real sector, the economic growth recorded in 1988 was broad based, with the agricultural, mining, trade, manufacturing, and construction sectors all contributing to the encouraging performance. As indicated in the staff report, the expansion in agricultural output in

1988 was made possible by the prevalence of good weather during the year. It should be stressed that, over the past years, the sector also benefited from increased investment outlays under the public development program and the five-year development plan which aims, among others, at achieving food self-sufficiency. Of far greater significance to the authorities is the buoyant activity in the commerce and manufacturing sectors. Indeed, the pickup in activity in these sectors indicates a positive response to the Government's efforts to encourage private sector participation in economic activity. In this context, and in order to reassure the private sector about the direction of the Government's economic policies, the authorities held seminars throughout the country with private traders and businessmen to discuss the factors that impede their involvement, and to find solutions, whenever possible, to such impediments. Among the impediments identified was a perceived slowness in the administrative procedures under the pricing and marketing system. Consequently, in line with their overall objective of introducing further flexibility in the system, the authorities took steps to reduce the scope of the price control system and to shorten the waiting period for granting price increases under the system of price homologation.

In the fiscal sector, the authorities are concerned about the relatively low level of government revenue and the accumulation of domestic and external payments arrears. With regard to government revenue, they are aware that, despite their intensified efforts toward domestic resource mobilization, there is still room for further improvement. Such improvement is all the more imperative in view of the need to secure sufficient resources to deal with the problem of payments arrears, as well as to maintain an efficient administration. To that end, two important steps have been taken in line with their revenue mobilization efforts. First, the system of exemption from import duties is being reviewed thoroughly, and second, a study on the feasibility of a value-added tax has been launched. Technical assistance has been sought from the Fund in the context of these undertakings, and the authorities are awaiting the recommendations of a recently concompleted mission to guide their action in these areas.

With respect to the accumulation of payments arrears, the authorities are of the view that the ongoing efforts to strengthen the revenue performance would go a long way in improving the liquidity position of the Treasury and help address this problem. It is worth mentioning that in the past, the Government has made ad hoc reductions in these arrears through cash payments when the liquidity position of the Treasury permitted it. This was the case in 1985 and in 1986, when the operations of the Central Government were virtually in balance and recorded a surplus. More recently, on November 24, 1989, external arrears amounting to about CFAF 4 billion were settled to international organizations. In addition, steps are being taken to strengthen the management of the external debt.

In the public enterprise sector, the restructuring program initiated in recent years is proceeding well. The authorities are encouraged by the positive results achieved so far, as evidenced by the substantial improvement in the financial performance of the pilot enterprises that underwent a restructuring program. In order to broaden the scope of this program, 12 other public enterprises have been selected, and the United Nations Industrial Development Organization (UNIDO) is providing assistance to the Government to define the terms of reference of studies for the reform of these enterprises.

The Burkinabè authorities are cognizant that the overall external position is fragile and could deteriorate rapidly. As indicated by the medium-term outlook, such a deterioration could occur as early as this year, with the overall balance of payments position expected to shift from a surplus representing 1.7 percent of GDP in 1988, to a deficit representing 0.7 percent of GDP in 1989. This underscores the need to promote export diversification in order to strengthen the external position, and allow for imports of much-needed investment goods to sustain economic growth over the medium term. In this regard, the authorities are working closely with the World Bank on an export diversification program in the context of the upcoming five-year development plan.

On statistical issues, the authorities recognize that despite the recent improvement, much remains to be done. Over the past two years, they have devoted increasing efforts to this problem, with some encouraging results. This is evidenced by the wealth and quality of statistical information provided to the staff during the Article IV consultation mission. While they agree that the lack of continuity at the administrative level has somewhat affected the efficiency of the National Institute of Statistics and Demography, they are of the view that the technical potential for producing reliable data does exist. The Burkinabè authorities expect that the technical assistance they have requested, and other assistance which may be forthcoming, would contribute to a mutually enriching exchange of experience to enable them to bring the data base in Burkina Faso up to international standards. Consequently, they will continue to give due consideration to improving the collection and analysis of statistical data.

