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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 89/135

10:00 a.m., October 13, 1989

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
	C. Enoch
	J.-L. Menda, Temporary
	D. McCormack
Dai Q.	
T. C. Dawson	
	L. Hubloue, Temporary
E. T. El Kogali	J. O. Aderibigbe, Temporary
	S.-W. Kwon
	P. O. Montórfano, Temporary
	R. Marino, Temporary
	N. Kyriazidis
	A. M. Othman
	M. Pétursson
	O. Kabbaj
	B. Goos
	T. T. Do, Temporary
	L. E. N. Fernando
	L. I. Jácome, Temporary
	D. Saha, Temporary
	Z. Iqbal, Temporary
	G. P. J. Hogeweg
	K. Ichikawa, Temporary

J. W. Lang, Jr., Acting Secretary
S. L. Yeager, Assistant

Also Present
IBRD: F. Dhanyi, Europe, Middle East and North Africa Regional Office. European Department: M. Guitián, Deputy Director; M. Mecagni, L. E. Molho, G. C. Pastor, E. Spitäller. Exchange and Trade Relations Department: T. Leddy, Deputy Director; S. Kanesa-Thasan. Legal Department: W. E. Holder, Deputy General Counsel; J. V. Surr. Research Department: N. M. Kaibni. Western Hemisphere Department: S. T. Beza. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: B. S. Newman, A. Raza, R. Wenzel. Assistants to Executive Directors: M. E. F. Jones, M. J. Shaffrey, C. C. A. van den Berg, J. C. Westerweel.

1. REPORT BY MANAGING DIRECTOR

The Chairman remarked that he had visited Brussels at the invitation of the President of the Commission of the European Communities to discuss matters of common interest. The first item on the agenda had been how to improve the common work of the Fund and the European Communities (EC) on trade matters, particularly the examination of trade policies for EC member countries with which the Fund conducted Article IV consultations. The talks had been noncommittal, but the Commission had recognized the problem of coordination and had agreed to work with the Fund in an effort to provide the Executive Board a better overall view of trade policies in Europe.

The second item of the agenda, the Support Group for Guyana and other support operations, had focused on the Fund's interest in cooperating more closely with the EC on those countries with the most severe adjustment problems, including the problem of arrears, the Chairman continued. He had briefly explained the Fund's strategy for support groups. The Commission, which had tended to view the strategy as a scheme for repaying arrears to the Fund, was now convinced that the strategy was more broadly based and had agreed that in the future, the EC would take part, if invited, in support groups and cooperate with them in the financing of countries with tremendous payments difficulties.

The perspectives opened by the Fourth Lomé Convention had also been discussed, the Chairman commented. Lending under the Convention was expected to shift from project financing toward structural adjustment financing. In that regard, although the Commission recognized that conditionality was of the essence, it tended to shy away from that concept. He had indicated that the Fund stood ready to supply the necessary conditionality in the context of its support of members' programs if the EC would support the Fund's efforts through the provision of additional financing for members' adjustment efforts. The two institutions would certainly cooperate better in the future, and they would organize contacts with a view to being mutually supportive.

In the Commission's view, collaborative efforts in support of Eastern European countries was particularly important, the Chairman remarked. The major industrial countries, at their last economic summit, had invited the Commission to coordinate support for Poland and Hungary. In that regard, it was essential that the EC and the Fund avoid duplication of work, cross-conditionality, or conflicting advice. It was agreed that an adjustment program approved by the Fund was the absolute prerequisite for assistance and that other entities should not interfere in the design of programs for those countries, although there might be iterations with other parties before conclusions could be reached, for example, on the desirable level of balance of payments for Poland. In that connection, it was essential for the Fund to have a clear perception of available financing and other support to be provided to Poland by governments, including project financing, retraining, technical assistance, and food assistance. The Fund would establish an informal dialogue with members of the Commission to facilitate that work and to ensure the best possible action at such an important juncture.

He had also had conversations with the Belgian authorities, including the Prime Minister and the Governor for the Fund, the Chairman stated. They were concerned about the snowball effect of a huge internal debt on their economy and had sought advice on that issue as well as on several other projects, particularly with respect to the acceleration of financial reform with a view to the integration of European financial markets by 1992. In addition, he had spent some time briefing King Baudouin, at his invitation, on the world economic outlook.

In Vienna he had had conversations with the Minister of Finance, the Governor for the Fund, the Minister of Economy, and groups of economists and industrialists on the prospects in Eastern European countries, the Chairman remarked. Austria had a unique network of bilateral micro-economic relations--including industrial relations and joint ventures--with Hungary in particular. In addition, Austria was a unique source of perceptions and information on what was feasible in those countries. The information he had received in the course of those discussions would be helpful to the future work of the Fund's European Department.

2. CYPRUS - 1989 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1989 Article IV consultation with Cyprus (SM/89/165, 8/9/89). They also had before them a background paper on recent economic developments in Cyprus (SM/89/171, 8/17/89).

The staff representative from the European Department said that the signs of overheating were much clearer now than they had been at the time of the consultation mission. Domestic demand and output were growing at a faster rate, inflation was picking up, and imports were increasing more rapidly than had been predicted. The trade balance and the current account deficit, excluding the bulk purchase of airplanes, were widening considerably.

Mr. Hogeweg made the following statement:

> My Cypriot authorities basically agree with the analysis in the staff report and would like to draw attention specifically to Cyprus' excellent economic performance over the last few years, which took more than full advantage of the favorable external environment. Recent data seem to confirm the indications given in the staff report that growth in 1989 may be slightly higher than the forecast of 5.5 percent and that buoyant revenues will prevent the government deficit from rising. Sectors performing especially well at present are tourism, shipping, and offshore companies.

