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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/78

3:00 p.m., May 16, 1988

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

Executive Directors

Dai Q.

J. de Groote

M. Massé

H. Ploix

G. A. Posthumus

C. R. Rye

S. Zecchini

Alternate Executive Directors

W. K. Parmena, Temporary

C. Enoch

D. A. Woodward, Temporary

D. C. Templeman, Temporary

J. Prader

M. Hepp, Temporary

S. K. Fayyad, Temporary

B. Goos

D. V. Nhien, Temporary

J. Hospedales

J. Gold, Temporary

K. Kpetigo, Temporary

B. Fuleihan, Temporary

V. J. Fernández, Temporary

M. Pétursson, Temporary

G. P. J. Hogeweg

I. Sliper, Temporary

O. Kabbaj

L. E. N. Fernando

S. Yoshikuni

L. Van Houtven, Secretary and Counsellor
S. L. Yeager, Assistant

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Also Present:

IBRD: J. Q. Harrison, Europe, Middle East and North Africa Regional Office. Asian Department: G. Szapary. European Department: P. de Fontenay, Deputy Director; P. Beaugrand, G. Belanger, L. Hansen, L. G. Manison, J. Somogyi. Exchange and Trade Relations Department: J. T. Boorman, Deputy Director; H. B. Junz, Deputy Director; E. Brau. Fiscal Affairs Department: G. F. Kopits. Legal Department: H. Elizalde, J. K. Oh. Western Hemisphere Department: K. B. Bercuson, D. J. Donaway, O. J. Evans, S. M. Fries, Y. Horiguchi. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: P. Kapetanovic, K.-H. Kleine, P. Péterfalvy, G. Pineau. Assistants to Executive Directors: S. Appetiti, Di W., F. El Fiky, C. L. Haynes, G. K. Hodges, Hon C.-W., M. A. Kyhlberg, C. Y. Legg, V. K. Malhotra, T. Morita, L. M. Piantini, S. Rebecchini, C. C. A. van den Berg, R. Wenzel.

1. HUNGARY - 1987 ARTICLE IV CONSULTATION AND STAND-BY ARRANGEMENT

The Executive Directors continued from the previous meeting (EBM/88/77, 5/16/88) their consideration of the staff report for the 1987 Article IV consultation with Hungary together with Hungary's request for a 12-month stand-by arrangement in an amount equivalent to SDR 265.35 million (EBS/88/47, 3/1/88; and Sup. 1, 5/12/88). They also had before them a background paper on recent economic developments in Hungary (SM/88/62, 3/14/88).

The Deputy Director of the European Department remarked that Mr. Posthumus's observation that interest rates, even after the recent adjustment, were still negative in real terms was correct if the rate of inflation for the first quarter of 1988 was compared with that for the first quarter of 1987. However, the rate for the first quarter of 1988 included an 8 percent one-step increase in the price level on January 1, 1988. Since January, the rate of inflation had been low, and for the remainder of the year the monthly rate of inflation would be only about 5 to 6 percent, on an annualized basis, which was consistent with an average inflation rate of 15 percent for the whole year. The authorities' forecast of an annual average rate of 10 percent for 1989 was considered to be the best estimate of the underlying rate of inflation for the coming 12-18 months.

Mrs. Hepp made the following statement:

The performance of the Hungarian economy in 1987 was more positive than originally estimated. Moreover, the results for the first quarter of 1988 have been in line with the program targets. It was gratifying to hear from the staff that performance criteria for end-March 1988 have been met, with the exception of a shortfall in domestic savings associated with higher inflationary expectations, which required the introduction of additional measures.

Since mid-1987, the authorities have adopted a series of policy actions to redress the economic situation and to regain momentum in the reform process. On the demand side, financial policies in the fiscal and monetary areas were tightened, and the forint was allowed to depreciate significantly in real terms. On the supply side, the actions taken in 1987 included, among others, the implementation of the bankruptcy law, the introduction of a two-tier banking system, and preparations for a comprehensive tax reform. All these measures are positive actions in the right direction and will contribute to stop the deterioration of economic performance and to renew the reform process.

However, the most important step taken by the authorities is the adoption of a comprehensive three-year program aimed at limiting the growth of external debt in convertible currencies and accelerating the process of structural reform, so as to

further improve the efficiency of the economy. In this connection, I fully support the request for a 12-month stand-by arrangement and the economic program for 1988, which constitutes the key, first part of the three-year program.

I am in general agreement with the staff report and therefore will concentrate my remarks on some specific points of the economic program.

On fiscal policy, the reduction in the budget deficit to not more than Ft 10.4 billion in 1988 is welcome. This reduction is accompanied by a lower tax burden owing to the impact of the tax reform and a significant reduction in total expenditures largely owing to the decline in subsidies and transfers. The budget law, however, includes a "budget reserve" amounting to an additional Ft 10 billion, to be used as warranted by developments in domestic and external savings. I encourage the authorities not to use this reserve.

The fact that the budgetary cost of the recent interest rate measures will be offset by reductions in subsidies, thereby keeping the fiscal deficit unchanged, shows the authorities' commitment to meet the agreed fiscal target. It is also noteworthy that a significant share of the budget deficit will be financed through the issue of treasury bills to be sold for the first time to enterprises and the household sector. I welcome the introduction of this nonmonetary financing of the fiscal deficit.

On monetary policy, I note the tightening of credit policy by limiting the amounts of credit and raising refinancing costs, which are expected to be passed on through freely determined interest rates. However, the coexistence of some free deposit rates and administered interest rates on household deposits could create some problems in household savings. I also note the mechanism included in the program to reverse the potential outflow of deposits from the National Savings Bank. However, I agree with the staff that a more liberal interest rate policy combined with direct subsidies to housing purchases could be a more efficient solution to reversing these flows in the medium term. In this regard, the integration of banking services for enterprises and households in 1989 could provide a good opportunity to reform housing finance.

Regarding interest rate policy, the authorities' adoption of the measures to mobilize financial savings is welcome. The flexible adjustment of the interest rate structure, as described in the letter of intent, is an important step in the right direction.

The program for 1988 includes substantial efforts in the area of structural reform, which have been formulated in close coordination with the World Bank. The establishment of performance criteria for some structural reform measures reflects the importance of these reforms to the success of the economic program. Particularly notable in this connection are the successive steps toward price liberalization, as well as the wage reform aimed at achieving a more differentiated and freer wage system that will be implemented in 1989. Moreover, capital market and commercial legislation aimed at the further development of capital markets and facilitating the formation of new firms and companies is to be backed by a performance criterion. Also, limits are established for the financial support to loss-making enterprises.

As for the medium-term outlook for the Hungarian economy, it should be stressed that under the general assumptions for the program, the external debt to GDP ratio is expected to decline significantly, and the borrowing required should not pose major financing difficulties in the international capital markets.

In sum, the authorities have embarked on an ambitious and comprehensive three-year economic program including a strong stabilization effort and reform measures. The first key part is the 1988 program, to be supported by a stand-by arrangement with the Fund. I support the proposed decisions.

Mr. Templeman made the following statement:

At the time of the 1986 Article IV consultation with Hungary (EBM/87/55, 3/27/87), the disappointing performance and outlook for the economy raised questions about Hungary's continued creditworthiness in international capital markets, and represented a lost opportunity for achieving the stabilization and economic reform objectives espoused by the authorities. It is therefore gratifying to see that a renewed effort in both areas is now under way. While it is unfortunate that there has been some delay in bringing the new program to the Board, it is more important that Fund management be in a position to give its full support to the program for the stand-by arrangement. Moreover, the program has several important innovative features for which staff is to be commended. The most recent Fund mission was particularly reassuring because the weakness which had emerged in household savings performance earlier this year has now been addressed by an agreement on substantial increases in interest rates on time deposits.

The adoption of a new three-year economic program aimed especially at strengthening the current account and arresting the increase in external debt is also welcome. A comprehensive

approach embodying the containment of excess demand through more restrained fiscal and monetary policies, an active exchange rate policy, and a wide array of structural reforms offers good prospects of achieving these goals. Nevertheless, the description of the 1988 program as a "first step" seems appropriate. In the structural area, in particular, much remains to be done, which underlines the importance of continued close cooperation between the Fund, the World Bank, and the authorities.

Success in achieving sustainable economic growth with financial stability over the medium term will be crucially dependent on measures designed to facilitate the efficient allocation of capital and labor resources. Increased capital mobility will require both the more efficient use of existing capital by enterprises and the mobilization and investment of new savings. This highlights the need to expose existing enterprises to the winds of competition, through a variety of measures aimed at either forcing them to eliminate their losses or to go into liquidation. The actual planned reduction of budget subsidies and bank financing for loss-making enterprises and the financial penalties imposed on those creditors who are reluctant to press for improved performance or liquidation of enterprises, should go some way toward achieving the first objective. At the same time, the establishment of new enterprises in the form of limited liability private ventures and the planned creation of joint stock companies are important innovations. It is particularly encouraging to hear from Mr. de Groote that new commercial legislation would allow for broad and nondiscriminatory participation by individuals, cooperatives, and nonresidents in the establishment of joint stock companies and in the purchase of stocks of existing state enterprises. Current efforts to foster household savings by offering real positive interest rates and a greater variety of financial savings instruments should both reduce present excess consumer demand and help to provide capital for new investment. And, ongoing financial market reforms should strengthen the mechanisms of financial intermediation necessary to channel such savings into productive investment.