To conclude, I would like to reaffirm the authorities' willingness to work closely with the Fund and the World Bank in order to develop a medium-term strategy to address the problems confronting the Burkinabè economy. They have submitted to the staffs of the two institutions, for comments, a draft document on their medium-term policies which, they hope, could form the basis for a useful discussion with a view to developing a full-fledged policy framework paper.

Mr. Serre made the following statement:

Burkina Faso's economic performance over the period 1982-87 was on the whole satisfactory, and average economic growth (4.3 percent) outpaced population growth (3.3 percent). As the staff report clearly shows, 1988 was another year of strong growth, and several indicators registered favorable results--the reduction in the overall fiscal deficit, among others. However, structural weaknesses continue to seriously undermine the soundness of the economy, and economic developments in 1989 demonstrated the necessity of urgently addressing the growing imbalances, especially since a financing gap might emerge. There is no room for complacency in the face of the emerging evidence that the medium-term outlook will be unsustainable, unless a comprehensive set of adjustment measures is adopted in the short term.

Reforming public finance should be the first priority of macroeconomic policy, since monetary policy remains under control, although monetary expansion deserves to be closely monitored, in line with the increase in external arrears.

We fully share the staff's analysis that it will be urgent henceforth to undertake a comprehensive review of both revenue and current and capital outlays, to avoid further deterioration of the fiscal deficit. On the revenue side, the staff rightly devotes considerable attention to the issue of tax reform. Streamlining customs duties, as well as broadening the tax base and increasing the elasticity of taxation, are of the utmost importance. There is room for maneuver to improve the situation significantly.

On the expenditure side, containing the expansion of the wage bill without delay is also crucial, given recent developments. Moreover, the persistence of domestic and external arrears points to the need to reconsider expenditure procedures as a whole. We hope that drawing up the 1990 budget should provide the opportunity to adopt a comprehensive set of actions, with the technical assistance of the Fund. In this respect, could the staff comment on the results of the latest technical assistance mission that visited Ouagadougou recently?

The growth performance registered during the recent period was due largely to developments in the agriculture and public sectors. In contrast, the development of other sectors has been rather disappointing, particularly in the service and industrial sectors--except for the mining subsector. This points to the need to reassess the overall economic environment, and to overcome structural bottlenecks that prevent the smooth functioning of the economy. Price control, exchange regulations, and wage and contribution policies deserve particular attention in that regard, in order to improve the competitiveness of the economy.

Although the parastatal sector remains basically sound, there is a need to undertake a closer examination of the degree of sustainability of several enterprises, in order to rationalize the sector and avoid further budgetary slippages through direct and indirect subsidies. The financial intermediation system should be rationalized, in order to improve the mobilization of resources and savings.

Burkina Faso's external position has developed relatively favorably, due to the strong performance of the agriculture and mining sectors and remittances from abroad. However, the developments of 1989 and the projected deterioration in the external position over the medium term, as illustrated in the staff report, are a cause of concern. Moreover, a realistic policy of borrowing on concessional terms for investments aimed at diversifying the export base is crucial. A significant reduction of arrears is also needed, to maintain the confidence of the international community. The recent partial payment made in November by the authorities is welcome.

We would like to stress the necessity of improving the overall data base, as recommended by the staff. The present situation is less the result of the absence of technical skills than the lack of continuity in monitoring the economic figures.

The present difficulties should not mask the progress already achieved. We therefore urge the authorities not to risk jeopardizing their achievements. An adjustment strategy for Burkina Faso does not need to be radical at this stage, and a step-by-step approach is more likely to succeed than major stabilization measures. We hope that the coming year will provide the opportunity for Burkina Faso to embark on the Fund-supported program, sustained by a rigorous medium-term analysis.

Mr. Hubloue made the following statement:

I welcome Mr. Mawakani's confirmation that the Burkinabè authorities firmly intend to prepare a policy framework and adjustment program which could be supported by resources under the Fund's structural adjustment facility. They have every reason to work toward an early realization of those intentions. First, the favorable output performance of recent years still makes it possible to implement adjustment measures which would be much more painful if they had to be implemented during a period of declining incomes. Second, agreement on a policy framework monitored by the World Bank and the Fund would greatly facilitate the catalysis of external assistance in support of the country's development objectives. The low implementation rate of the public investment program suggests that a stronger consensus between the authorities and the donor community on the country's development plan is indeed desirable.