There is a tendency toward overheating, which manifests itself in shortages in labor, notably in the construction and tourism areas. The current account position is deteriorating, and inflation, while remaining low, is rising. Both developments are not yet alarming but could cause concern if they were to continue. For the time being the overall balance of payments is set to record a surplus, and competitiveness seems adequate. The authorities continue to believe that the decline of the private sector savings rate will level off.

The response of economic policy to the risks of overheating is complicated by the existence of some long-standing structural rigidities in the economy, which are correctly identified in the staff report. In particular, I would note the tax system, which relies heavily on import duties and direct taxation; agricultural subsidies; wage indexation; lack of interest rate flexibility; and the incomplete control of the monetary authorities over the financial system.

The authorities are fully aware that these issues will have to be addressed urgently. At the same time, it is precisely the good performance of the economy that makes it difficult to gather political support to tackle these sensitive issues. However, strong incentives for structural reform stem from the Customs Union Agreement with the European Communities (EC) and even more so if Cyprus would become a full member. All future legislation will be aligned with EC directives.

The process of gradually diminishing import duties on the road to customs union with the EC compels the Government to raise alternative revenue. A tax reform bill, including the introduction of a value-added tax (VAT), will be submitted to Parliament later this month. All attention is currently directed at the tax reform, but this in no way indicates that the authorities attach less importance to other structural issues, especially those in the monetary area.

The authorities have already responded to the signs of overheating by increasing the bank liquidity requirements. This instrument, however, does not affect the credit cooperatives, which have grown to around one third of the deposit base. Moreover, the lack of interest rate flexibility prevents effective open market operations and complicates the efforts under way to increase nonmonetary financing of the government deficit.

The authorities stress that the tax reform package is essential to their aim to further reduce the government deficit in line with their medium-term target of 1 1/2 percent of GDP by 1992. Meanwhile, they will continue to seek ways of limiting monetary financing as much as possible. The proposal before Parliament to temporarily double the Government's access limits to the Central Bank is only intended as a precaution and is seen as the lesser evil among options for monetary financing if the need arises.

As to the remaining restriction on the amount of foreign exchange made available for foreign travel, the authorities emphasize that it poses no severe restriction on travel. Rather, it must be seen as a complement to capital controls to prevent possible capital flight. Such circumstances cannot be ruled out as long as the problems created by the war of 1974 have not been solved.

Currently, the economy is doing well, and capital is flowing into, rather than out of, the country. Cyprus' problems are problems of success. The rigidities mentioned have not impeded the strong economic performance but may complicate economic management if the overheating continues. Expenditure restraint and tax reform are the first priorities; structural reform in other areas will undoubtedly follow in view of the country's increasing orientation to European markets, where the authorities clearly see Cyprus' future.

Mr. Kyriazidis made the following statement:

It is gratifying to note that, as Mr. Hogeweg has explained, the problems of the Cypriot economy are problems of success, especially in view of my personal involvement with the Cypriot economy in two respects. The first was in an advisory capacity during Cyprus' negotiations with the European Communities in 1972-73 and again in 1978-81. The second, and more sobering, experience was my involvement in the administration of financial aid to Cyprus in the tragic years after the invasion of 1974. The progress over the past ten years has been significant, and the staff's description in that regard is an accurate one: "Over the past ten years Cyprus has moved from reconstruction to sustained expansion at a rapid pace, with the production base progressively widening, productivity improving, and per capita income and wealth consistently growing. Over the same period, the economy has moved from high inflation and large external imbalances to low inflation and a sounder and more sustainable balance of payments position. In the process, employment growth has been sustained, and the rate of unemployment has fallen to an historical low."

These statements, although accurate, do not describe the somber situation that the authorities faced at that time, particularly with regard to reconstruction. The problems were indeed daunting. More than 200,000 refugees--between one third and 40 percent of the population--had to be resettled and absorbed. At the same time, the authorities had to recreate, practically from scratch, a manufacturing productive capacity and a tourist industry, while expanding social services to deal with the refugee problem. They also had to restructure agriculture and exports, because the major export product and mainstay of agricultural production in Cyprus--citrus production--had passed out of their hands and remained in the occupied territories. In the light of this background, I cannot help but wonder at the success, the strength, and the resilience that has been shown by the authorities, the economic agents, and the entrepreneurship of Cyprus.

The signs that the economy is now facing a phase of overheating are clear. I agree with Mr. Hogeweg and the staff that the problem presented by this overheating is complicated by long-standing structural rigidities that have left the Government with weak instruments of macroeconomic policy, and it underlines the importance of structural reform. I also agree with Mr. Hogeweg that so far, the structural weaknesses have not impeded the progress of the economy--a point that merits further investigation, particularly regarding the main factors that offset the effect of these rigidities in the Cypriot economy. Those factors perhaps explain the persistence of the rigidities as well as the limited attempts that have been made so far to reform both the tax and the financial systems.

The prosperity that the island now enjoys is not a great incentive for further structural reform. I hope that the authorities will realize that the time for structural reform has come and that it is particularly urgent in the fiscal sector. The planned tax reform should be pursued with vigor, despite the difficulties that might arise for the reasons that Mr. Hogeweg has mentioned. These measures are essential not only to strengthen revenue performance and improve the fiscal balance, but also to ameliorate the savings rate and the supply performance of the economy. They are also essential prerequisites for sustained rapid growth compatible with external viability in the medium term, particularly, to arrest the rise in public debt over the medium term, which may become a serious problem.

The planned efforts aimed at structural reductions in subsidy outlays and their replacement in cases of hardship by direct income support are also of primary importance and urgency. I am more concerned about reform in the financial sector, where there are no clear indications regarding the measures to be taken or envisaged by the authorities. Major reforms are perhaps even more urgently needed in this area than in the fiscal sector. The financial system has to be substantially deregulated, corporate credit institutions must be brought under the control of the monetary authorities, interest rates must be liberalized, and the Central Bank must have the means to control liquidity adequately through open market operations. In the absence of such measures, the monetary authorities will have little control over liquidity and credit expansion, and the fiscal authorities will have little possibility of shifting the financing of the public debt to the nonbank public under appropriate terms.