In view of the nearly full employment of existing labor resources, it is particularly important that labor mobility be increased, if sustainable growth is to be achieved. The containment of labor costs and greater wage differentiation would help to provide firms with incentives to hire workers where they can be most productive. The expected decline in real wages this year and the liberalization of wage determination planned for 1989 should contribute to these goals. In addition, the availability of funds for retraining workers and establishing small independent ventures should also contribute to labor mobility.

The establishment of an array of more market-determined relative prices for labor, capital, goods and services, and

foreign exchange can go a long way to direct resources to efficient uses within the context of more open markets for domestic and foreign trade. In that connection, the inclusion as of specific timetables as formal performance criteria for price and wage liberalization is especially welcome. Still, even by 1989 a fairly substantial number of prices would remain subject to some form of administrative control, and the precise extent of wage differentiation which can be expected to emerge under the planned global limit on the wage bill is not easy to foresee. Wage and price flexibility will be particularly important if a flexible exchange rate policy is to be effective because of the need to assure that the impact of exchange rate movements is passed through to the domestic economy.

Of course, if excess domestic demand is allowed to persist, then a flexible rate will be ineffective as an adjustment tool. This fact underlines the importance of restrained fiscal and monetary policy. If the targets of a reduction in the general government deficit ratio by 2.1 percentage points in 1988 and the deceleration in the rate of increase of net domestic assets from 17 percent in 1987 to 5 percent in 1988 are achieved, this should go some way to containing excess demand.

Over the longer run, the fiscal and financial market reforms now under way will be essential in helping to provide the incentives and the mechanisms necessary for fostering savings, investment, economic growth, and a sustainable external position. In general, I support the creation of the value-added tax (VAT) and introduction of the personal income tax (PIT). Also, there appears to be room for reform of taxation of enterprises. It is hoped that the approach taken in such reforms would be non-discriminatory with respect to enterprises whether they are in the socialist, cooperative, or private sectors. In the financial market area, the creation of separate commercial banks and the planned integration of banking services of households and enterprises should go some way toward providing broader channels for intermediating household savings. The introduction of new financial instruments, such as treasury bills, bonds issued by banks for sale to households, and the possibility of introducing certificates of deposit offer promising new ways of mobilizing savings. One area which seems clearly in need of reform is housing finance, particularly with respect to the indiscriminate use of subsidized housing credit and the continued existence of rent controls, which could be having adverse effects on labor mobility.

It is encouraging to see that balance of payments performance in the first quarter was stronger than anticipated. I wonder whether this offers the base for a somewhat faster pace of external adjustment. The rather steady real effective depreciation of the forint over the past two years, plus continued exchange rate flexibility and the full pass-through of rate

movements should help to assure that medium-term balance of payments and external debt-servicing goals are achieved. It is hoped that during this period, greater progress on trade liberalization than has been possible recently would be an integral part of Hungary's overall policy approach.

I particularly welcome the renewed effort at stabilization and reform which is now under way. Some progress in both areas is evident, but much remains to be done, particularly in the structural area, where the effectiveness of reforms may well depend on complementary reforms in other areas.

Mr. Dai made the following statement:

It is gratifying to note that in 1987 the Hungarian economy started to improve after a two-year deterioration. As a result of the authorities' decisive adjustment efforts, the current account deficit in convertible currencies was reduced and the budget deficit was contained within the limit of the budget plan. Although agricultural output was again severely affected by harsh climatic conditions, production as a whole improved, with real GDP growth increasing from less than 1 percent in 1986 to about 2 percent in 1987. Nevertheless, the economy is by no means clear of difficulties, particularly with respect to the external sector and the reform process.

The authorities are well aware of the existing problems in the economy and are determined to address them in a positive and forceful manner. As clearly indicated in the Government's new three-year economic program, the authorities have stressed the importance of accelerating structural reform in order to eliminate distortions and improve efficiency in the long run, while focusing on the reduction of external imbalances as an urgent and immediate objective. The correction of internal and external imbalances will clear the way for a smooth and successful reform, while a resolute implementation of reform measures will help eradicate imbalances and ultimately bring about a viable supply performance and a more efficient and productive economic management system for the country. The 1988 program rightly aims at stabilization, on the one hand, and acceleration of the reform process, on the other.

The stabilization effort will mainly rely on a further tightening of financial policies, with emphasis on the promotion of enterprises' efficiency. The wide-ranging structural reform package, which covers the reform of enterprises, prices and wages, taxes, banking, capital markets, commercial legislation, and the foreign trade system, comprises a courageous and comprehensive program. The authorities' basic policies are in the right direction and deserve Fund support.

Although the authorities' efforts to stop the deterioration in the balance of payments have yielded positive results, external imbalances are still at a critical level. More notably, the external debt in convertible currencies has reached an unsustainable level. In view of the continued vulnerability of the economy to exogenous factors, the authorities' decision to adopt a more prudent policy stance toward external borrowing--especially from commercial sources--is correct. It is encouraging to see that in the new economic program, top priority has been given to a reduction of the current account deficit and the containment of external debt.

Under the program, the trade balance is projected to improve by more than \$500 million, and the reduction in the current account deficit is dependent on restrictive demand-management policies and an active exchange rate policy. However, it is not clear from the staff papers what factors will come into play to expand export capacity, in view of the current uncertain market prospects. Certainly, reliance on exchange depreciation alone will not be sufficient in the circumstances. To reduce the foreign debt in convertible currencies, more effective measures should be taken to ensure an increase in exports to convertible currency areas. The current policy prescriptions do not take into account the special trade relations between Hungary and other member countries of the Council for Mutual Economic Assistance (CMEA). Although the staff views this as a major obstacle to improving the role of market forces in Hungary, trade with CMEA countries accounts for a considerable share of Hungary's present market. The complexity of the situation merits further study. In this connection, I wonder what measures the authorities will take to ensure the accumulation of foreign exchange earnings while completely decentralizing the foreign trade system.

Price and wage reforms are essential components of the overall economic reform. They are, at the same time, the most sensitive factors in the reform process. It is not at all unusual to find that during the transition from the old to the new structure, price liberalization results in some price increases, especially in economies where competition is insufficient, monopolistic practices prevail, and excessive demand persists. If these price increases become out of control or do not correspond to the readjustment of wage incomes, the stabilization effort and the economic reform process could be hampered. Because of this extremely sensitive situation, great caution must be exercised. The authorities have correctly scheduled the price liberalization and wage reform to assure their implementation in an energetic and steady manner; they also have indicated that some form of price surveillance might still be needed. According to the authorities, real wages will be cut by 10 percent in 1988 while big strides will be taken to liberalize prices. It would

be interesting to know what conditions can ensure maximum tolerance from the population and the economy for such significant changes.

I also note with great interest that in the process of structural reform, the banking system has been significantly reformed, bankruptcy legislation was put into effect, and different types of ownership are being promoted. All these policy measures are similar to those that have been pursued in China. If the banking system is to play a greater role in economic reform, not only the structure but also the function of the banking system should be substantially reformed. Although more commercial banks have been established to compete in the two-tier banking system, macroeconomic control by the Central Bank might need to be strengthened to ensure a tightening of credit policy. Apart from raising reserves and interest rates, a strengthening of financial discipline might also be needed to assure that commercial banks take full responsibility for their profit- and loss-making activities. Every measure taken to deepen the reform of the banking system will, in the end, help improve the country's economic performance. Persistence in carrying out a comprehensive reform is necessary if a country is to adapt itself to a changing world and accelerate its socialist economic development and modernization program. The Hungarian people have had many years' experience with economic reform, and if they hold firmly to the right course and address the problems that might arise during the reform process correctly and in a timely fashion, I believe that they will achieve their aims in accordance with the timetable for reform.

In view of the pressing and complex nature of Hungary's economic reform and the uncertainties and potential risks associated with the implementation of the program, timely and adequate international financial assistance is essential. In this context, I agree with the staff that continued Fund and Bank involvement and support may be needed to maintain the momentum of Hungary's reform and stabilization efforts.

In conclusion, I support the proposed decisions. However, I wonder whether the performance criteria with respect to the phasing of price liberalization, the introduction of wage reforms, and the implementation of new legislation represent some new, innovative type of conditionality for a second tranche drawing by a planned economy? Even if these criteria have been voluntarily agreed to by the authorities, I must stress that first, this case should not be taken as a precedent, and second, the Fund should be very careful in imposing such complicated and multifarious performance criteria upon a member which is determined to embark on a comprehensive reform program. It must be fully recognized that such comprehensive reform is not a simple task. Any unforeseen adverse factors--economic, political, or

social, endogenous or exogenous--might influence or disrupt the reform process. Therefore, twists and turns and, at times, setbacks are inevitable. If these possible factors are not fully taken into account, mechanical enforcement of these performance criteria could have undesirable and unfortunate consequences, which lead to the ultimate failure of the program and great frustration on the part of the reformers.

Ms. Gold made the following statement:

My authorities welcome Hungary's request for Fund assistance in support of a major reform program to be implemented over the next several years. They also support the objectives of the stand-by arrangement as well as the medium-term goals of the three-year program, and I can therefore support the proposed decision. I am in general agreement with the staff's assessment, but would like to comment briefly on the financial, fiscal, and external sectors of the economy and on the speed of implementation of the reform program.