Let me comment briefly on the issues where basic understandings between the authorities and the staff concerning the desirable policy actions have not yet been reached.

The staff advocates much greater flexibility on pricing policies, while the authorities would prefer, for social reasons, to keep the present intervention system in place. I fail to see the social merits of a policy which sells agricultural products below cost in an economy where agricultural production accounts for 90 percent of all employment. If any protection is deemed necessary to ensure stable food access for the other population groups, alternative measures more precisely targeted than the present pricing system would provide it much more efficiently. The operation of the Cereal Marketing Board is symptomatic of the deficiencies of the present pricing system. As I read the account in the background paper on recent economic developments of the operations of this Board, foreign food grants and other aid funds have recently been used to limit or offset its financial losses. In other words, even though domestic crop conditions have improved dramatically since 1985, the present pricing system continues directly or indirectly to allocate a large share of foreign aid flows to food support. I hope that I am wrong on that point, because otherwise, the implication is that the economic costs of the pricing policy may be even higher than would appear at first glance. In any case, it suggests that any reform of the present policy should be combined with a reformulation of present aid policies vis-à-vis Burkina Faso, which is just one more reason why a program supported by the structural adjustment facility would be highly desirable.

The surpluses of the parastatal agencies is a second issue on which the authorities and the staff hold different views. While the staff would prefer to see these surpluses transferred to the budget, the authorities consider depositing them with the commercial banks to be essential to the stability of the banking system. Does the position of the authorities indicate that without these deposits, the banks' access to more normal resources would be insufficient to fund their operations? Or does it mean that, to some extent, these deposits are the counterpart for nonperforming loans, so that the banking system is after all less sound than has been assumed? Some clarification from the staff on this point would be welcome.

On external policies, I welcome the intention of taking steps aimed at a diversification of exports. I would also urge the authorities and the staffs of the Bank and the Fund to extend their work in the trade area to the import side of Burkina Faso's current account. Imports now account for almost 250 percent of the country's exports, and have recently been growing at an underlying rate much higher than the 5 percent projected in the staff's medium-term outlook. Under these conditions, it is my view that balance of payments viability cannot be achieved unless external policies also aim at reducing the country's dependence on imports.

The staff representative from the African Department stated that the technical assistance mission that had recently returned from Burkina Faso had made preliminary recommendations with respect to the customs duty exemption system and the centralization and consolidation of taxes that were currently earmarked for certain parastatals, such as the Stabilization Fund. The Minister in charge of the budget had pledged full cooperation to ensure that the Government would implement the preliminary recommendations. The staff was at present preparing a full report, which would be sent to the authorities in time for the recommendations to be considered in the formulation of the 1990 budget.

The Government was still reviewing possible changes to pricing policy and the certification procedure, the staff representative continued. A national seminar had been conducted in the fall of 1988 to enable all concerned economic agents to make their views about the pricing process known. While the Government had taken some first steps in that regard, additional measures might be taken in the following year to introduce a greater degree of flexibility into the pricing process.

The relationship between the losses run by the Cereals Marketing Board and the aid which it received from the Government was a delicate issue, which would have to be reviewed carefully by the authorities before the staff would be in a position to report to the Board on the matter, the staff representative noted. The staff was unaware that aid was being used to enable the Government to continue an inappropriate pricing policy, but would nevertheless investigate and report to the Board.

There had been a divergence of views between the staff and the authorities on the question of the accumulation by a number of parastatals of deposits with the banking system, and whether or not those deposits should be transferred to the Treasury, the staff representative concluded. The development bank was already experiencing difficulties, and would likely experience more in the light of the current reforms, because the bulk of the deposits of the parastatals was maintained there. On a related point, Burkina Faso was one of the few countries of the West African Monetary Union to maintain a high level of deposits on the money markets of the Union. If the deposits of the parastatal agencies were reduced, the banks would reduce their own deposits with the Union, and any excess liquidity that had been introduced into the money markets would be withdrawn. The reduction in the level of deposits in itself was not likely to impair the soundness of the banking system.

