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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/124

10:00 a.m., August 5, 1988

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	S. M. Hassan, Temporary
	C. Enoch
Dai Q.	
	C. S. Warner
	A. Rieffel, Temporary
	J. Prader
A. Donoso	
M. Finaish	A. M. Othman
	B. Goos
	K.-H. Kleine, Temporary
J. E. Ismael	
	J. R. N. Almeida, Temporary
M. Massé	
Mawakani Samba	
	P. D. Péroz, Temporary
	B. R. Fuleihan, Temporary
	E. Ayales, Temporary
J. Ovi	
H. Ploix	
G. A. Posthumus	G. P. J. Hogeweg
C. R. Rye	
	A. A. Agah, Temporary
	A. Vasudevan, Temporary
	S. Yoshikuni
	S. Rebecchini, Temporary

J. W. Lang, Jr., Acting Secretary
L. Collier, Assistant

Also Present

IBRD: S. K. Berry, L. Derbez, Latin America and the Caribbean Regional Office; R. Key, Africa Regional Office. African Department: J. C. Brou, R. L. Daumont, M. de Zamaroczy, A. Doizé, K. Enders, Z. Ibrahim-Zadeh, P. T. Matthieu, S. M. Nsouli, P. C. Ugolini. Central Banking Department: L. M. Koenig, Deputy Director. Exchange and Trade Relations Department: H. B. Junz, Deputy Director; A. Basu, M. H. Rodlauer. External Relations Department: H. P. Puentes. Fiscal Affairs Department: I. Coelho. IMF Institute: O. B. Makalou. Legal Department: H. Elizalde, J. V. Surr. Secretary's Department: C. Brachet, Deputy Secretary. Western Hemisphere Department: S. T. Beza, Director; J. Ferrán, Deputy Director; M. E. Hardy, D. S. Hoelscher, C. S. Lee, R. K. Rennhack. Advisors to Executive Directors: W. N. Engert, M. Eran, A. R. Ismael, M. Pétursson, G. Pineau, M. A. Tareen, D. C. Templeman, K. Yao, J. E. Zeas. Assistants to Executive Directors: F. E. R. Alfiler, H. S. Binay, R. Comotto, P. Gorjestani, M. A. Hammoudi, C. L. Haynes, M. Hepp, J. Heywood, V. K. Malhotra, T. Morita, C. Noriega, V. Rousset, Shao Z., R. Wenzel, D. A. Woodward.

1. CHILE - 1988 ARTICLE IV CONSULTATION, EXTENDED ARRANGEMENT - REVIEW AND LENGTHENING, AND EXCHANGE SYSTEM

The Executive Directors considered the staff report for the 1988 Article IV consultation with Chile and for the review under and lengthening of the extended arrangement with Chile that had entered into effect August 15, 1985 (EBS/88/139, 7/15/88). They also had before them a background paper on recent economic developments in Chile (SM/88/159, 7/26/88).

The staff representative from the Western Hemisphere Department noted that Chile had observed all the performance criteria for which data were available, with ample margins, as of June 30. Final data were not available for the public sector, but apparently the limits on the public sector deficit had also been observed. The rate of inflation in July had fallen to 13.7 percent on a 12-month basis, and prices had risen by only 0.1 percent during July. Monthly inflation was expected to continue to be low in August. In its report, the staff had expressed concern about the rapid growth of monetary aggregates; in July the Central Bank of Chile had raised the real interest rate by about one-half percentage point on its open market instruments, with a view to cooling down the rate of growth of monetary expansion, and the staff welcomed that move.

On the basis of the latest data from partner countries, a recalculation of the real effective exchange rate index showed that in real effective terms the exchange rate had remained broadly unchanged since the beginning of the year, the staff representative said. In July, the Executive Directors of the International Finance Corporation had approved participation in the Escondida copper project, which virtually assured that project of implementation.