Since the staff report on the original program was circulated to the Board, a positive turn of events has resulted in stronger than expected economic activity without any parallel deterioration in the current account. Nevertheless, during this period there was a substantial shortfall in financial savings, possibly indicating serious problems with financial policy in the original program. The measures under the revised program, as outlined in the supplementary paper, appear to effectively counter the shortfall in savings. Nevertheless, that development raises a couple of issues. First, if the inflation rate for the first quarter of 1988 was broadly consistent with the program, as indicated in the supplementary paper, why was this shortfall not anticipated? Second, will the planned increase in the premium of the basic rates by 1 percentage point be adequate to raise savings to the desired levels? More specifically, will real interest rates remain negative despite the new measures? I have noted the staff's comments in this regard. However, the authorities should exercise utmost caution on this front, as further unanticipated declines in savings will create problems for meeting the quantitative performance criteria.

A related concern is that the cost of higher interest rates will be offset by a reduction in budget subsidies to enterprises. This significant addition to the already ambitious subsidy reduction plan would bring the total subsidy reduction target to nearly 4 percent of GDP. I wonder if Mr. de Groote or the staff could provide some information on how this further reduction in subsidies will be implemented and whether it will have any notable impact on the inflation rate.

Another concern in the fiscal area is the implied increase in the growth of transfer payments to individuals. The staff report indicates that real wages will decline by 10 percent, but the decline will be partly offset by increases in transfers, so that real household incomes are expected to fall by only 2 percent. Could Mr. de Groote or the staff provide more information on the magnitude of the increase in transfer payments, and how it will be offset in order to achieve the overall deficit reduction target at a time when revenues are forecast to decline somewhat. I hasten to add that it is not meant to suggest that the authorities should allow real household incomes to fall by an amount exceeding 2 percent. However, such an increase in transfers is seldom temporary in nature and may create other long-term budgetary problems.

The assumption that there will be no growth in imports in 1988 is also cause for concern. The supplementary paper indicates that fixed investment outlays in the first quarter of 1988 were 15 percent higher than a year earlier, with enterprise investment rising by 22 percent. However, according to the staff report, real investment was forecast to decline by 1.1 percent for the year as a whole. While there may be scope for some substitution between imports of capital goods and consumer goods, it is necessarily limited, particularly since total imports are forecast to remain constant. In light of more buoyant investment, the authorities may face increased difficulties in meeting their external sector objectives without resorting to more active import compression. Therefore, I wonder whether more aggressive action with respect to exchange rate policy would not help to meet the authorities' objectives. In this connection, I note the lack of any import liberalization measures in the program. Again, more aggressive exchange rate policy could facilitate important import liberalization measures without risking external sector objectives.

Finally, the authorities are well aware that valuable time has been lost in failing to respond quickly to the deterioration of external factors in the past. The steps that they have taken thus far are welcome and in the right direction. Of particular importance are the enactment of bankruptcy legislation, banking reforms--including greater interest rate flexibility--the labor relocation scheme, industrial restructuring, and some import liberalization. However, as has been observed for a number of countries, the more prolonged the adjustment program, the greater the risk of the program going off track and of adjustment fatigue. I therefore urge the authorities to hasten the implementation of the adjustment program so as to increase the probability of its success.

Mr. Sliper made the following statement:

Over the last few years economic policymaking in Hungary has been of a "stop-go" nature. In the early 1980s a comprehensive reform program was carried through, but this was followed by some noteworthy policy slippages in 1985, 1986, and the first half of 1987. Mr. de Groote's remarks at the previous meeting (EBM/77/88, 5/16/88) were helpful in explaining developments in this period. As a consequence of these slippages, growth faltered, major imbalances emerged, and the economy lost its ability to respond effectively to external developments. The authorities are now engaged in another major reform effort, which forms the essence of the request for a stand-by arrangement.

In reacting to the current set of measures, the question I asked myself is whether they go far enough to inject more vigor into the economy. The answer is a qualified yes, which seems in line with the views of the staff. Clearly there are some risks attached to the current program, but overall it should yield an economy which is more responsive and more able to yield continued positive growth than at present.

It is especially hard to determine whether the planned measures go far enough because of the extent of centralized controls that exist in Hungary. It is recognized that reforms in Eastern European countries like Hungary need to be selective and must concentrate on the key areas, for example, exchange rate management, fiscal and tax reform, opening up the trade system and allowing for more market-determined prices. All of the proposed measures are in these critical areas.

I can understand the authorities' reluctance to implement more reforms during calendar year 1988 at a time when an extensive tax reform is under way. The tax package, including the introduction of a value-added tax and a personal income tax system, will have a significant effect on both the fiscal accounts of the Government and on the economic behavior of both individuals and enterprises. The magnitude of the tax reform is demonstrated in its dramatic effects on both consumption and savings behavior, as outlined in the supplementary paper. I note that the risks of a shortfall in savings were identified in the staff report; the actual impact, however, has been somewhat greater than anticipated.

The staff emphasizes that the main burden of the tax reform and the general stabilization effort in 1988 is likely to fall on the household sector, where disposable incomes are expected to fall in real terms. As recent events in Poland have shown, this is a difficult plan of action to implement, and there is likely to be significant pressure on wages during the year.

Many of the measures that form the basis of the stand-by arrangement are not due to be implemented until January 1, 1989. These reforms will be critical if sustainable growth is to be maintained. I refer here particularly to the reform of the wage system, the improvements planned for capital markets, and the further steps on banking reform, including housing finance.

The major question I have about the overall package of measures concerns the enterprise sector. The measures will include reductions in subsidies and transfers to loss-making enterprises, especially those firms which are engaged in such activities as steel and coal. Moreover, the number of products that are subject to price control will be reduced. Also, there will be some improvement in the ability of enterprises to determine wages for individual employees, within an overall wage ceiling. Despite these measures, I wonder whether commercial enterprises are being given sufficient autonomy to manage their activities successfully; the staff report suggests that the authorities still have some way to go to decentralize decision making so that commercial enterprises really have an effective influence over pricing and an ability to reduce costs, including labor shedding. I was pleased to hear from Mr. de Groote about changes in commercial law and efforts to equalize the treatment of enterprises in various sectors of the economy. Also, Mr. Enoch has referred to forthcoming changes in the regulatory framework in September. I would appreciate staff comment on these scheduled changes and the extent to which they will contribute to the management autonomy of the enterprise sector. I support the proposed decisions.

Mr. Fernández made the following statement:

I support the proposed decisions and believe that the present program in support of the stand-by arrangement with the Fund will provide the Hungarian economy with the necessary framework to implement the required structural reforms in the context of macroeconomic stability.

At the previous discussion on Hungary, my chair pointed out that the credibility of policies was perhaps the main point to be taken into account in designing a set of structural reforms. Credibility requires, on one hand, macroeconomic stability and, on the other, the consistency of structural policies. The credibility of government policies is sometimes more important than the policies themselves. Nevertheless, I am aware that it is not easy for Hungary to make progress simultaneously in both macroeconomic adjustment and structural reform. There is also the problem of choosing the adequate pace for the reform process. Although doing too many things at once can lead to policy reversals, not being ambitious enough can also lead to reversals.

Before commenting on economic development in 1987 and policy intentions and prospects for 1988, let me express my support for the authorities' economic program. Its full implementation will require a strong political commitment and will, but the expected returns are large.

At the time of the 1986 Article IV consultation with Hungary, it was clear that demand-management policies were not maximizing the economy's long-term growth potential, and that more stable, preannounced policies could contribute to the attainment of balanced growth and the implementation of structural reforms. The economic policies of recent years have tried to promote growth through expansionary financial policies without taking into account the restrictions imposed by multiple rigidities on the supply side of the economy. These inconsistent macroeconomic policies reached a turning point when the balance of payments situation emerged as an effective constraint in mid-1987.

Macroeconomic developments were disappointing during 1984-86 and the first half of 1987. Overall, 1987 turned to be a better economic year than 1986; growth was stronger than expected, the current account deficit in convertible currency terms was reduced by approximately 70 percent, and the fiscal deficit is estimated to have been significantly reduced mainly in response to tighter financial policies adopted by mid-1987. Also, the growth of investment and exports in 1987 are promising developments.

The three-year program adopted in mid-1987 can provide the economy with the necessary point of reference to make progress in the macroeconomic and structural fronts. The main targets of the program--namely, the progressive elimination of the current account deficit and the improvement in the efficiency of the economy--have been chosen with realism: they are indeed the two key problems to be resolved before the economy enters the path of sustainable economic growth. To achieve these goals, both the macroeconomic policy mix for 1988 and the speed of implementation of projected structural reforms are particularly important. In this regard, it is gratifying that, as stated by the staff, "developments and policies were broadly in line with the program during the first quarter of 1988."

Financial discipline is essential to achieve the stable macroeconomic environment that is required to implement the envisaged structural reforms. Therefore, domestic credit must be kept under control by reducing both the fiscal deficit financing requirement and the recourse of enterprises to working capital credit. The achievement of the targets for the general government account deficit and the current account deficit of the balance of payments for 1988 is important to maintain the

credibility of the whole program. Finally, the authorities should stand ready to adjust the value of the forint to a realistic level.

As for structural reform, significant progress has been made in certain areas of the economy, but much remains to be done to further improve the efficient allocation of resources. I encourage the authorities to implement timely reforms with respect to the further liberalization of prices, the differentiation of wages, the integration and liberalization of the banking system, and the abolition of inefficient taxes. These structural measures are of great importance to make the supply response of the economy more flexible. However, there are risks and uncertainties, such as those encountered by the introduction of the tax reform in January 1, 1988, and a realistic approach may be the most appropriate one. This does not imply an overly gradualistic approach, but the opportunity to achieve a second-best solution should not be lost by trying to achieve the first-best solution too quickly and in an inconsistent manner.

The price liberalization implemented on April 1, 1988 is welcome. Also, keeping real interest rates positive in order to tackle the saving problem is a substantial step in the economic reform effort. However, this policy must be sustained in the medium term through the support of other financial policies.