Mr. Mawakani commented that he wished to assure the Board that the authorities of Burkina Faso were conducting discussions with the Fund and the World Bank with the aim of coming to an agreement in the near future on the possible use of Fund resources under the structural adjustment facility.

The Acting Chairman made the following summing up:

Directors were in broad agreement with the thrust of the staff appraisal. It was noted that over the last three years real GDP growth had increased at a faster rate than that of population, food security had improved, and inflation had remained moderate. They also observed, however, that major structural weaknesses hampered development, and that the medium-term external position was projected to weaken significantly.

Directors supported the authorities' decision to introduce flexibility into the pricing system, and encouraged them to take further steps that would allow prices to be determined increasingly by market forces, as well as to reduce government intervention in the marketing of staple products. Reference was made in particular to the impact of price controls and pricing policies on agricultural production; in that connection, it was suggested that direct subsidies would be more transparent and effective than subsidy effected via the pricing mechanism.

Directors stressed the importance of budgetary reforms and of containing the overall fiscal deficit. The authorities were urged to strengthen expenditure control and to limit the expansion of the wage bill in line with revenue prospects, while avoiding extrabudgetary expenditure. Directors also urged the authorities to increase government revenue through tax reform, including the taxation of imports, and a widening of the tax base.

Directors noted the rehabilitation plans currently being implemented in the public enterprise sector, and advised that those efforts be extended to other ailing enterprises and to the banking sector.

With respect to Burkina Faso's external prospects, Directors expressed concern about the projected weakening of the balance of payments, and urged the authorities to undertake appropriate structural and financial policies to foster the growth and diversification of exports, and to eliminate external payments arrears.

Directors stressed the need more systematically to collect and report economic data, including on the national accounts, government finances, the balance of payments, and the external debt.

Directors welcomed the Government's desire to initiate discussions on a comprehensive adjustment program that could be supported by Fund resources under the structural adjustment facility.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/89/166 (12/18/89) and EBM/89/167 (12/20/89).

6. DEBT AND DEBT-SERVICE REDUCTION OPERATIONS - EARLY REPURCHASE EXPECTATIONS

In the context of the guidelines on the role of the Fund in the debt strategy, the Fund adopts the following decision on expectations of early repurchase by members with respect to purchases of additional resources for interest support under stand-by or extended arrangements, and purchases of amounts set aside under such arrangements to support operations involving debt reduction:

A. Failure to Use Resources for Specified Purposes

1. Whenever the Fund approves a member's request for (i) *purchases of amounts set aside to support operations involving* debt reduction under a stand-by or extended arrangement, or (ii) additional resources for interest support under a stand-by or extended arrangement, pursuant to the Fund's guidelines on the role of the Fund in the debt strategy, the Fund shall specify in the decision approving the request the purposes for which, and the period of time within which, such set-aside amounts or additional resources can be used.

2. If the member, having purchased such set-aside amounts or additional resources, has not used them by the end of the specified period of time for the specified purposes, the Managing Director shall, after consultation with the member, promptly report the matter to the Executive Board. In this report, the Managing Director shall recommend that the Executive Board decide that the member is expected to make an early repurchase of the set-aside amounts of additional resources that were not used for the specified purposes, or shall recommend such other action as may be appropriate.

3. The Fund may decide that the member shall be expected to repurchase the set-aside amounts or additional resources that were not used for the specified purposes within 30 days of the decision or within such longer period as the Executive Board may specify.

B. Subsequent Derailment of Program

4. (a) If the program of a member that has previously made accelerated purchases of amounts set aside to support operations involving debt reduction under a stand-by or extended arrangement is off track on the date a purchase becomes available under the phasing provision in the arrangement, and is not back on track within 90 days after that date, the Managing Director shall report the matter to the Executive Board promptly after the expiration of the 90-day period.

(b) For purposes of this decision, a member's program is off track if the member is unable to make a purchase under the arrangement because of (i) the nonobservance of a performance criterion, the noncompletion of a review or the failure to meet any other condition under the arrangement, or (ii) the cancellation of the arrangement by the member before the purchase; the program is back on track if the member is again able to make purchases under the arrangement.