Mr. Donoso made the following statement:

Economic performance

Chile is experiencing rapid growth in production, investment, and exports, with positive repercussions on employment and wages. Further growth in production, through its impact on the demand for labor, should be especially beneficial in terms of employment and wages, thus improving social conditions while the reduction of external indebtedness continues.

Consumption increased moderately as a consequence of the growth of output at rates of between 5 percent and 6 percent a year, and gross domestic savings increased by close to 40 percent in real terms between 1985 and 1987. The counterpart of this increase in savings was an increase in gross domestic investment of almost 38 percent in real terms during these two years and an increase in the trade surplus and the surplus in nonfinancial services of over 45 percent in real terms during the same period.

While imports of consumer goods increased by 23.6 percent between 1985 and 1987, imports of capital goods increased by 70.4 percent during the same period. For every increase of US$1 in imports of consumer goods during this period, imports of capital goods increased by US$2.64. The growth of imports was significantly exceeded by the growth of exports. Noncopper exports--so as not to bring the improved price of copper into play--increased from US$2,015 million in 1985 to US$2,989 million in 1987. Total exports increased from US$3,804 million in 1985 to US$5,224 million in 1987 and are expected to total close to US$6,400 million in 1988.

Economic policies

The basis of the policies aimed at increasing the trade surplus has been changes in relative prices and fiscal and monetary discipline. The authorities devalued the peso significantly in 1985 and 1986, and the objective from 1987 onwards has been to stabilize the exchange rate in real terms. Minor exchange fluctuations in real terms during the past year and a half have resulted basically from lags in incorporating the changes in external inflation in exchange rate adjustments. This exchange policy was accompanied by a careful and cautious handling of real wages, which also contributed to a mobilization of resources promoting the production of tradable goods and a more rapid drop in the unemployment rate.

The policies on relative prices were accompanied by cautious monetary and fiscal policies. The real interest rate stood at between 4 percent and 5 percent a year during the most recent period. The financial position of the public sector improved, so that the deficit of the nonfinancial public sector moved toward the equivalent of 0.5 percent of GDP, using an estimate of the long-term price of copper instead of the actual price.

Both the economic policies and the trends described will be maintained in 1988 and in the period covered by the program extension. The higher price for copper--which is considered to be temporary--has resulted in a budget surplus and an accumulation of international reserves, which should make it possible to affect external debt directly.

Structural reforms: reduction in the size of the public sector and debt conversion

In the February 1988 review under the extended arrangement (EBM/88/25), I included in my presentation to the Executive Board a table illustrating the program for enterprise privatization and its progress. The table that follows is the same as that presented in February 1987 through the third column. The fourth column shows the percentage of shares sold in the respective enterprises up to August 1988. As can be seen, not only has the program been complied with, but the original objectives have been replaced by even more ambitious ones. At present the decision is to totally privatize all the enterprises mentioned in the table except for Laboratorio Chile (LAB. CHILE), where the State would retain 27 percent of the shares. Additionally, the program is being extended to privatize 49 percent of ENDESA (electricity generation), 100 percent of CHILE FILMS; 49 percent of LAN CHILE (the national airline), 100 percent of ELEMAG (electricity distribution), and 100 percent of SCHWAGER (coal) and to reduce the State's participation in Sociedad Chilena del Litio from 45 percent to 20 percent. In this process of privatization, more than 150,000 Chileans, including the workers of the privatized enterprises, have become shareholders.

Enterprises	Percentages to be Sold (2/87)	Percentages Sold (2/87)	Percentages Sold (8/88)
IANS (Sugar production)	49	14	87.5
CHILGENER (Electricity production)	49	35	100
S.Q.M. (Nitrate production)	65	48	100
CHILMETRO (Electricity distribution)	65	55	100
CHILQUINTA (Electricity distribution)	65	62	100
ENTEL (Communications)	30	30	51
LAB.CHILE (Pharmaceutical products)	49	19	67