To conclude, more room should be given to private initiative and subsidies, and support to loss-making enterprises should be progressively eliminated. Finally, the continued involvement of the Fund and the World Bank is a positive element in helping the Hungarian authorities to achieve their economic goals.

Mr. Yoshikuni made the following statement:

Based upon the information provided by the staff and Mr. de Groote, I can support the proposed decisions.

The Hungarian economy has responded positively to the adjustment measures implemented in 1987. I welcome the authorities' intention to maintain the momentum of adjustment through a program supported by a stand-by arrangement with the Fund.

The main focus of the program is demand management through tight fiscal and monetary policies. The reduction of consumption in real terms and of the fiscal deficit in terms of GDP will be the key issues, among others. To achieve these aims, it is particularly important to reduce the inflation rate to a low level. In an economy such as Hungary's, with many subsidies and administrative price controls, a high rate of inflation is detrimental, may increase economic distortions--for example,

with respect to the public sector deficit--and may cause the program to go off track. The inflation rate must be kept under close review and the need for a tight monetary policy should be emphasized.

Much of the burden of demand management will be borne by the household sector. More specifically, the authorities are aiming at a reduction in real personal consumption through strong income and tax policies. Such policies will be acceptable to the public in the short term but, in the medium term or long term, other courses might be more appropriate. For example, such a reduction of consumption could be achieved through incentives to increase savings, while the fiscal consolidation target could be pursued through cutting more subsidies.

From this viewpoint, the significant shortfall in the growth of household savings in the first quarter of 1988 is regrettable. However, the authorities' quick response to raise interest rates is highly appropriate. I welcome the authorities' plan to issue treasury bills this year, and I agree with the staff on the need for banking reform, particularly with respect to housing finance.

There appears to be further scope for a flexible exchange rate policy. In 1987, the authorities adopted a flexible exchange rate policy, but its effectiveness was reduced owing to the existence of price controls. In this connection, I attach importance to the performance criteria relating to price reform, and to further price reform in the future.

It is also important to continue the reform of loss-making enterprises. The Bankruptcy Law that was put into effect in 1986 is welcome, but there is more room for the active employment of this law. Also, stronger financial discipline must be sought for these enterprises. It is regrettable that state guarantees are planned for bank lending to enterprises that cannot finance the cost of the grossing up of wages; these guarantees should be withdrawn as soon as the situation permits.

The measures envisaged in the authorities' program will be adequate to support the 12-month stand-by arrangement. However, medium-term structural reform must be addressed more appropriately. I have already mentioned the need for further reforms with respect to monetary policy and the public enterprises. Moreover, wage differentiation is expected to be limited in 1988. The price reform should be further accelerated, and the reduction of subsidies should be intensified. Nevertheless, I broadly support the thrust of the authorities' three-year program, and I look forward to discussing their medium-term structural reform program in the context of the arrangement with the Fund.

Mr. Zecchini made the following statement:

The Hungarian authorities have embarked on a major program of adjustment and reform, which will require several years of determined efforts to achieve durable results. It is reassuring to see that the authorities have set out on an appropriate course. The envisaged stabilization measures seem adequate to start tackling the country's major imbalances, namely, excessive credit and fiscal expansion and a rapidly deteriorating external position. The objectives of structural reform are far-reaching and should enable the country to reduce the inefficiencies and distortions that have arisen under the present system. Moreover, the stabilization component and the structural component of the adjustment program seem well balanced and well integrated. For these reasons, the program deserves the financial support of the Fund.

With respect to demand management, it should be recalled that business cycle stabilization is the necessary prerequisite for any successful structural reform. An appropriate setting of fiscal and monetary policies is required to enhance the credibility of the authorities' commitment to adjustment and to reduce the overall cost of adjustment.

The planned fiscal deficit reduction envisaged in 1988 seems appropriate, especially as it will be brought about by sizable cuts in transfers and subsidies equivalent to 3.4 percent of GDP. Notwithstanding these cuts, subsidies will remain a substantial portion of GDP--at 9.5 percent--and are particularly concentrated in the area of production subsidies; serious consideration should be given to further reduce these amounts in the near future. The budget law approved by Parliament includes a new substantial "budget reserve" amounting to 1 percent of GDP, by which the deficit could be allowed to rise above target. The authorities should do everything necessary to avoid using this reserve, and the establishment of a performance criteria for the fiscal deficit should provide an effective incentive in this direction.

The significant tightening of the monetary policy stance and the initiatives to improve both monetary management and the transmission effects of monetary policy by increasing reliance on interest rate movements are steps in the right direction. Still, many interest rates remain under administrative control. To obviate the possible consequences of these remaining rigidities on savings formation, the authorities, in agreement with the staff, have set up a mechanism of "trigger points." This is obviously a second-best solution and, it is hoped, a temporary one. The effectiveness of this mechanism will crucially depend

on the appropriate assessment of expected inflation, and in this respect, I have some reservations regarding the staff's optimistic projections.

Inflation is an often expected by-product of a major reform program such as Hungary's. The entire structure of relative domestic prices will have to be readjusted. In view of the likely downward rigidity of several prices and wages, the adjustment most probably will be carried out by raising the general price level. Moreover, the substantial increase in indirect taxation, the exchange rate depreciation, and the envisaged reduction in price subsidies will also exert upward pressure on prices. All things considered, I am somewhat skeptical about the projection of a 15 percent inflation rate in 1988 and of a reduction to a single digit rate in 1989. Notwithstanding the tight monetary objective already in place, the authorities should be well aware of the unpleasant effects of the structural reforms on price dynamics. Should these unpleasant effects materialize, they would not be a sufficient justification to postpone or cancel planned reforms. The authorities should instead be ready to adapt their monetary policy stance accordingly.

As for the scope of the reform program, in spite of the significant steps taken so far, more needs to be done in the future in a continuous and gradual manner. The critical mass of reform measures needed to set the reform process on an irreversible path has not yet been achieved. In this respect, further action is needed in three key areas. First, the rapid approval by Parliament and implementation of the new Law of Association is required. This law will allow the formation of limited liability companies by individuals and facilitate the conversion of state enterprises into joint stock companies. Therefore, it will set the ground for managing both state-owned and privately owned companies according to market principles, and will eventually lead to improvements in the efficiency and profitability of the productive system.

Second, the liberalization of prices and of the wage-setting system has to be completed. The authorities should set a timetable for phasing out the price control mechanisms that will remain in place after complying with the January 1989 performance criteria. Setting an additional performance criteria on the elimination of these controls could be considered. By the same token, the commitment to implement the reform of the wage system as of January 1989 is welcome, and the authorities could also consider a performance criteria in this area. Completion of price and wage liberalization seems a necessary complement to the reform of the loss-making enterprises and the implementation of the bankruptcy law. In fact, it will be difficult to identify profitable enterprises unless an appropriate system of input and output prices is in place. These considerations, however, should

not discourage the authorities from acting promptly to eliminate enterprises that are unlikely to be profitable even under the most favorable circumstances, such as, for instance, enterprises in the metal industry.

Third, additional steps in banking reform are needed, particularly to fully integrate the two-tier banking system recently introduced. I realize that the reform of the National Savings Bank poses some challenges. The problem here is somewhat similar to that faced by the savings and loan banks in the United States in the recent past, because of the coexistence of long-term loans at relatively low fixed interest rates and deposits paying regulatory interest rates, which are now unattractive compared with alternative financial instruments with market-determined rates. If deposit rates of the National Savings Bank are increased to match those of the competition, losses will arise which will, in turn, have an impact on the state budget. If deposit rates are maintained in line with loan rates, there is a risk of disintermediation and a reduced flow of savings to finance housing. The solution of the problem would require changing the structure of the bank's loans and deposits so as to better match assets with liabilities in terms of costs and maturities. Movement in this direction, of course, has to be gradual. Meanwhile, the staff's recommendation that any subsidy on housing loans should be borne explicitly by the budget rather than by depositors seems appropriate since at least interest rate distortions would be reduced.

In conclusion, further efforts in addition to the commendable measures already taken by the authorities are necessary to consolidate Hungary's reform process. Moreover, time is an essential factor. I understand the authorities' concerns in scheduling reforms because of the need to alleviate the adjustment costs on the population. At the same time, they should be aware that nothing is more costly than the protracted coexistence of two conflicting systems. The risk of inducing reform fatigue should not be overlooked. Finally, I support the proposed stand-by arrangement and believe that the Fund should provide additional financial support in the future should the authorities request it to foster the implementation of more extensive economic and financial reforms.

Mr. Kabbaj made the following statement:

During the discussion on the 1986 Article IV consultation with Hungary, Directors were disappointed at the progressive deterioration in Hungary's external economic performance during 1985-86. Concern was expressed about the slowdown in the implementation of structural reforms adopted by the authorities, which had caused further disequilibria in the balance of payments

and misallocation of financial resources. Directors emphasized the need for a credible and rapid reform so as to particularly correct the external imbalances in the near term and to attain sustainable growth over the medium term.