Further measures to increase flexibility in the labor market are also indicated, although modification of the wage indexation system is not perhaps urgently required in the present climate of low inflation and rapid productivity increases. The authorities, however, should consider seriously the staff's suggestion to modify the indexation mechanism by excluding the terms of trade effect. Such a modification will have a beneficial effect on the stability and control of public expenditure, which is important for the process of fiscal consolidation. To alleviate labor shortages, additional measures similar to those already taken in the construction and tourism sectors may be needed. There are, of course, political constraints to a total liberalization of employment opportunities, particularly toward the Turkish Cypriots. On balance, however, such measures are not only economically helpful but also politically constructive.

The economy is performing strongly. Inflation remains low, and the external position is, on the whole, balanced. The problem of overheating at this stage is certainly manageable, despite the fact that only fiscal instruments remain and that an urgent adjustment to the present situation presents some problems. The maintenance of economic strength and stability in the future, however, will crucially depend on the implementation of structural reform measures already envisaged in the staff report.

The success of the Cypriot economy is all the more remarkable because it has been achieved in the face of a delicate political situation with serious security implications, which can at any moment adversely affect expectations and public confidence. In this connection, progress toward the integration of Cyprus into the European Communities, aiming at full membership, as now envisaged by the Cypriot authorities, can play a crucial role in consolidating confidence in the future. Even in this respect, the structural reforms envisaged are essential and urgent.

Mr. Marino said that the Cypriot authorities were to be commended for the remarkable performance of their economy. Over the past decade, Cyprus had maintained an average growth rate above 6 percent, an average inflation rate below 6 percent, and an average unemployment rate close to 3 percent, which compared favorably with the performance of other countries.

Cyprus' current problems were those associated with success, as Mr. Hogeweg had rightly highlighted in his statement, Mr. Marino considered. A strong domestic demand, an economy operating near full employment levels, and rapidly rising imports were all signs of the economy's buoyancy.

The favorable internal and external conditions provided a good framework in which to remove many of the structural rigidities in the economy, Mr. Marino observed. For instance, in view of the confidence in the economy reflected in capital inflows, the monetary authorities could try to increase interest rate flexibility and remove the regulatory disadvantages that commercial banks faced vis-à-vis the savings and credit cooperatives. Similarly, in view of the impressive price stability that the economy had enjoyed over the past few years, it would seem justified to try to phase out the practice of wage indexation. As the authorities rightly recognized, a deterioration in the terms of trade could lead to real wage increases through the cost of living adjustment mechanism currently in place, thereby eroding enterprise competitiveness and profitability.

Cyprus' challenges were to maintain the momentum in the economy without falling into internal or external disequilibria and to undertake the institutional adjustments that were required to face increased competition as economic and financial integration advanced in Europe and protection was reduced, Mr. Marino concluded. He supported the proposed decision.

Mr. Enoch made the following statement:

> The staff report documents clearly the continued impressive performance of the Cypriot economy, although it perhaps understates the authorities' achievements. I have little disagreement with the staff appraisal. The comparative data shown on page 2 of the staff report are particularly illuminating, and I will therefore offer only a few specific comments.
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> Concerning the need for further progress toward fiscal consolidation, control of expenditure is clearly essential, and subsidies in particular offer a source for immediate savings. But in reading the papers, I was particularly impressed by the importance of tax reform. The buoyant economy has sustained tax revenues, which have been supported by successful efforts to improve the efficiency of tax administration. But the authorities recognize that indirect taxation in the form of a value-added tax would be more equitable between those taxed on income at source and others, and I was pleased to hear from Mr. Hogeweg that a tax reform bill, including the introduction of a VAT, is to be introduced into Parliament later this month. There is also a reference at the beginning of the staff paper to a sizable underground economy. I would be interested if

Mr. Hogeweg or the staff could offer an estimate of its size; bringing a part of it within the tax net might have a dramatic effect on tax revenue.

The persistence of a fiscal deficit, although reduced, is of particular concern because of the sharp increase in recourse to the Central Bank, the effects of which were not fully offset by increases in commercial banks' required liquidity ratios. I welcome the authorities' intentions to persevere in efforts to develop other forms of government finance. But their earlier problems in this field point to a lack of free competition in the financial sector, which warrants close attention for future action. Chart 6 of the staff report suggests that higher interest rates may be appropriate in view of the desire to finance the fiscal deficit outside the banking sector, the upward drift in inflation, the fall in the savings rate, and the buoyancy in the economy.

The need for corrective monetary action may be particularly important in view of the inadequacy of price indices, which I understand from the background paper impart a downward bias to measured inflation. As one of the notable features of Cyprus' success story has been a combination of growth with apparent low inflation, I found this somewhat disturbing.

Underestimation of inflation will have served the economy well in respect of the six-monthly indexation of wages. But this indexation is unwelcome, especially as tightness in the labor market is tending to put pressure on wages. Such indexation may cause problems when the VAT is introduced, in that a transient one-time price hike may be transformed into a sustained higher rate of inflation.

With respect to the current account, I note that strong tourist receipts continue to make an important contribution to offsetting the trade deficit. The authorities have in the past rightly concentrated on up-market tourism, in view of the capacity constraints in Cyprus. The background paper notes that 1988 witnessed some setbacks to the up-market tourism policy, with per capita expenditure increasing by much less than the number of arrivals. Tourism was again unexpectedly strong in the first months of this year, as measured by numbers of arrivals. I would be interested in any comments on per capita expenditure for 1989. Regarding the strong growth in the financial services sector, I would be interested in further comment from the staff or Mr. Hogeweg on the medium-term prospects for this sector.