Enterprises	Percentages to be Sold (2/87)	Percentages Sold (2/87)	Percentages Sold (8/88)
C.T.C. (Telephones)	51	11	64
C.A.P. (Steel production)	80	49	100
TELEX (Telex)	100	100	100
ENAEX (Chemicals)	100	100	100
ECOM (Computerization)	100	100	100
EMEL (Electricity)	100	100	100
EMEC (Electricity)	100	100	100

After the debt crisis, the current expenditure of general government reached 30.8 percent of GDP in 1984. As a result of fiscal discipline, this figure has gradually been reduced since 1984 and is expected to be less than 25 percent of GDP in 1988. Moreover, public sector investment--general government and enterprises--increased from 4.7 percent of GDP in 1983 to 6.9 percent in 1987. Public investment is projected to reach 7 percent of GDP in 1988. Combined general government current expenditure and public sector investment expenditure have declined from 37 percent of GDP in 1984 to a little more than the 31 percent forecast for 1988. Containing the scope and degree of public sector participation in the economy has made it possible, first, to reduce the public sector deficit and release financial resources for the private sector. Second, it opened the way for a reduction of import duties, income tax rates, and taxes on luxury goods and elimination of the special tax on gasoline and a 2 percent payroll tax, all of which measures were aimed at encouraging greater efficiency and activity in the economy. Recently, the rate of the value-added tax was reduced from 20 percent to 16 percent, which had a considerable impact in terms of increasing the availability of resources to the private sector.

This evolution was made possible by the major effort to increase efficiency in the public sector and by the transfer to the private sector of activities previously under the public sector's control. Health reform has given incentives to the private sector to invest in the infrastructure required to provide health services. The private sector is today allowed and motivated to invest in transportation, irrigation projects, port development, social security services, educational services, and so forth.

With fiscal policies being kept on course, current expenditure will continue to decrease to close to 20 percent of GDP in the next five years. By maintaining adequate incentives for the private sector, it will also be possible to keep direct public sector investments at their current percentage of GDP. This will mean that with the passage of time, new scope will be created for implementing additional tax reductions and for increasing the efficiency of the tax.

The package of measures adopted to encourage investment in Chile and to increase the trade surplus raised the possibility of supplementing traditional macroeconomic policies with more direct action on the external debt.

Chapter XVIII of the Foreign Exchange Law has been the principal vehicle for the repatriation of capital. The benefits the country has received from operations under Chapter XVIII have included a decrease in external indebtedness without the simultaneous creation of external liabilities. Another benefit was the gathering of resources by the Central Bank of Chile through the sale of rights in this kind of operation. From the time of their introduction until March 1988, Chapter XVIII operations totaled US$1,580 million, the equivalent of 9.2 percent of the country's total medium- and long-term external debt as of December 1987.

Chapter XIX of the Foreign Exchange Law authorizes nonresidents to use Chile's external debt instruments to purchase capital assets in the country. In this case, rights to remit dividends and capital under special conditions are created. The total conversion of debt into capital by means of this mechanism, and the capitalization of debt in accordance with the basic regulations on foreign investment (Decree-Law No. 600), came to US$1,308 million through March 1988, or 7.6 percent of Chile's medium- and long-term external debt as of December 1987. In addition to such benefits as transfers of technology and entrepreneurial expertise and access to external markets, which may be attributed to foreign investment, the capitalization of debt instruments in accordance with Chapter XIX has other direct economic benefits:

- In general, debt instruments have been converted into domestic resources for the acquisition of assets in Chile at a discount. This discount has increased over time, as the prices of these instruments on the secondary markets changed.

- When foreign investors purchase assets on the domestic market, there is an increase in total taxes collected. Under Chilean law, personal income, rather than corporate profits, is taxed. The tax rate applicable to foreign investors is higher than the average tax rate paid by domestic investors on the same profits because of the specific levels and structure of personal income in the country. This means that the income tax collected tends to increase when a domestic asset is transferred to a foreigner.

- The process of capitalization of debtor companies is behind a significant portion of debt conversions under Chapter XIX. Since the payment of interest is deducted from the tax base under Chilean law, this capitalization process increases the tax base, and, through increased tax collection, the country retains part of the surpluses generated by the assets transferred.