Against this background, it is encouraging to note from the staff report that the authorities have made certain progress in halting the deterioration of the external sector that culminated in 1986-87 and have adopted a new three-year program for 1988-90 aimed at improving the economy's performance in view of prevailing constraints. The new program aims primarily to stop the growth of external debt denominated in convertible currencies. This objective, if achieved, would maintain the favorable international market sentiment toward Hungary, and will help the authorities to easily meet the country's external financing requirements. Progress was already achieved in 1987 by reducing sizably the current account deficit in convertible currencies. The external current account deficit in convertible currencies for 1987 amounts to \$847 million, or \$63 million lower than the staff's preliminary estimate. It is projected that this deficit will reach a level of no more than \$500 million in 1988. The budget deficit has also been reduced from Ft 47 billion in 1986 to Ft 35 billion in 1987. These developments demonstrate the authorities' determination to restore external and internal balance in the near term. Acceleration of the restructuring of the economy and the reform of economic management so as to lay a sound foundation for improvement in the standard of living are other main elements of the program.

The staff report highlights various aspects of this comprehensive three-year program. It is hoped that the program, if implemented firmly, will achieve its aims irrespective of the constraints facing the authorities. I broadly agree with the thrust of the staff appraisal and feel the intended measures envisaged in the program are adequate to meet the objectives of the stabilization and structural economic reform. I would, however, like to make a few brief comments on certain areas of the program.

On fiscal policy, a projected improvement in the general government deficit equivalent to 2 percent of GDP in 1988 despite a lower than anticipated overall tax revenue seems to be optimistic. Introduction of a value-added tax and a personal income tax in place of numerous other taxes that have been recently abolished is an important element of the tax reform. I hope that the authorities will succeed in maintaining the internal balance, which is a prerequisite for correcting disequilibrium in the balance of payments. A durable improvement in the external balance depends, to a great extent, on the achievement of a firm and lasting internal balance. It is heartening to learn from

the supplementary paper that preliminary indications suggest that the tax reform was implemented smoothly and that collection of new taxes has proceeded as scheduled.

As regards the introduction of treasury bills to finance a significant portion of the budget deficit, it would prove more effective if the household sector and the State Insurance Company would be encouraged to purchase larger amounts than those to be taken up by the banking sector.

In line with fiscal policy, the restriction of credit will mainly affect the Government as well as the working capital requirements of public enterprises. Limiting the amount of loans and raising the cost of borrowing by commercial banks at the National Bank of Hungary would help to restrain the undue increase in the credit-creating capacity of the banking sector.

The forint's revaluation against the transferable ruble on January 1, 1988 and its further revaluation during 1988, as well as the forint's further depreciation in 1987 against convertible currencies, have been most appropriate steps toward improvement of the current account deficit in convertible currencies.

In 1986, no significant progress was made on the application of the bankruptcy law and the phasing out of financial support to financially weak enterprises owing to the reluctance of banks to initiate bankruptcy proceedings and to curtail loans to loss-making enterprises. In contrast, the authorities are now determined to encourage curtailment of the absorption of resources by loss-making enterprises and the instigation of bankruptcy proceedings. This element of the program is crucial to increase the efficiency of resource allocation.

In light of the sound policies adopted by the authorities for 1988 as the key part of the new three-year program, I support Hungary's request for a one-year stand-by arrangement with the Fund.

Mr. Fernando made the following statement:

My authorities welcome the adjustment efforts of the Hungarian authorities to bring about a viable external account in convertible currencies, to reduce the growth of external debt, and to lay a foundation for an improvement in living standards. In view of the large external current account deficits in convertible currencies and low growth rates in recent years, as well as the growing external debt-to-GDP ratios since 1984, I support the authorities' request for a stand-by arrangement and the proposed decisions.

The staff report shows that an adjustment program to achieve the authorities' objectives could be painful and perhaps costly in the short run. The burden of adjustment is borne by restrictive demand-management policies in which fiscal retrenchment and an active exchange rate policy--which must mean depreciation against convertible currencies--are to play key roles. The authorities accord high priority to debt reduction, in view of the effect of currency realignments on the stock of outstanding debt and the reluctance of private creditors to increase their exposure.

In the light of the cushion of reserves still at the authorities' disposal, which will also be useful to close financing gaps in the balance of payments, the stand-by arrangement is striking for the relatively low level of access Fund financing and the large dosage of adjustment. Financing under the arrangement amounts to only 50 percent of Hungary's quota, and in net terms, it is negative over most of the arrangement period. The program's emphasis is on rapidly reducing domestic absorption, which has left little room for addressing the questions of investment and growth. The lack of growth orientation in the program--the growth rate would be 0.5 percent in 1988, compared with 3.4 percent in 1987 and 0.7 percent in 1986--also raises the question of the sustainability of adjustment.

As a result of the adjustment undertaken since the early 1980s, gross capital formation has tended to decline, thereby constraining the capacity of the economy to grow. In addition, there is also the problem of a high average capital-to-output ratio, which usually indicates that the productivity of investment is relatively low. However, on the basis of the staff report and the medium-term scenarios, it is difficult to judge how far the growth rate might be raised by improving the efficiency of public capital in the short to medium term.

The program's retrenchment policy in support of stabilization is being supported by structural reform in a variety of areas. However, when the dividends from adjustment in terms of growth are low and the transmission effects of demand management on growth and price stability are not clear, it is difficult to be definitive about the type of structural reforms that are needed and the pace of their implementation. The medium-term scenarios are of little help in this regard. The effects of exogenous developments such as the terms of trade or international interest rates on the balance of payments or the debt situation is only one aspect of the program's vulnerability. Moreover, the effects of structural reform on elements affecting the evolution of the external sector and the debt situation are unclear. What would happen if the effects of the reforms are different from those envisaged or there is a slowdown in implementation? Are there

any alternative courses of action? Are the transmission mechanisms between structural change and growth sufficiently clear?

It is commendable that performance has been on track so far. There is merit in keeping interest rate policy and the incentives for saving under close review. In this context, the authorities have recently expressed a clear commitment to taking some steps to raise deposit rates.

I welcome the authorities' attempts not merely to achieve a quantitative reduction of the budget deficit, but also to influence the quality of that reduction through greater reliance on financing from the nonmonetary and household sectors rather than the monetary system. As experience has shown, the success of this policy is crucially dependent on the interest rate.

On performance criteria, I note that the completion of two reviews is required under the arrangement. I wonder whether this unusual requirement is in line with the guidelines on conditionality. Also, how many times in the past have two reviews been introduced in a one-year stand-by arrangement? For the first review, in addition to the quantitative criteria, policy-based criteria are also envisaged, including wage reform to introduce greater relativities, and commercial legislation to dilute state ownership of enterprises. I have not seen such a wide diversity of nonquantitative, structural reform-oriented performance criteria specified in a program in support of a one-year stand-by arrangement. Perhaps these criteria have been provided at the request of the authorities. Since the peculiar institutional setting in Hungary would have probably been a factor in this exercise, the specification of such criteria should be regarded as special and applicable uniquely to Hungary. In the light of my earlier comments on the design of the program, some clarification on how the macroeconomic impact of these structural measures is expected to increase the effectiveness of the member's program would be appreciated.

Mr. Pétursson made the following statement:

A good number of measures to be introduced under this stand-by arrangement will have a noticeable effect only within a medium-term time horizon. Meanwhile, the more immediate economic imbalances are to be tackled within the existing shorter-term policy framework. This dichotomy gives rise to questions about how adjustment efforts will proceed when the present program expires. On the whole, the program is sound, and I support the proposed decisions.

The staff report clearly reveals that from a medium-term perspective, a broadly based transformation of the productive

sector is needed. However, such a transformation can hardly proceed at a pace that will revitalize economic growth in the short run. This fact seems to be clearly recognized by the authorities.

In this connection, the decision reached on new steps to liberalize prices is certainly welcome, as a properly functioning price system is of primary importance for effective resource allocation. The authorities are to be commended for their present policy of gradually abolishing the regulation of consumer prices. The strength of the price liberalization program, however, lies equally in the possibilities for improving the pricing of the factors of production. I therefore support the staff's view that the liquidation of loss-sustaining enterprises and increased wage bargaining should be accelerated.

The authorities may have to address some difficulties in the short run, including some uncertainty owing to higher interest rates. Clearly, the recent rise in nominal interest rates represents a major improvement. I also note that under the program, interest rates are to be adjusted if the rate of inflation or the growth of household deposits lags behind the growth of credit to households. But this rise in interest rates has to be seen against the background of a fall in private consumption in 1988 for the first time in 30 years. An intended fall in real wages of about 10 percent is likely to be partly resisted by consumers through a temporary lowering of household savings, as was seen in the first quarter of this year. The effects of trying to neutralize a decline in real wages through the use of interest rates can, therefore, be somewhat unpredictable.

The authorities are to be commended for tightening demand management and reforming the public sector. The retrenchment of public expenditure under the program, especially with respect to subsidies to enterprises and households, seems to be well justified. However, I have some concerns about the tax reforms in a longer-term perspective. In particular, the VAT to be introduced will undoubtedly make a valuable contribution to improving the fiscal sector finances and will provide the authorities with a powerful instrument for conducting fiscal policy. Nevertheless, since the tax is to be levied on limited categories of consumer goods only, it is likely that sooner rather than later, the problem of broadening the tax base will have to be addressed. The implementation of a uniform VAT on all goods and services might, therefore, have been preferable from the outset.

I note with interest that the authorities intend to continue liberalizing the monetary system. I welcome the reform of the banking sector, where more competition among, and integration of, credit institutions will be introduced. A new step in this

direction is to be taken at the beginning of 1989. Also, introduction of open-market operations, such as the sale of treasury bills and more extensive use of medium- and long-term bonds, will be valuable in encouraging enhanced household savings. However, reform of housing credit, particularly increased efficiency in the building sector, still remains to be addressed and should have a high priority. Reform in this area could also serve to reduce the budgetary deficit as housing loans are heavily subsidized.