(c) Subparagraph (a) shall not apply if, on the date the purchase becomes available, all set-aside amounts that were purchased by the member by virtue of the acceleration would already have become available to the member under the phasing provision in the stand-by or extended arrangement in the absence of the acceleration.

5. In the report submitted under paragraph 4 above, the Managing Director shall recommend such action as may be appropriate, including the possibility of an expectation of early repurchase of the accelerated set-aside amounts.

6. (a) In the event that the Executive Board, taking into account the member's economic and financial position, decides that the member shall be expected to repurchase accelerated set-aside amounts, the member would be expected to make the repurchase, to the extent that such amounts would not yet have become available to the member under the phasing provision in the stand-by or extended arrangement in the absence of acceleration, within a period specified by the Executive Board, provided that such period would not be less than 30 days. The Executive Board shall give special consideration to those cases where the program has gone off track because of circumstances beyond the control of the member.

(b) A member shall not be expected to repurchase pursuant to subparagraph (a) above if its program is back on track within the period specified in that subparagraph, or if the Executive Board determines that the member has already begun to implement measures designed to bring the program back on track.

(c) If the Fund finds that the program is back on track after the repurchase has been made under this paragraph, the amount of the stand-by or extended arrangement shall be increased by an amount equivalent to the repurchase, subject to such phasing as shall be specified.

C. <u>General Provisions</u>

7. The Fund shall not approve, and the Managing Director shall not recommend for approval, a request for the use of the general resources of the Fund by a member that is failing to meet a repurchase expectation pursuant to paragraph 3 or 6 above.

8. (a) Provision shall be made in stand-by and extended arrangements for the suspension of further purchases under the arrangement whenever a member fails to meet a repurchase expectation pursuant to paragraph 3 or 6 above.

(b) Paragraph 5 of the standard form of the stand-by arrangement in Attachment A to Decision No. 6838-(81/70) adopted April 29, 1981, as amended, shall be modified as follows:

> (Member) will not make purchases under this stand-by arrangement during any period of the arrangement in which (member) has an overdue financial obligation to the Fund or is failing to meet a repurchase expectation pursuant to the Guidelines on Corrective Action in respect of a noncomplying purchase or pursuant to Decision No.   .

(c) Paragraph 5 of the standard form of the extended arrangement in Attachment B to Decision No. 6838-(81/70) adopted April 29, 1981, as amended, shall be modified as follows:

> (Member) will not make purchases under this extended arrangement during any period of the arrangement in which (member) has an over-due financial obligation to the Fund or is failing to meet a repurchase expectation pur-suant to the Guidelines on Corrective Action in respect of a noncomplying purchase or pur-suant to Decision No. .

9. If a repurchase pursuant to the expectation under paragraph 3 or 6 above has not been effected within the specified period of time, the Managing Director shall submit promptly a report to the Executive Board accompanied with a proposal on how to deal with this matter.

10. Nothing in this decision shall be deemed to limit the power of the Fund to take any other action that may be taken pursuant to the Fund's Articles.

Decision No. 9331-(89/167), adopted
December 19, 1989

7. ARAB REPUBLIC OF EGYPT - 1989 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, as amended, the Executive Board agrees to extend the period for completing the 1989 Article IV consultation with Egypt to not later than January 22, 1990.

Decision No. 9330-(89/167), adopted
December 20, 1989

8. BENEFITS FOR STAFF MEMBERS' CHILDREN - ELIGIBILITY

The Executive Board approves the proposals set forth in EBAP/89/302 (12/15/89), with one Executive Director's understanding as set forth in EBAP/89/302, Supplement 1 (12/19/89).

Adopted December 19, 1989

9. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to Executive Director as set forth in EBAP/89/301 (12/14/89).

Adopted December 19, 1989

10. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAP/89/299 (12/15/89), and by an Assistant to Executive Director as set forth in EBAP/89/300 (12/14/89) is approved.

11. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director as set forth in EBAP/89/304 (12/18/89) and Correction 1 (12/19/89) is approved.

APPROVED: August 30, 1990

LEO VAN HOUTVEN
Secretary