Operations under Chapters XVIII and XIX as well as other debt conversion operations executed mainly by nonfinancial public and private debtors totaled US$3,755 million between mid-1985 and March 1988. Because of these operations, Chile's medium- and long-term debt declined from end-1985 to the present, while domestic production and exports increased rapidly.

Extension of the extended arrangement

Having completed three successful years supported by the extended arrangement program, Chile would be the first country to avail itself of the recent change in the extended Fund facility. Owing to the importance of the structural reforms being implemented in Chile, the country would benefit greatly from an extension of the extended arrangement for a fourth year. Such an extension would indicate less relative emphasis on macroeconomic management and greater emphasis on the need to apply structural reforms, which is precisely what is called for in the situation of Chile's economy. Growth and liquidity have been achieved in the short term, but there remains a need for continued discipline in macroeconomic management and for expanding structural reforms so as not to fall back into financial difficulties.

The Executive Board has stated on previous occasions that the country is particularly vulnerable because of high indebtedness and lack of access to the financial market on both voluntary and normal bases, and that only a carefully sustained effort over a number of years can eliminate the risk of a return to a critical situation. The Chilean authorities have requested an extension of support under the extended Fund facility, aware of the validity of these recommendations.

Mr. Almeida remarked that Chile's extended arrangement was the first to be lengthened to four years. More notable, however, was the success of the program. Between 1984 and the current year, in terms of GDP, the public sector borrowing requirement had declined from 5.8 percent to zero, the fiscal current account surplus had increased from 0.6 percent to 6.1 percent, and the deficit of the current account of the balance of payments--excluding the copper windfall--had declined from 10.7 percent to 6.1 percent. The keystone of the program had been the increase in the domestic savings ratio--from 3 percent of GDP in 1984 to 15.4 percent in 1988--to a level above the inevitable reduction in the absorption of external savings during those years.

Savings had increased in both the public and private sectors, Mr. Almeida continued, although it was not clear how they had done so in the private sector in the context of moderate, and sometimes even negative, real interest rates in the short run. While interest rates had been positive for long-term instruments, data in Table 49 in the background paper indicated moderate or even low interest rates for short-term instruments. He asked Mr. Donoso or the staff to elaborate.

Despite a flexible exchange rate and perhaps the most successful debt-equity conversion scheme in Latin America, the spread between the exchange rate in the parallel market and the official rate had increased recently, Mr. Almeida observed. It seemed that the proceeds of debt conversion in the official market had a way of leaking to the parallel market in times of uncertainty, which increased the volatility in the exchange market. He would appreciate staff comment on those matters.

The authorities were pursuing an appropriately conservative policy during the present time of high copper prices and were sterilizing most of the windfall gains or using them to buy back debt and ease the country's external debt, Mr. Almeida remarked. Despite those high prices, the authorities had not decreased the incentives for noncopper exports, and as a result those exports had risen from US$2.0 billion in 1984 to about US$3.5 billion in 1988.

The depth of the structural changes and reforms in the Chilean economy was impressive, and he wondered whether the staff could provide more precise indications about the size and the economic importance of the privatization of enterprises that had already taken place, Mr. Almeida said. He would also appreciate any information on how that privatization had been financed.

Despite all those favorable policies and net gains in terms of trade, the Chilean economy continued to need the support of the financial community, Mr. Almeida commented. Financing gaps would appear in 1991, when the grace period of previous reschedulings would expire. The authorities' efforts warranted the support of the international financial community.

Mr. Ayales made the following statement:

We commend the Chilean authorities for the remarkable success in economic management that has been achieved since the previous review of the arrangement under the extended Fund facility and over the course of the program. Significant progress has been made in reducing domestic and external imbalances within a framework of robust economic growth, increasing employment, and declining inflation rates.

A delicate balance of demand-management policies, accompanied by wide-ranging structural measures, has proved to be very effective in improving Chile's economic performance. Furthermore, the progress made so far toward achieving sustained economic growth and external viability has provided the Chilean authorities with room for maneuver in tackling the external debt.