As for the capital account, I notice that direct investment has continued to decline in importance, despite the authorities' expressed desire to encourage such inflows as a means of increasing efficiency in the industrial sector. There would appear still to be considerable scope for relaxation of obstacles to foreign investors.

I can support the proposed decision and welcome the further exchange liberalization which it notes. However, I urge the authorities to adopt full Article VIII status. It is not clear whether the staff views the remaining restrictions as having any significant effect, but the inclusion of Cyprus within the operational budget since the last full Article IV consultation suggests that the Fund does not consider the external position to be precarious.

Mr. Ichikawa made the following statement:

My authorities broadly agree with the staff appraisal. Cyprus has shown a remarkable performance of sustained economic growth at a high rate over the last few years, which is likely to continue this year. The growth rate in 1989 will be more than 5.5 percent, while the inflation rate is relatively low, and the external account is almost balanced. There is, however, a tendency toward overheating in the economy, stemming from strong domestic demand and a tight labor market; this overheating becomes clearer if one looks at marginal changes in the inflation rate and the current account balance in 1989. The authorities are to be commended for the encouraging overall economic performance. However, it is hoped that they will take the appropriate actions to tackle this recent unfavorable development in the economy. Furthermore, caution is warranted with respect to structural problems, although they are currently masked by the impressive success of the economy.

With regard to fiscal policy, the mechanism of central bank financing of the budget deficit is one of the most worrisome structural problems. This mechanism mitigates the external public borrowing requirement by passing on the burden to domestic borrowing, at the cost of risking the flexibility of monetary policy. Furthermore, the effects of the Government's proposal to double the fiscal authorities' access limits to the Central Bank is cause for concern in view of the recent resurgence of inflationary pressures. Instead, recourse to nonmonetary financing might be an urgent task for the authorities.

The concise statement of Mr. Hogeweg provides helpful information on the tax reform proposal. The proposed reform, which reduces the dependence on import duties by broadening the tax base, seems to aim in the right direction, taking into account possible future developments and the circumstances of the Cypriot economy. The authorities should pursue the tax reform vigorously. Similar discipline should also be imposed on expenditure, as the budget follows an expansionary tendency.

On the monetary front, the main instrument of control is the liquidity requirement of banks, while the interest rate generally lacks flexibility. The rigidity of interest rates seems to be partially responsible for the unsuccessful sale of government bonds, according to the staff's analysis. In this regard, the staff's views on whether deregulation of interest rates is desirable, or feasible, would be appreciated.

With respect to short-term prospects, the authorities' tightening of liquidity requirements is welcome as an important step to prevent the further overheating of the economy. However, it is not clear from the staff report whether these macroeconomic policies would sufficiently cool down the economy. I would appreciate receiving the staff's view on this point.

As for the medium-term outlook, it is encouraging to see that the external debt is projected to decline rapidly. The achievement of the medium-term scenario, however, depends significantly on whether the authorities are able to correct the current overheating of the economy.

As to structural reforms in other areas, my authorities are in broad agreement with the staff's appraisal, and I have few comments to offer. It is hoped that the Government will take full advantage of structural reforms, especially in the financial sector, to improve the efficiency and competitiveness of the economy over the medium and long term. I support the proposed decision.

Mr. Goos said that the Cypriot authorities were to be commended on the impressive performance of their economy over the past few years. That performance was puzzling, in view of the substantial structural rigidities, including wage indexation, weaknesses of monetary control, and administrative interest rate regulations. Those were among the factors that normally tended to reinforce the destabilizing impact of easy financial conditions and rapid domestic demand expansion. He therefore wondered whether the authorities might have a secret recipe for successful economic management, and, if so, he would be interested to hear from the staff or Mr. Hogeweg what the ingredients of that recipe might be.

He agreed with Mr. Hogeweg that, while developments were not yet alarming, they could be cause for concern if allowed to continue, and that concern had been reinforced by the information provided by the staff at the beginning of the meeting, Mr. Goos continued. Clearly, there was a need for countering the existing overheating of the economy with a tightening of financial policies. That need was clearly brought out in the staff's medium-term analysis, which underscored the risks of excessive financing of growing financial imbalances. There was, in particular, the risk that the current favorable terms of borrowing that seemed to be stressed by the authorities could prove to be short-lived. There also was little doubt that financial tightening should be complemented by efforts to tackle the various structural weaknesses that had been identified by the staff.

It was encouraging to note that the authorities were aware of the urgent need to address those issues, Mr. Goos remarked. But little immediate progress was in sight, which was all the more regrettable considering that the structural weaknesses were already the subject of widespread concern at the 1987 Article IV consultation discussion (EBM/87/63, 4/22/89). Moreover, there was the prospect of a serious setback on a critical front of monetary stabilization, in that the authorities were seeking a doubling of the limits to central bank financing of the budget. For obvious reasons, a complete discontinuation of such financing might have been expected with a view to strengthen fiscal discipline.

In view of the strong external performance, including in particular the comfortable reserve position, he was surprised to see the staff's proposal to further extend the approval of the exchange restrictions on foreign travel, Mr. Goos commented. He invited the staff to explain its proposal. In the circumstances, and in view of the Fund's mandate to foster an open external payments system, he had difficulties with that proposal. Obviously, the more appropriate course of action to meet the authorities' concern about possible capital flight--which applied also to the remaining capital controls--would be to strengthen the effectiveness of monetary control through financial sector reform, and in particular, the introduction of interest rate flexibility. With those observations, he could support the staff appraisal.

Mr. Dawson remarked that the Cypriot authorities were to be congratulated on an impressive economic performance in recent years, reflecting both a favorable external environment and prudent economic policies. Few countries could point to such a record of sustained economic growth, low inflation, and a strong external situation.