It is understood from the staff report that owing to the aim of reducing the current account, there is limited scope for trade liberalization in 1988, as this might be counterproductive. Indeed, it is stated that a substantial reduction in imports is to be achieved through demand restraint as well as through import substitution. I hope this objective will not conflict with the customary performance criteria, namely, that limits on exchange and trade restrictions are not to be introduced or intensified. I note that only some cautious steps will be taken at the outset of the program to allow enterprises easier access to foreign markets. I agree with the staff that more courageous moves should be taken in this area, as Hungary would benefit, like other economies, from increased competition and international trade. Clearly, however, more liberal trade presupposes stronger domestic adjustment. At the same time, overall progress could undoubtedly be accelerated through a more extensive liberalization of trade.

The Deputy Director of the European Department, commenting on aspects of the macroeconomic adjustment program, remarked that the budget reserve was aimed at providing additional resources for further expenditure in the event that the supply side developed better than anticipated. However, the authorities recognized that use of the reserve was not consistent with the external target, and they had therefore abandoned their intention to use that reserve. The performance criteria on the budget deficit ceiling excluded the reserve. As for the impact of fiscal policy on the position of the municipalities, transfers from the Central Government to the municipalities would be higher in nominal terms, but would not compensate for the loss of revenue from taxes that had been eliminated. Consequently, the municipalities were being forced to cut expenditures, particularly capital expenditures.

A question had been raised on the financing of interest rate increases and its impact on subsidies and prices, the Deputy Director recalled. Actually, those increases would be financed through reductions in subsidies to enterprises, and therefore they were not expected to have any impact on prices. In 1988 there had been a large cut in subsidies but, at the same time, there had been an increase in transfers to compensate segments of the population, mainly large families with several children and pensioners, for the increase in the cost of living.

On monetary policy, it had been suggested that perhaps a selective credit policy could be used instead of subsidies, the Deputy Director continued. As the authorities tended to be overly selective in their credit policy, the staff would be reluctant to encourage them further in that regard. On whether the authorities would be able to maintain control over foreign exchange earnings in a decentralized system of foreign trade, it should be noted that there was a surrender requirement for enterprises, which remained in effect and was considered to be consistent with the decentralization of foreign trade activity. With regard to the scope for adjustment in the nonconvertible area, the authorities had on occasion reduced subsidies to enterprises exporting to the CMEA area by periodically revaluing the forint. Those measures should continue to encourage enterprises to shift their production to the convertible currency area.

Commenting on the reform aspects of the program, the Deputy Director observed that the autonomy of enterprises had been increased to a large extent earlier when enterprises were allowed to elect their own managers. Under the program, the form of ownership would be changed: enterprises would be allowed to issue shares, and the shareholders would exercise some control over the enterprises, thereby increasing the autonomy of enterprises even further. With respect to tax reform, both Mr. Templeman and Mr. Pétursson had referred to the higher personal income tax and the value-added tax rates. The authorities were, in fact, considering a reduction in personal income tax rates. The present rates reflected both the narrow tax base and the need to reduce the budget deficit. However, from a long-term perspective, the staff agreed that the high tax rates were an undesirable aspect of fiscal policy, and they would be given great attention in coming months.

Questions had been raised about the use of nonquantitative performance criteria in the design of the program, the Deputy Director recalled. Such criteria had been used in other programs, usually in the area of exchange system reform. An innovative aspect of the Hungarian program was the focus on some key areas of the reform process, and the performance criteria were introduced mainly to ensure the timely implementation of essential reforms so as to avoid slippages. That approach explained the criteria on price and wage liberalization, which were essential elements of the program. The third essential element was changes in corporate legislation to allow new forms of ownership and permit the development of new enterprises. On another point, it should not be concluded that because the rate of growth for 1988 was low, the program was not a growth-oriented program. The 1988 growth rate reflected adjustment necessitated by the expansionary policies of previous years, and that adjustment would have a short-run effect. It was hoped that the various measures to be taken by the authorities would result in a pickup in growth in future years.

Provision had been made for two reviews owing to the delay in bringing the program to the Board, the Deputy Director noted. The arrangement would expire in May 1989, and the last purchase would take place, based on the fulfillment of performance criteria, at the end of March 1989. The staff was not yet in a position to set the performance criteria for March

1989. Those criteria would be based on the budget and on the new plan, which would be discussed with the authorities toward the end of the year; hence the need for an additional review.

On the pace of adjustment under the program, it was true that the reduction of the current account deficit over the program period did not seem to be considerable, the Deputy Director of the European Department commented. However, it should be noted that the figure for 1987 was understated because of favorable leads and lags. When the program was negotiated, it had been assumed that the current account deficit would be close to Ft 1 billion; in the event, it had amounted to only Ft 850 million, which reduced the magnitude of the adjustment under the program. He fully agreed with Mr. Templeman that if the favorable results of the first quarter of 1988 continued, the authorities should be encouraged to move faster toward the elimination of the current account deficit. More generally, it had been extremely difficult for the staff and the authorities to determine the maximum safe speed of reform. If the reform was too slow, it might not garner support or produce results; if it was too fast, there was a risk of backlash, which was equally undesirable from a medium-term perspective. In particular, price increases that might be desirable from a reform perspective could, in the short term, have undesirable consequences if the popular consensus turned against the reform process. In that respect, while he fully agreed with Directors that it was unfortunate that greater progress toward trade liberalization was not expected in 1988, it must be recognized that trade liberalization would have required a large exchange rate adjustment, and the price effect of such an adjustment--coming on top of an already large price increase resulting from the tax reform--would have meant a rate of inflation that was socially and politically unacceptable.

Mr. de Groote remarked that it was important to stress the honesty of the Hungarian authorities in their dealings with the Fund. During the two previous years when there had been no possibility of presenting a workable program in support of a request for Fund assistance, the authorities had not made such a request. The present request was being made because they were convinced that it was possible to implement correctly and fully the program in support of the stand-by arrangement.

The suggestions made by the Directors were mainly concerned with the coherence of the economic reform program and the necessary speed of reform, Mr. de Groote observed. On coherence, he would transmit to his authorities the observations made by Directors on the coexistence of administrative prices and freely determined interest rates, and on the need for coherence in the reform of the banking system, namely, that to bring the banks to a more profitable position, their assets and liabilities would also have to be restructured. On the speed of reform, he was certain that if the process could be accelerated, it would be, and perhaps even in the course of the year. An important element in that respect was the authorities' intention to reduce subsidies by a further 10 percent annually after 1988, which would certainly accelerate the pace of reform. Of course, the authorities would be careful not to enter into a situation where the strong support

that the program currently enjoyed would be put at risk. In that respect, a wide range of the populace knew about the program and were aware of the large advances already made by Hungary compared with neighboring countries.

The structural content of the reform and the nonquantitative performance criteria in that respect had been requested by the authorities as important safeguards vis-à-vis public opinion and by various segments of the decision-making establishment to ensure that the reform process could be pursued with the appropriate speed, Mr. de Groote continued. To regard the arrangement for Hungary as exceptional or unique in that regard implied that such clauses were imposed on, or were disadvantageous to, a member. On the contrary, in his authorities' view, the program and the financing were justified by the fact that the important structural reforms that were being implemented had an effect on the balance of payments. That particular innovation was the most important feature of the program.

It was a time of great challenge for Hungary, not only because the reform effort had to take shape and gain momentum in order to obtain the results that were hoped for, but also because the general political circumstances gave Hungary a unique opportunity, Mr. de Groote commented. His authorities would take up that challenge in a realistic way without unduly hastening or delaying the pace of reform.

Mr. Fernando remarked that his comments on the inclusion of performance criteria for structural reforms were based on his reading of the guidelines on conditionality. He agreed that under various circumstances, it was appropriate that structural policies constitute performance criteria. But the guidelines clearly stated that those circumstances were exceptional and country specific. In such instances, clearly there should be some indication in the staff paper of how the macroeconomic impact of the structural policies would contribute to the effectiveness of the program. Regarding the growth-oriented character of the program, he was not completely convinced by the staff's explanation. He would have liked to see the medium-term scenario expanded to indicate how growth was expected to develop over the coming three or four years.

Mr. Dai recalled that he had noted that the inclusion of innovative performance criteria had been agreed upon by the authorities because they were considered to be in the interest of the country concerned. However, what he would stress was that, given the wide difference in member countries' circumstances and interests, the inclusion of such performance criteria should continue to be decided on a case-by-case basis.

The Deputy Director of the Exchange and Trade Relations Department observed that the performance criteria in the stand-by arrangement with Hungary were neither unique nor precedent-setting. Many other arrangements had had similar performance criteria, particularly in the areas of exchange system reform and price liberalization, including criteria that required legislative action. For example, the introduction of a sales tax as well as limits on payments to loss-making enterprises, both of which required legislative action, had previously been used as performance criteria.

Mr. Zecchini remarked that it could be argued that structural measures should not have been included in a program supported by a stand-by arrangement. But because of Hungary's economic system, the impact of market mechanisms was limited by institutional and structural constraints. If a better microeconomic balance was to be achieved, the structural component could not be overlooked even in the context of a stand-by arrangement which was basically aimed at cyclical stabilization. Perhaps the staff could elaborate on why the inclusion of such measures was considered as an exception. The question had wide implications for Fund policies at a time when increasing emphasis was being placed on structural adjustment.