We fully support the proposed decisions. We agree with the authorities and the staff that although the medium-term outlook has been improving steadily, as a result of both sound macroeconomic management and the highly successful debt strategy followed by the authorities, the heavy debt burden remains the central problem facing Chile.

In line with the main objective of the country's economic program, which is to achieve sustained economic growth with external viability, the Chilean authorities introduced a package of measures aimed at deepening the process of structural adjustment.

In addition to the external debt policies, described by Mr. Donoso and the staff, aimed at further promoting export growth and, more generally, at improving the country's external debt profile, a comprehensive--and already very successful--program for enterprise privatization is being further strengthened, and important changes in the tax structure are being implemented. The importance of this process of privatization may be assessed from different angles. First, it has a direct impact on the budget; the restructuring and sale of these firms reduce the current and prospective financing requirements. Second, by redefining the role and size of the public sector, the Government may use its resources more flexibly to invest in infrastructure in those sectors considered as having priority. Finally, the privatization should enhance the overall efficiency of the economy, thus ensuring high rates of growth.

The reduction of import duties and tax rates also was described by Mr. Donoso. It is almost unprecedented in middle-income countries to reach a position in which the overall tax burden may be reduced without impinging negatively on the budget. The structural adjustment element of the program is clearly seen in these measures. By reducing the rate of taxation, a strong signal is sent to the private sector in favor of investment, and, at the same time, possible distortions in terms of relative prices are lifted. In this concrete form, fiscal retrenchment becomes a stimulus to private production.

The measures in these three areas--namely, external debt, privatization of public enterprises, and tax structure--are a clear indication of the Government's commitment to pursue comprehensive and consistent structural adjustment. However, as Mr. Donoso reminds us, the authorities intend to strengthen these measures both to enhance efficiency and to contribute to the management of macroeconomic policies. It thus seems appropriate for the Fund to continue supporting this process, taking advantage of the revitalization of the extended Fund facility, particularly through the extension of the program to a fourth year. The case of Chile, with its strong emphasis on structural adjustment within a relatively satisfactory macroeconomic framework, would set a positive precedent for the application of the extended Fund facility.

Mr. Posthumus made the following statement:

Chile has requested a lengthening of the current extended arrangement. The staff supports the authorities' request, but it does not provide sufficient arguments to show why the Board should approve this request.

The 1974 decision on the extended Fund facility describes the situations to which an extended facility could apply: "An economy suffering serious payments imbalance relating to structural maladjustments..." and "an economy characterized by slow growth and an inherently weak balance of payments position which prevents pursuit of an active development policy." The Board's decision of June 6, 1988 states that "where appropriate, and at the request of the member, the period of an existing extended arrangement may be lengthened up to four years."

To determine what is appropriate, we have to look at the summing up of the Board discussion on the extended Fund facility of March 31, 1988: "Many Directors felt that such an extension might prove to be a useful mechanism to accommodate unexpected delays that can occur when it is necessary to modify policies during the period of an arrangement."

Looking at Chile's current present situation and the medium-term outlook, I note that, first, there is no longer a serious payments imbalance; the overall balance of payments is expected to be in surplus in 1988, 1989, and 1990. No financing gaps are expected in 1989 and 1990. Gross official international reserves are the equivalent of 7.5-10 months of imports, which I consider comfortable. Second, growth is not slow; it has been almost 6 percent during the past two years, and a growth rate of 5 percent is expected to be attained in 1988 and 1989. Third, there have been no unexpected delays; it has not been necessary to modify policies; and all purchases available to date have been made. Fourth, circumstances are not leading to the elimination of the remaining multiple currency practices and exchange restrictions, and the Government merely stated that "it intends to follow policies that over time should result in a convergence of the exchange rates." Fifth, the staff indicates only that it believes that the policies being followed by the authorities will contribute to the attainment of the objectives of their program, but I do not see why this should be the argument to support the authorities' request for a one-year lengthening of the extended arrangement.