Continued success would require timely and effective action to deal with the potential problems on the horizon that were noted in the staff report, including continued strong domestic demand growth at a time when the economy was at or near full employment; rising, albeit still modest, inflation and the potential for renewed wage pressures as labor constraints intensified; and, a deterioration in the external accounts despite record tourist receipts, Mr. Dawson considered. In that regard, the overshooting of the monetary targets and indications that the authorities were prepared to expand recourse to central bank financing of the budget deficit were particularly troubling. While that approach might be the lesser evil among options for monetary financing, as Mr. Hogeweg had suggested, it was a choice within an option that was already a second-best alternative. The need to choose such an approach in part reflected the authorities' reluctance to implement financial reforms that would improve the flexibility of monetary policy. While his authorities appreciated the need to give priority to tax reform, a further delay of possibly two years or more in undertaking financial market reforms was unfortunate.

Clearly, a reduction of the budget deficit would ease the policy dilemma on the monetary front, Mr. Dawson commented. Therefore, the decision to freeze overall government spending in 1990 at the 1989 budgeted levels was welcome. However, actual 1989 expenditures appeared to be running well ahead of budgeted levels, and a freeze would therefore imply reductions in expenditures from current levels. In those circumstances, he would be interested to learn how the authorities intended to implement such reductions and whether consideration was being given to further cuts in agricultural subsidies and possible changes in the wage indexation system. Moreover, in view of the possible delays in implementing tax reform, was there scope for other measures to increase revenue if the budget situation deteriorated?

The overheating of the economy had contributed to a deterioration of the external position, although he agreed that the overall situation did not pose an immediate problem, Mr. Dawson remarked. It would be important, however, to build on recent competitive gains as Cyprus became more fully integrated into the EC. That reinforced the need to come to grips with inflationary pressures before they got out of hand.

While the present economic situation of Cyprus remained generally satisfactory, recent trends suggested the need for a strengthening of monetary and fiscal policies, including structural reforms, which would increase the effectiveness of policy, Mr. Dawson stated. The success of the past few years provided the time to take the actions needed, but the safety margin was narrowing rapidly.

Mr. Iqbal made the following statement:

> Following robust growth during the past three years, the Cypriot economy appears to be overheating. There is now a need for consolidation and a greater stress on addressing structural impediments to secular growth. Although official reserves remain ample, there has been a sharp increase in imports, while the growth of exports has decelerated. Inflation, although still moderate, has started to pick up. The last two years have witnessed a significant shift toward domestic demand as the primary source of growth, the continuation of which could be inflationary. At the same time, the labor market has tightened and, if not addressed, would adversely affect competitiveness. Moreover, the evolution of the financial sector and policies has not kept pace with the impressive growth in the real sector and, if not corrected, may impede continued growth.

In view of the underlying strength of the Cypriot economy, no fundamental redirection of objectives or policies is called for. Instead, the focus should be on moderating domestic demand growth so as to arrest inflationary and balance of payments pressures, avoiding the emergence of supply bottlenecks to ensure competitiveness, strengthening monetary policy instruments, and initiating structural reforms, including those of the financial sector. The authorities should seize upon the prevailing, generally comfortable, economic environment to implement the needed adjustments.

I agree with the staff that a tightening of both fiscal and monetary policies is called for in 1989 and the near term. In this context, it is important that the authorities should avoid recourse to the planned increase in access to central bank credit. This can be accomplished only if targets to freeze overall government expenditure in 1990 at the level budgeted for 1989 and to reduce the deficit to the equivalent of 1.5 percent of GDP by 1992 are strictly adhered to. A rationalization and reduction of subsidies, in particular to agriculture, not only would help in reducing the budget deficit, but also would enhance efficiency by releasing labor to the industrial and tourism sectors. I note with satisfaction that the authorities are pursuing with determination the reform of the tax system to widen the revenue base, including the enactment of the value-added tax. The VAT would not only address the need to accommodate imperatives of EC membership, but would also tackle the budgetary requirements.

The need to strengthen prospects for domestic nonbank financing of the budget is of particular importance and would not only avoid the unnecessary expansion of base money, but would also facilitate a deepening of the financial sector. This should be undertaken in the context of a broad-based restructuring of the financial sector and policies. I agree with the staff's view that a more flexible use of nonbank financing would help in easing interest rate rigidities and in enhancing the Central Bank's ability to undertake open market operations, and, thus, reinforce existing instruments for regulating liquidity. Over the long run, consideration should also be given to amalgamate credit cooperatives into a separate commercial bank, so as to enhance central bank supervision of the financial sector and increase competition. In this context, I would appreciate the staff's comments on the policy toward offshore banking units in Cyprus, their growth, so far, and future prospects.

In view of the importance of labor market behavior in determining Cyprus' competitiveness, I support the staff's view that greater flexibility in wage determination is essential. In the present environment of prosperity, the authorities may find it easier to abandon the policy, allowing full cost of living adjustment of wages. In this context, care should be taken to ensure that the implementation of the value-added tax in conjunction with the cost of living adjustments provisions, does not encourage a wage-price spiral.

Cyprus' exchange rate system and policy are appropriate for the time being. However, if the U.S. dollar continues to appreciate, the authorities should consider revising their policy in order to protect competitiveness. I support the proposed decision.

Mr. McCormack said that the performance of the Cypriot economy was commendable. There was clearly broad agreement between the authorities and the staff on the general thrust of policy recommendations. However, the staff report left the impression that the urgency with which fiscal reform was being addressed was not matched in the financial area, and in that regard, the rigidities in the financial sector were particularly striking. That matter should be addressed as a matter of urgency. Moreover, it was worrisome to see the increased access of the Government to central bank financing, even on a temporary basis. "Temporary" suggested short term, but was being used by the authorities to describe a five-year period. He would prefer to see an increase in access for one year only, and to overcome specific contingencies.