The Deputy Director of the European Department commented that the staff was paying greater attention to structural measures in stand-by arrangements because an adjustment effort might not be viable in the medium term unless it was accompanied by structural adjustment. For instance, it would do Hungary no good at all to reduce its budget and current account deficits if at the same time it did not pursue the structural adjustment measures that would make that adjustment permanent. Perhaps the staff should have been more explicit in linking those measures to a medium-term growth rate. However, for the three key areas identified for Hungary-- wage reform, price reform, and reform of corporate legislation--indicating precisely how the measures would affect growth in the medium term would be difficult, and perhaps impossible given the state of the art.

Mr. Fernando observed that often such measures were included in Fund-supported programs as understandings between the authorities and the staff. What would have been the situation if the structural policies included as performance criteria had instead been included as understandings?

The Deputy Director of the European Department remarked that using certain structural adjustment measures as performance criteria gave them some importance in the program and ensured that implementation took place on schedule in those areas where there had been slippages in the past. Both the authorities and the staff felt it was important to agree on a precise timetable to be backed by performance criteria. In contrast, understandings did not carry the same weight as performance criteria and were only subject to review on a six-monthly basis, or on the occasion of the program reviews.

The Chairman made the following summing up:

On the occasion of the 1987 Article IV consultation with Hungary, Executive Directors also considered and approved a request for a stand-by arrangement.

Directors welcomed the turnaround in the current external position in convertible currencies that had begun in mid-1987 and commended the authorities on their tightening of demand-management policies. They noted in particular the greater fiscal restraint implemented in the second half of 1987 and the pursuit of an active exchange rate policy.

Directors commented that for the improvement in the external accounts to be durable and to be accompanied by a healthy rate of economic growth, the maintenance of tight financial policies would have to be reinforced by economic reforms. They argued that the transition from a centrally administered to a more market-based economy would require the consistent implementation of a comprehensive set of structural reform measures in accordance with specified timetables. Directors were generally encouraged by the reform initiatives of the last 18 months, including the establishment of a new banking system, the reduction in financial support to less efficient enterprises, and the overhaul of the taxation system, which involved the introduction of a value-added tax and personal income taxation.

Directors welcomed the Government's three-year program and its goal of eliminating the current account deficit in convertible currencies. While this program was seen to be courageous and reasonably well balanced, some Directors regarded the planned reduction in the deficit for 1988 as less than desirable in view of Hungary's high level of external debt and debt-servicing burden and the consequent dependence of the external situation on the confidence of foreign lenders. They urged the authorities, if possible, to move faster toward eliminating the current account deficit. In terms of demand restraint, the key elements of the program were the planned reduction in private consumption and in the public sector deficit. Directors stressed the need for sustained demand restraint and, in this context, noted the key role of the planned reduction in budgetary subsidies and in credit expansion and the importance of keeping within the credit targets without resorting to direct controls on the activities of the banks. In this connection, the authorities' decision not to use the budget reserve and to stand ready to respond quickly to any deterioration in the fiscal position was welcomed. Directors also welcomed the authorities' recent decision to issue treasury bills and to make greater use of variations in interest rates and reserves requirements.

Directors noted that the authorities were committed to undertake wage and price reforms, integrate banking services for the enterprise and household sectors, and introduce commercial legislation to promote the formation of joint stock and limited liability companies. Directors also noted that the recent banking and tax reforms had to be consolidated. In particular, the tax regime of the private sector had to be revised so as not to discourage activity in that sector.

The effective and speedy implementation of a package of mutually reinforcing reform measures was considered essential for restructuring industry and stimulating exports to the convertible currency area. A number of Directors emphasized the importance in this context of liberalization in the determination of prices

and wages and in the trade regime. They therefore welcomed the reduction in the scope of price controls in 1988 but hoped that there would be further progress in this area. Regarding wages, Directors noted that the severe constraint on wage increases in 1988 limited the scope for wage differentiation. Such differentiation was seen as an important ingredient of the reform process, and Directors hoped that an earlier reduction in the scope of wage regulations would be possible. In considering the trade regime, Directors recognized that the authorities would want to proceed cautiously with import liberalization because of the balance of payments situation. However, a number of Directors felt that within these constraints, a bolder approach might have been undertaken and supported, as necessary, by a more active exchange rate policy.

Several Directors noted that the official inflation target of 15 percent for average increases in consumer prices in 1988 could be difficult to attain. In view of the uncertainty about inflationary expectations and the unsatisfactory rate of household financial saving, Directors attached considerable importance to the recent decision to raise interest rates on the bulk of saving deposits to levels above the rate of inflation expected over the next 12-18 months and welcomed the authorities' commitment to review interest rates in the light of savings performance. Directors believed that this move would be helpful in fostering household savings. However, some Directors noted that interest rates charged on housing loans, which accounted for much of the borrowing by the household sector, were extremely low. They argued that early consideration should be given to raising these rates, and that the burden of housing subsidies should be made explicit and borne by the budget.

Directors welcomed the close coordination between the Fund and the World Bank in designing demand-management and structural reform measures to support the authorities' program. They also agreed with the staff that Hungary would continue to need the assistance of the two institutions to carry out the full program of reform of its economy.

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

The Executive Board then took the following decisions:

Decision concluding 1988 Article XIV Consultation

1. The Fund takes this decision in concluding the 1988 Article XIV consultation with Hungary, in the light of the 1987

Article IV consultation with Hungary conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. The restrictions on the making of payments and transfers for current international transactions, including a restrictive multiple currency practice, are maintained as transitional arrangements under Article XIV. The Fund encourages the authorities to pursue policies that would permit them to remove the multiple currency practice evidenced by the broken cross rates as soon as possible. Moreover, the Fund encourages the authorities to take early steps to eliminate the restrictive features in the remaining bilateral payments arrangements with Fund members.

Decision No. 8871-(88/78), adopted
May 16, 1988

Hungary - Stand-By Arrangement

1. The Government of Hungary has requested a stand-by arrangement for a period of 12 months in an amount equivalent to SDR 265.35 million.

2. The Fund approves the stand-by arrangement set forth in EBS/88/47, Supplement 3.

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

Decision No. 8872-(88/78), adopted
May 16, 1988

2. THE BAHAMAS - 1988 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1988 Article IV consultation with The Bahamas (SM/88/87, 4/20/88). They also had before them a background paper on recent economic developments in The Bahamas (SM/88/96, 4/29/88).

Mr. Massé made the following statement:

My authorities appreciate the staff's constructive and balanced report and agree with its principal conclusions and recommendations. However, data which have become available since the discussions were held suggest that a somewhat more optimistic assessment of the near-term outlook may now be justified.

Since the last Article IV consultation, economic performance in The Bahamas has been generally favorable. Reflecting primarily rapid growth in tourism, the pace of economic activity has been vigorous. Real GDP is estimated to have grown by more than 4 percent in 1987. At the same time, inflation has been modest and is currently running at a somewhat lower rate than that in the United States. The one area of weakness was the balance of payments, on which pressures emerged in the second half of 1987. In 1987, the current account of the balance of payments is estimated by the staff to have risen to the equivalent of about 4 percent of GDP, and official international reserves fell by some \$60 million.

The deterioration in the balance of payments was associated with a very rapid expansion of bank lending to the private sector in the second half of the year. The staff has documented the factors underlying this surge in credit expansion. A major contributory factor was the abrupt shift of deposits from the Central Bank to the commercial banks by the National Insurance Board (NIB). This episode also highlighted certain areas of weakness in monetary control. In particular, commercial banks were not all complying with primary reserve and liquid asset ratio requirements.

Expansion of credit at the rates recorded in the second half of the year clearly could not be sustained without adverse consequences for the balance of payments and external reserves. The authorities therefore moved decisively to contain and reverse this trend. In January, the Central Bank raised its discount rate to 9 percent. In March, the authorities issued \$35 million in long-term debt, with a view to absorbing the excess liquidity in the system; about half of this issue was taken up by the National Insurance Board and the other half by the commercial banks. To retain balances held with it by the National Insurance Board and the Government-owned Hotel Corporation, the Central Bank is now offering these institutions a more attractive interest rate of 6 percent. The Central Bank has also made it clear to commercial banks that in future there should be full compliance with the primary and secondary ratio requirements. In addition, the Central Bank indicated its position to the head offices of the banks concerned with a view to preventing any recurrence of the excessive credit expansion which had occurred last year. Reporting has been tightened and all banks are now in full compliance with the ratio requirements. The net result of all these measures has been a distinct slowdown in the rate of credit expansion, especially for consumer purposes. While total bank lending is still expanding, this reflects primarily prior commitments to finance investment expenditure. Recovery in the level of official international reserves, apparent at the time of the consultations, has continued in subsequent months. Although to some extent this may reflect seasonal factors, international

reserves now stand at some \$220 million, a level which is close to the three-month import cover which the authorities believe to be desirable.

Regarding fiscal policy, the authorities are in broad agreement with the staff's assessment. The authorities have in recent years taken measures to improve revenue collection and are determined to contain current expenditures within budgetary allocations. Regarding current expenditure, the authorities agree that a major factor will be the outturn of the current negotiations on public sector pay. These negotiations, which are still in progress, are proving difficult. However, the authorities are determined to ensure that awards are consistent with budgetary targets. Concerning capital expenditure, both by the central government and by public corporations, there is agreement on the need for careful project appraisal to ensure the attainment of the highest possible rates of economic and social return.

Finally, my Bahamian authorities now believe that the near-term outlook for the economy may be somewhat more favorable than was thought at the time of the consultation discussions. In March and April, there was a strong upturn in tourism, to the extent, in fact, that some overbooking was recorded. With consumer demand in the United States likely to be somewhat stronger than had been previously forecast, this trend can be expected to continue. The pace of activity in the construction sector also remains rapid. Although it is not possible to quantify their effects at this stage, these developments, coupled with tighter control over bank lending, give grounds for optimism concerning both growth and the balance of payments.