In light of the discussions we have had about the lengthening of extended arrangements, we have to look carefully at the arguments for such a lengthening in a specific case. I would like to know why management supports the request in this case, where further drawings on the facility clearly are not necessary, where the extended facility has functioned satisfactorily, and where no delays in policy implementation under the arrangement have taken place.

Mr. Massé observed that although Chile had recently benefited from the high price of copper, generally speaking, the country's favorable economic performance had been the result of the persistent implementation of broadly appropriate economic policies. Economic activity had been strong, domestic savings had improved considerably--helping to finance investment--and a welcome diversification of exports had occurred in recent years.

His authorities were in broad agreement with the staff appraisal and with the thrust of the 1988-89 economic program designed to strengthen savings and investment and to improve economic efficiency, Mr. Massé said. Given the strong expansion of the economy, the authorities would need to continue the cautious stance of fiscal and monetary policies in order to make progress vis-à-vis inflation. In that connection, he noted that the staff was projecting a decline in inflation to 11 percent by December 1988, compared with 21.5 percent in the year ended December 1987. If achieved, that development would be very welcome, as that area was one where the authorities had been somewhat less successful in meeting their objectives. The latest information given by the staff indicated that the policies of the authorities were beginning to pay off in the control of inflation, especially in the past few months.

Chile's long-term external prospects had been improving steadily, Mr. Massé commented. The exchange rate policy and the measures taken to encourage a more efficient economy had played an important part in improving competitiveness. In addition, the reduced reliance on foreign financing in recent years, together with the debt conversion program, had resulted in a decline in external debt and a significant improvement in debt ratios. His authorities believed that the success of the debt conversion program had been influenced significantly by Chile's open attitude toward foreign investment, as well as by the establishment of a well-defined and consistent set of regulations for conversion operations.

Nevertheless, Chile's debt burden was projected to remain heavy, and its external position remained vulnerable to adverse movements in copper prices and interest rates, Mr. Massé remarked. Given that vulnerability and the successful record of the past three years, his authorities endorsed the proposed decisions and fully supported the lengthening of the extended arrangement to a fourth year.

Mr. Rye made the following statement:

> It is a pleasure to be able to make a brief statement on Chile--simply because so much is going well on the economic front. Chile is indeed one of the Fund's real success stories of recent years. The policies that have brought sound growth, reduced inflation, lower debt, and a stronger and more diversified export performance need of course to be maintained, but the record of Chile's economic authorities over the period of this extended arrangement gives us confidence that they will continue the necessary vigorous pursuit of growth-oriented adjustment.
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> Looking at recent achievements, it is particularly gratifying that the limits and targets for the first quarter of 1988 have been readily achieved. There seems to be an inbuilt safety margin in this program that leaves room to cope with adverse developments. At the same time, growth has been maintained at nearly 6 percent a year, unemployment has fallen to below 8 percent--an enviable figure for a developing country--and inflation, after the worrying surge last year, has receded sharply so far in 1988. Meanwhile, the external debt ratio fell

in 1987 by 15 percent of GDP, greatly aided by what seems to be the most successful debt-conversion scheme adopted by any of the high-debt countries.

Naturally, the sharp improvement in Chile's terms of trade--particularly in copper prices--has contributed to these achievements, but that is not by any means a full explanation; other countries with a similarly favorable external trend have failed to realize the across-the-board economic gains of Chile. An important role was played by the Copper Stabilization Fund, which has functioned very much in the manner envisaged for the contingency facility over which we have labored in recent days.

I have only a few comments to offer. First, the value-added tax rate was lowered from 20 percent to 16 percent, which should make a useful contribution to the further reduction of inflation. Of course, the resulting loss of revenue will be justifiable only if the authorities are able to persevere in their policy of restraint in current government expenditures.

Second, an interesting approach to holding public sector employment down is the requirement to eliminate two jobs for every new job approved. I wonder how long such a policy can be maintained, and also whether it can continue to be applied in such a way as to avoid incentives to ossify public sector employment structures.