More specifically, in view of the large agenda of required structural measures, the absence of a program to ensure the effective use of the time available was particularly striking, Mr. McCormack remarked. In that regard, he shared Mr. Dawson's views, especially on the diminishing safety margin and delays in financial market reform. Did the staff have any ideas on how to overcome the problem of excellent performance being an obstacle to mobilizing political support for change? Would there be merit in, for example, preparing a policy framework for Cyprus in the form of a short statement that addressed specific questions of phasing, especially in view of the extensive agenda of structural reforms? Time was running out, particularly in view of Cyprus' envisaged integration with Europe, and some direction regarding structural reforms in the coming year would be important.

The staff representative from the European Department, commenting on the apparent contradiction of an economy rife with rigidities showing such an excellent economic performance, observed that the rigidities were less cumbersome than they appeared. Because the restrictions were found in all sectors, they were mutually offsetting and established a certain balance. For example, the cumulative increase of unit labor costs over a number of years suggested that profit margins should be desperately low. In fact, enterprises had been profitable owing in part to favorable tax breaks, such as investment allowances, export allowances, and duty-free imports of raw materials and equipment, which offset increased labor costs and restored balance. Another example was the measure of flexibility with respect to interest rate rigidities. The fact that cooperatives were outside the purview of central bank control and supervision--which was deplorable in itself--had helped to make the market more flexible since the cooperatives did not pay liquidity requirements on their deposit base and, hence, could afford to operate on a smaller spread than commercial banks. Moreover, the taxation of interest income from deposit accounts was not enforced. In principle, recipients of interest were subject to a marginal tax rate on their income tax, but the authorities did not administer those regulations. Thus, over the medium term, the real after tax rate of return on deposits appeared to be adequate. That was not to say that rigidities were not a problem, but rather to point out that the authorities had been ingenious in finding ways of administering those rigidities in a flexible and mutually offsetting manner.

It was true that the margins of maneuver were narrowing and that the urgency of undertaking decisive structural reform was increasing, the staff representative remarked. By embarking on a path leading to full customs union with the EC, Cyprus had locked itself into a situation where deregulation was required on a variety of fronts, which meant that restrictions would also have to be scaled down. For example, the anticipated loss of tax revenue from customs duties would have to be offset by another tax to bridge the financing gap. In that connection, the introduction of a value-added tax, together with certain fiscal measures to lower the government deficit consistent with the medium-term target of 1 1/2 percent of GDP by 1992, should help to restore a better balance in the external accounts, because the VAT would favor a distribution of income more toward savings than toward expenditure.

The staff supported the authorities' emphasis at the present time on the introduction of the VAT rather than on the abolition of wage indexation in view of the difficult task of gaining public support for the tax, the staff representative continued. Wage indexation would protect the purchasing power of the public so that the VAT would have a substitution effect, thereby helping savings, and, in turn, the current account. The authorities intended over the medium term to reform the wage indexation system, and in particular, to remove changes in the terms of trade from the index.

The apparent downward bias in consumer prices was partly attributable to lags in cost adjustments, particularly with respect to import prices, the staff representative explained. For example, oil price increases were passed through with a lag, because decisions on domestic price adjustments were taken only twice a year. At present there was a measure of suppressed inflation in the economy because increased prices, together with the rise in the U.S. dollar, had not yet been fully passed through. The staff feared that inflation might accelerate over the first half of 1990, which made the need for decisive financial policy reform even more urgent. In that connection it should be noted that even though the 1990 target of a budget deficit of 2.8 percent of GDP could be realized--the 1989 budget deficit was likely to be on the same order as that in 1988, namely, about 3 1/2 percent--if the authorities' declared intentions of freezing expenditure were carried out to any reasonable extent, the degree of restraint was still insufficient to withdraw fiscal stimulus. Moreover, the expenditure ratio remained high. Subsidies also remained high, and the authorities had not yet made a decisive commitment beyond declarations of intent to scale down or phase out subsidies. Nevertheless, the Government had a variety of issues to tackle. Foremost among them was the introduction of the VAT, to be followed by personal income tax reform, including the reduction of the number of tax brackets, the lowering of marginal tax rates, increasing the transparency of the tax system, and improving tax administration.

Both the effective interest rate and the exchange rate were targeted, which was possible because of the controls that were in effect, the staff representative stated. It was true that if the U.S. dollar strengthened, Cyprus may have to reconsider its exchange rate policy. To keep the average exchange rate constant in relation to a basket of currencies, the Cyprus pound would have to appreciate vis-à-vis other important European currencies as it depreciated vis-à-vis the U.S. dollar, which would undermine the competitiveness of Cyprus in the increasingly important European market.

The issue of competitiveness involved more than real exchange rate indices, the staff representative continued. Since 1984, export unit values had declined, and competitiveness had improved while profit margins remained ample. Moreover, in the past few years the GDP deflator had risen, on average, more rapidly than unit labor costs. As a result, profit margins were protected. Exporters were helped further by a variety of other policies, for example, duty-free importation of raw materials and capital equipment.

Over the years, the staff had adamantly supported the elimination of subsidies, which had been a particularly heavy drag on the budget in 1988 and in 1989, the staff representative stated. While it was politically difficult to push through the subsidy reform, the Government intended to do so as soon as possible.

The staff shared Directors' concerns about the doubling of the Government's access limit to central bank financing, the staff representative commented. That undesirable development increased the urgency of financial reform. Cyprus had received technical assistance not only from the Fund's Central Banking Department, but also from a Commonwealth fund, and there were many advisors in Cyprus working with the authorities on a reform program to increase the flexibility of the financial system.