Mr. Hospedales made the following statement:

The economy of The Bahamas is at a crossroads; measured by standard macroeconomic performance indicators, the record over the last five years has been particularly satisfactory, with solid growth, inflation, and external current account performances being registered. Yet, despite this favorable performance and satisfactory short-term prospects, two partly interrelated features of the current economic situation give rise to some concern: first, the financial position of the overall public sector shifted into a deficit in 1987, which is projected to widen somewhat in 1988; second, the international reserve position is coming under pressure in the context of a deteriorating balance of payments.

The emergence of these difficulties stems from the considerable developmental activity that has taken place in The Bahamas in recent years, and attention is now being appropriately focused

on reconciling rapid development with stability over the long term. Apart from international trends, which bear particular relevance to The Bahamas because of the openness of the economy and the uncertainties surrounding the international economic environment, the objective of reconciling development with stability will depend crucially on strengthening demand management and on implementing far-reaching structural reforms in the fiscal accounts. In this respect, the authorities are correctly focusing their attention on fiscal consolidation and monetary action.

The extent of the fiscal consolidation cannot be underestimated. Indeed, as a revenue shortfall became apparent, public expenditure was effectively restrained so that approximately 80 percent of the capital program of the overall public sector is being covered by current balance surpluses. The authorities are correctly supporting, through their investment program, directly productive activities and exports through investment in economic infrastructure and communications to sustain the growth process and the expansion of tourism where significant investment has taken place. We would add a word of caution: a more effective screening of investments should be undertaken to ensure, generally, that external resource usage generates an adequate future stream of resources to effect debt service requirements.

The authorities are well aware that these objectives can be derailed by excessive domestic credit creation, and they have moved to correct the situation through appropriate monetary policy action. The decision to issue government debt in excess of government financing requirements is well advised as is the decision to heed the staff's advice to enforce primary and liquid asset requirements.

The pursuit of disciplined fiscal and monetary policies has served The Bahamas well in managing their external position. Complementing this policy mix should be a firm incomes policy to moderate costs and prices, especially in the light of the authorities' commitment to a relatively stable exchange rate regime.

Mr. Hogeweg remarked that, for a number of years, the economy of The Bahamas had developed within a set of favorable circumstances that were partly exogenous--namely, the rapid growth of consumer spending in the United States, where the tourists originated--and partly policy induced. In 1987, however, fiscal policies had become more expansionary, commercial bank lending had accelerated enormously, and the outlook for travel receipts had become more uncertain. The staff stressed the role of the Dow Jones Index in that context.

On fiscal policy, he agreed with the staff that foreign borrowing to finance the government deficit was no solution in view of the risk of diverging interest rates and project yields, Mr. Hogeweg continued. In

that connection, he wondered how the remarks in the staff appraisal that there was not enough room to finance the deficit internally without crowding out private investment could be reconciled with the staff's advice to issue long-term government debt in excess of the government financing needs in order to withdraw liquidity from the banking system.

On monetary policy, the rapid expansion in commercial bank lending in the second half of 1987 had been caused in part by large shifts of funds of the National Insurance Board from the Central Bank to the commercial banks, providing them with ample liquidity, Mr. Hogeweg noted. That was somewhat surprising. Since the NIB was part of the Government, it should be possible to devise an arrangement to prevent the NIB from disrupting monetary management. Offering competitive rates on NIB deposits at the Central Bank was only part of that solution.

The Bahamas offered an example of the importance of the human factor in the monetary transmission mechanism, Mr. Hogeweg observed. The background paper indicated that the NIB had started to shift its funds around when it came under new management. Also, with the change in management at one of the largest commercial banks, a surge in lending had begun. The influence of a change in perhaps only two personnel positions in the banking system on the parameters of monetary policy was remarkable, as was the fact that the Central Bank had evidently been taken by surprise.

He fully agreed with the staff that for a small country with a fixed exchange rate, it was important that interest rates be market determined, Mr. Hogeweg commented. If interest rates were fixed under a fixed exchange rate regime, some other macroeconomic variable would move if imbalances arose, and first of all, official reserves.

The draft Annual Report on Exchange Arrangements and Exchange Restrictions, 1988 showed that The Bahamas maintained a dual exchange market, Mr. Hogeweg remarked. He wondered why neither the staff report nor the background paper mentioned that fact.

Mr. Woodward remarked that he generally shared the views expressed in the staff appraisal.

The Bahamas had been successful in maintaining a good rate of growth combined with low, though gradually increasing, inflation since 1983, Mr. Woodward observed. However, developments in the fiscal and external accounts had been rather less favorable over the past two years. Neither was yet a cause for serious concern, but the authorities would do well to exercise some caution in their future policies in these areas.

On the fiscal side, the current account surplus of the public sector remained broadly constant in nominal terms in 1987, implying some real reduction, and that was repeated in the 1988 budget, Mr. Woodward commented. That development followed a substantial strengthening of the current balance between 1984 and 1986, which left a certain amount of room for real erosion. However, capital expenditure was at present high by historical standards,

and if that level were to be sustained, some further improvement in public sector savings would be desirable. In that context, he endorsed the staff's view that efforts to improve the collection of existing taxes needed to be intensified. He also noted the substantial increase in current expenditure in the 1988 budget and the risk of both revenue shortfalls and overruns on wage costs. The authorities' commitment to take compensatory expenditure measures in the event that those risks materialized was welcome.

On investment expenditure, the staff had doubts about the economic viability of some investment projects, Mr. Woodward noted. Careful project selection should be exercised to ensure that resources were used efficiently, even if the process of assessment caused some delays. A slower pace of investment might not in itself be a bad thing. Apart from the fiscal aspect, the bottlenecks in the construction sector might be eased, potentially reducing costs and gestation periods, and thus enhancing rates of return.

In 1987 there was a major increase in the current account deficit to a relatively high level of 4 percent of GDP, and further small increases were expected for the next two years, Mr. Woodward continued. In 1987 the current account deficit, together with a small deficit on the long-term capital account, had been financed entirely by a reduction in reserves and by unrecorded transactions. The latter was again expected to play a significant part in financing the deficit for the coming two years. He would welcome staff comment on the prospects for the continued high level of unrecorded exports that that expectation appeared to imply, particularly in view of the major shortfalls in 1985 and 1986. The remainder of the deficit for 1988 was projected to be financed by long-term public sector borrowing. While the external debt remained small, the rate of increase projected for the next two years was high, and it would be imprudent for the authorities to assume that they could continue to borrow on that scale without some adverse effect on the costs of servicing the external debt.

On the monetary side, the recent measures taken by the authorities to curb the growth of credit and to withdraw liquidity from the banking system were welcome, Mr. Woodward remarked. The authorities should, however, continue to monitor the situation closely.

The staff representative from the Western Hemisphere Department pointed out that the multiple exchange rate practice of The Bahamas was described in a footnote on page 25 of the background paper dealing with the foreign currency investment market.

In the staff's view, there was no inconsistency between its proposal for overfunding and its concern about the crowding out of the private sector, the staff representative remarked. To safeguard the reserve position, the authorities should keep credit growth under tight control. The proposed overfunding was one way to mop up undesired liquidity. Of course, once the policy to keep credit growth under control was in place, it would be necessary to reduce the public sector's demand for credit if the private sector was not to be crowded out.

On the evolution of unrecorded receipts, the balance of payments projection took into account the level of receipts in the second half, the staff representative from the Western Hemisphere Department explained. To the extent that there was a declining trend in that item, the projection might be optimistic. However, there was no better guide to balance of payments developments at the moment.

Mr. Massé remarked that as he had indicated earlier, the authorities were aware of the problems in the fiscal and external accounts and had recently taken some additional measures in those areas. Moreover, they stood ready to take further measures, as necessary. He would convey to his Bahamian authorities the remarks made by the Executive Directors and the recommendations that they had indicated.

The Acting Chairman made the following summing up:

Directors agreed with the thrust of the staff appraisal for the 1988 Article IV consultation with The Bahamas.

Satisfaction was expressed with the continuation of strong economic activity in recent years, which was accompanied by a moderation of inflation. Directors, however, noted with concern the substantial deterioration in the balance of payments and the loss of official international reserves in the second half of 1987 owing to the acceleration in bank lending, a deterioration in the fiscal position, and a slackening of tourist arrivals. While noting that some corrective actions had been taken, and that reserves had recently improved, Directors stressed that additional measures were necessary. Directors considered that the growth of credit needed to be brought further under control. To this end, it was urged that reserve requirements should continue to be strictly enforced and that interest rate policy should be flexible. Moreover, the Government might consider issuing debt in excess of its financing requirement.

The public sector deficit was expected to increase substantially in 1988, largely reflecting an expansion of investment spending, and Directors expressed concern about the potential adverse impact of this fiscal stance for the balance of payments and international reserves positions. They stressed that borrowing from abroad to finance sizable deficits could not be seen as a solution, in view of the need to keep the external debt burden at a manageable level. Directors therefore emphasized the need to reduce the Government's financing requirements through such measures as stepping up tax collection, curbing current expenditure, and re-examining investment programs. In addition, it was important to limit the public corporations' capital spending to those projects that were expected to yield adequate returns.

It is recommended that The Bahamas remain on the 24-month consultation cycle, and that the practice of an annual staff visit be maintained.

APPROVED: December 19, 1988

JOSEPH W. LANG, JR.
Acting Secretary