Third, the authorities consider that the present level of public investment is adequate--I assume in relation to GDP although the staff report is not clear. Mr. Donoso has placed this issue in the context of the sharp rise in private investment, and that is clearly a most legitimate point. I wonder, however, whether the staff and the World Bank would agree that it would be appropriate for public investment to remain at present levels.

Fourth, on the exchange rate, the spread between the parallel market and the official rate, though falling, remains at a rather high 13 percent. Any measures that the authorities can properly adopt to reduce this differential would be desirable.

Fifth, one can only applaud the authorities' vigorous pursuit of a low uniform tariff level and a liberal regime for foreign investment. These are policies that many other countries--industrial as well as developing--would be well advised to adopt.

Finally, on the lengthening of the extended arrangement, I agree with Mr. Posthumus that the staff might have made a clearer case for this proposal, but Mr. Donoso has partly filled the gap and I very much agree with his statement. It can be argued that, in our recent policy discussion on the extended Fund facility, most Directors were thinking of extensions in cases of the kind described by Mr. Posthumus. As he has clearly demonstrated, those circumstances do not apply to Chile. However, I must disagree with Mr. Posthumus, as I only very rarely do, in that it would be rather perverse to oppose the extension on those grounds. Despite its economic progress, Chile still has a long way to go, as illustrated most clearly by its remaining heavy debt burden. The Fund still has a most useful role to play, and I see no reason why it should not be through the lengthening of the present arrangement. I support the proposed decisions.

Mrs. Ploix made the following statement:

For the third year in a row Chile is displaying a healthy rate of growth while experiencing a significant slowdown of inflation. However, beyond the prudent financial policies followed since 1985, positive terms of trade developments have also contributed to the favorable outcome of the extended arrangement. This is why Chile's request for a lengthening of the arrangement is a wise decision and we can approve it. A continuation of the extended arrangement is the best approach to ensure the maintenance of adequate financial policies in the near future.

In view of the downside risks associated with future terms of trade movements, the authorities should stand ready to consolidate the progress already made so as to be in a stronger position to face adverse external conditions. I will comment only on the areas where continued efforts seem most needed.

On the fiscal front, the portion of windfall gains that was not sterilized in the Copper Stabilization Fund has been used to cut taxes, without lowering overall revenues. This has proved to be an efficient way of stimulating growth through less costly imports and of bringing inflation under control as a result of a reduced value-added tax. The authorities intend to pursue and even speed up the process of reducing the size of Government. However, in the event that windfall gains are no longer available, the maintenance of a low fiscal deficit will require some drastic expenditure cuts.

In fact, the approach just mentioned, which the authorities are now contemplating, raises two questions. First, the feasibility of such a sizable fiscal retrenchment may be problematic; the authorities should therefore be careful not to act on the revenue side before securing an adequate level of expenditure savings. A second issue relates to the adverse impact that this restrictive fiscal stance could have on growth. It would take some time, even if favorable conditions exist, for the private sector to pick up the slack. I would appreciate any comments Mr. Donoso could make on this type of risk.

Another point on which some clarification would be beneficial concerns privatization. The brunt of the forthcoming fiscal adjustment is to be borne by current outlays, while competition should be intensified in the public sector by opening up certain activities to private operations. Does this mean that the privatization program is almost complete?

The monetary stance must continue to be monitored closely in conjunction with fiscal developments. As the authorities note, the recent upward movement in monetary aggregates may be attributed to a higher demand for money rather than to a loosening of policy. However, considering the need to raise savings in the private sector, an appropriate level of real interest rates must be maintained. Adequately tight monetary conditions seem all the more justified as the fiscal policy will be geared toward stimulating private sector activity. In this respect, we welcome the recent rise in real interest rates announced by the staff. The recent headway made in controlling inflationary pressures is another element that should convince the authorities to adhere to a stringent approach.