The most disconcerting feature of the external accounts at the moment was the relatively high current account deficit, even if purchases of aircraft were excluded, the staff representative remarked. Even if there were certain improvements, for example, in export performance or reduction of import elasticities--areas where the staff believed that the authorities' expectations were too optimistic--the current account deficit would still widen. In that connection, the performance of the tourism sector in 1988, which showed an increase in arrivals but a decline in per capita expenditure of tourists, had broadly continued in 1989. Even so, the tourist sector continued to do well compared with tourism industries in other Mediterranean countries in 1989.

There were undoubtedly labor shortages in the system, the staff representative stated. The authorities' main effort at the present stage aimed at inducing Cypriots working abroad, particularly in the United Kingdom, to return to Cyprus and work in the hotel business. It was interesting to note that that effort compelled the authorities to reduce capital controls to allow returning workers to repatriate or transfer funds in and out of the country freely.

The authorities believed that they had to move in all areas of reform in a consistent manner, the staff representative stressed. That was particularly true because Parliament was in a position to water down the VAT bill while at the same time passing a full personal income tax reduction bill. Such an outturn would put pressure on the fiscal accounts, underlining the urgent need to introduce greater flexibility in the financial markets.

A more flexible domestic interest rate policy would tend to act as an automatic stabilizer, the staff representative observed. The rapid deterioration of the external accounts, although worrisome, helped to remove demand pressure in the economy and reduce the effect of such pressures on inflation. In those circumstances, with flexible interest rates, real rates would tend to increase in the upswing, which would tend to increase lending rates and work as an automatic stabilizer while increasing savings.

The authorities were also undertaking a variety of measures to increase the supply response of the economy, the staff representative commented. Both the manufacturing and agricultural sectors were characterized by relatively small enterprises, and the authorities planned to create conditions in which those enterprises could benefit from economies of scale through better coordination in marketing, in product design, and in quality upgrading of products. The authorities were aware that as the tariff barriers came down, the productive sectors would become more exposed and would need to be more competitive.

On the proposed decision, from an economic standpoint, there was little justification for retaining exchange restrictions rather than fully assuming Article VIII status, the staff representative from the European Department remarked. The authorities had only been persuaded to retain the restriction owing to the potential for shocks to the economy in the present political circumstances; hence they had asked for an extension of the approval of the restriction. They felt that the restriction, as currently administered, did not constitute too burdensome a constraint on Cypriot tourists traveling abroad. Of course, it was possible that on the expiration of approval, the authorities would again argue for its continuation, although they preferred to scale it down, pending a political solution to the Cyprus problem. While the request may be hard to justify on the basis of recent external performance alone, the staff found it difficult to ignore the authorities' wariness about the potentially unstable political situation and would support the retention of the restriction.

The staff representative from the Exchange and Trade Relations Department suggested that the approval of exchange restrictions should be for a period of 12 months--to September 30, 1990--which was consistent with the Fund's usual practice. In addition, the expiration date that had been initially proposed--April 22, 1990--did not coincide with the consultation cycle for Cyprus, so that approval would lapse before the completion of the interim discussions, which were expected to be concluded in September 1990.

Mr. Hogeweg said that he was grateful for Directors' interest in Cyprus. He had been impressed by Mr. Kyriazidis's account of the background against which present achievements should be measured. The secret to Cyprus' success in the face of rigidities in the economy had been explained to a large extent by the staff. He would only add that the entrepreneurship of the Cypriot people had also been an important factor. Moreover, Cyprus was a relatively small player in world markets as well as in European markets, to which it had increasingly turned, and being a small player had its advantages in terms of possibilities.

The system of counterbalancing rigidities underlined the importance of Mr. McCormack's remarks regarding the phasing of structural adjustment; action in one area should not inadvertently change the counterbalance in an unexpected or undesirable way, Mr. Hogeweg remarked. On the program for structural adjustment and the present emphasis on the tax reform, it was indeed the authorities' view that it was not possible to tackle everything at once and that it would not be conducive to final success. For instance, the example given by the staff on the interrelationship between the introduction of a value-added tax and the existence of a cost of living adjustment was an important one. Moreover, it should be kept in mind that the Government of Cyprus had no representation of its own in Parliament, which made the political decision-making process all the more precarious. Consequently, the authorities attached considerable importance to the deregulation of the financial system, but they were not tackling it forcefully at present because they felt that they had to await the results of the parliamentary discussions on the tax reform package.

While he was in Cyprus the previous week, he had seen a newscast of a long interview with U.K. Chancellor of the Exchequer Lawson, who was attacked forcefully because he had increased interest rates in the United Kingdom in response to actions in other European countries, Mr. Hogeweg recalled. In his view, the present rising interest rates in other countries was not conducive to persuading the public of the benefits of interest rate flexibility.

His authorities would support the staff's proposal to extend the approval of exchange restrictions beyond April 22, 1990, Mr. Hogeweg commented. It seemed reasonable that the expiration date should coincide with the interim report on Cyprus.

The Chairman observed that Directors could accept the period for approval of exchange restrictions that had been suggested by the staff. In his summing up, however, he would stress the need to reconsider those restrictions during the coming year as the authorities intensified their fight against overheating. Normally, as the external position of the economy strengthened further, Cyprus should consider the acceptance of Article VIII status.

Mr. Goos remarked that while he understood that unfortunate developments in neighboring countries had contributed to the expansion of Cyprus' output owing, among other things, to capital inflows, it was puzzling that the lack of monetary control had not led to higher inflationary pressures precisely because of the inflows and the impulses those developments had exerted on output. One explanation might be that the consumer price index tended to understate real developments. But he expected that over a number of years, the deficiencies of the consumer price index would have shown up in the acceleration of the inflation rate.

The staff representative from the European Department observed that the main vehicle for removing demand pressure was the external account. For example, in 1988 there had been a tremendous boom in automobile imports, which had contributed to the 9 percent increase in domestic demand, but the external accounts had functioned as a release mechanism to the buildup of considerable demand pressure without major repercussions on prices. Moreover, it was remarkable that since 1974, the manufacturing industry had practically been built up from scratch and that Cyprus had been able to redirect its exports to markets with higher growth rates. The considerable flexibility of supply had also helped to contain, or remove, demand pressures that might otherwise have fallen on prices.

Mr. Kyriazidis observed that as consumption rose, there was an increased demand for durable consumer goods. In Cyprus, such goods were entirely imported, so that imports were not competitive with the domestic economy. Instead, imports contributed substantially to the channeling of inflationary pressures to the balance of payments and to imports.

In addition, Cyprus was heavily dependent on the U.K. market, Mr. Kyriazidis remarked. For the first 10-14 years following independence, the bulk of Cyprus' exports went to the United Kingdom under the Commonwealth preferential arrangements, which applied until 1973. Europe continued to be the most stable market for Cyprus' exports, even though Cypriot entrepreneurs had taken advantage of the possibilities that opened in the late 1970s in the Middle East, particularly for light manufactured products. Thus, while Cyprus had expanded the geographical base of its export activities, its basic orientation remained toward Europe.

The Chairman made the following summing up:

Directors welcomed the sustained gains in economic performance registered by Cyprus in 1987-88, drawing attention to the impressive growth in output in an environment of external balance, virtual full employment, and low inflation. Directors cautioned, however, that signs of overheating are developing, which could cause concern if they continued. While the fiscal deficit had been lowered in relation to GDP in 1988, fiscal adjustment was required to halt and, eventually, reverse the trend increase in the public debt to GDP ratio. Directors expressed concern about emerging inflationary pressures as evidenced by spreading labor shortages and a pickup in the rate of increase of unit labor costs. A revival of domestic inflation could jeopardize the economic gains of previous years, particularly against a background of long-standing structural rigidities.

Directors endorsed the authorities' plan to lower the fiscal deficit to the equivalent of 1 1/2 percent of GDP by 1992, noting that this target seemed sufficient to reverse the upward trend in the public debt relative to GDP. Directors also supported the authorities' efforts to secure parliamentary approval of a comprehensive tax reform bill. Centered on the introduction of the value-added tax, this reform would help enhance revenues, while at the same time modernizing Cyprus' tax system and aligning it with those of the European Community countries. Meanwhile, Directors urged the authorities to implement promptly complementary expenditure restraint measures. Directors commended the authorities for their efforts to contain capital expenditure in the 1990 budget but noted that additional spending cuts may be needed to help stem the overheating of the economy. A curb on farm subsidies would help alleviate labor shortages and enhance allocative efficiency.

Directors regretted that the stance of monetary policy had recently been accommodating. Total liquidity and credit to the private sector had overshot the respective target rates of growth by large margins in both 1987 and 1988. During 1988, credit expansion was fueled by greater resort to central bank financing of the budget deficit. Directors commended the authorities for their recent measures to increase bank liquidity requirements, and they endorsed plans to rely on more nonmonetary domestic financing of the deficit beginning in late 1989. They cautioned, however, that the room for maneuver in the financing of the budget deficit and in the conduct of monetary policy was severely constrained by the legal ceiling on interest rates. Directors urged the removal of this ceiling as early as possible, noting that this would also create the conditions for the lowering of bank liquidity requirements as well as for the extension of central bank supervision to the increasingly important credit cooperatives. Directors regarded reform in the financial sector to be a matter of urgent concern for the authorities.

Although Directors welcomed the further easing of the restriction on the amount of foreign exchange available for tourist travel abroad, they urged the authorities to move decisively toward the relaxation of remaining restrictions on current payments. Directors invited the authorities to look closely to the prospect of Cyprus accepting the obligations of Article VIII status.

It is expected that the next full Article IV consultation with Cyprus will take place within 24 months, in accordance with the bicyclic procedure.

The Executive Board took the following decision:

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

2. Cyprus maintains a restriction on the amount of foreign exchange made available for foreign travel subject to Fund approval under Article VIII, Section 2(a). The Fund notes that the authorities have further liberalized this restriction and, in the light of the current circumstances of the country, it grants approval for its retention until September 30, 1990 or the next decision relating to the exchange restriction of Cyprus, whichever is earlier.

Decision No. 9271-(89/135), adopted
October 13, 1989

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/89/134 (10/11/89) and EBM/89/135 (10/13/89).

3. NAMIBIA - TECHNICAL ASSISTANCE

In response to a request from the United Nations Council for Namibia for technical assistance in the central banking field, the Executive Board approves the proposal set forth in EBD/89/304 (10/6/89).

Adopted October 11, 1989

4. YUGOSLAVIA - TECHNICAL ASSISTANCE

In response to a request from the Yugoslav authorities for technical assistance in the central banking field, the Executive Board approves the proposal set forth in EBD/89/305 (10/6/89).

Adopted October 12, 1989

5. OECD - RELEASE OF INFORMATION

The Executive Board approves the proposal to release the background papers on recent economic developments in Hungary (SM/89/76, 4/28/89) as well as that on Poland (SM/88/184, 8/18/88) and the staff report for the 1988 Article IV consultation with Poland (SM/88/175, 8/11/88; Sup. 1, 9/13/88; Cor. 1, 9/14/88; and Sup. 2, 9/19/88) to the Organization for Economic Cooperation and Development, as set forth in EBD/89/307 (10/6/89).

Adopted October 12, 1989

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/89/228, Supplement 1 (10/11/89), EBAP/89/238 (10/10/89), and EBAP/89/239 (10/11/89) and by an Advisor to Executive Director as set forth in EBAP/89/239 (10/11/89) is approved.

APPROVED: June 14, 1990

JOSEPH W. LANG, JR.
Acting Secretary