The exchange rate policy was also very helpful in bringing down price rises. Nevertheless, it is clear that favorable terms of trade developments have greatly facilitated the pursuit of a less active exchange rate policy. This approach must therefore be kept under review as copper prices evolve.

As regards the external position, the current account deficit has been reduced to a manageable size. However, price movements played a major role in this improvement. In volume terms, while nontraditional exports performed well over the recent period, import growth was more rapid. Such a pattern would no longer be sustainable in a situation where the terms of trade would deteriorate. Given the import content of capital formation in Chile, it would then become very difficult to maintain a sustained level of economic activity. The persistent weakness of the export sector should not be overlooked in assessing the medium-term viability of the balance of payments.

Obviously the debt burden is another element that has an important bearing on Chile's balance of payments viability. Undoubtedly the authorities can claim some success for their very active debt management. Interest payments in particular have been reduced significantly. Nonetheless, the overall debt service ratio is expected to remain stable, at about 30 percent of exports over the medium term. After several rescheduling arrangements, a bunching of principal payments is anticipated in the years ahead, to the point where financing gaps will re-emerge. It is thus understandable that the authorities are still exploring ways of reducing the stock of debt. The existing comfortable level of reserves provides an additional incentive in this direction. However, the authorities must remain aware that the re-establishment of a normal relationship with the banking community involves its agreement on the kind of debt reduction that can be worked out.

In conclusion, I believe that a fourth year under the extended arrangement can be used very efficiently by Chile to consolidate the impressive results already secured in its adjustment process.

Mr. Ismael said that he was in general agreement with the staff's analysis and appraisal of the Chilean economy, and he could therefore endorse the proposed decisions. Since the introduction in 1985 of the medium-term economic program supported by an extended arrangement, Chile's economy had continued to perform commendably. Thus, Chile had moved closer toward its medium-term objective of achieving sustained growth with external viability.

Nevertheless, the authorities would have to cope with some disquieting factors that remained, Mr. Ismael continued. First, the economy was still very sensitive to fluctuations in export commodity prices, especially copper. Second, external debt and the debt service burden remained high; the economy was therefore vulnerable to sharp increases in international interest rates. Third, domestic savings and investment, despite the progress achieved thus far, remained relatively low and would therefore be inadequate to support sustained growth. Under the circumstances, it was important to follow closely the medium-term strategy as outlined in the staff report. It was also important to pursue further diversification away from copper.

On fiscal policy, it was encouraging to note that the authorities were committed to continuing the successful approach of bringing down the public sector deficit through current expenditure restraint in the coming years, Mr. Ismael stated. He welcomed the authorities' policy of further tax reforms, such as reductions in the value-added tax and import tariffs. Since the progress of those measures would depend on the success in expenditure restraint, he agreed with the staff that it was important to monitor the impact of those measures closely and to take compensating actions whenever needed. It was also important that the overall fiscal objectives should not be compromised. As for the privatization of public enterprises, the significant progress reported by Mr. Donoso was heartening.

The main objective of monetary policy should continue to be aimed at controlling inflation, Mr. Ismael commented. Although the inflation rate had declined substantially during the first half of 1988, it should continue to be monitored closely, especially in relation to the developments in the exchange rate. He therefore shared the staff's view that the growth of the monetary aggregates should be slowed down to avoid any overheating of the economy, and he welcomed the authorities' commitment to tighten monetary policy whenever required. It was also encouraging that during the past year the solvency of the financial system had been restored.

On external policy, the authorities should continue to provide conditions conducive to promoting noncopper exports, Mr. Ismael remarked. In that regard, he welcomed the authorities' strong commitment to maintaining a competitive exchange rate. He shared the authorities' stance on the inappropriateness of further real appreciation of the peso from its current level. Also, he welcomed the efforts to reduce import tariffs and to make them uniform. The plan to phase out deferment of import payments would improve the relatively open exchange and trade system. He commended the authorities' plan to limit the growth of external debt through continued reductions of the current account deficit as well as through the pursuit of the debt conversion scheme. In addition, he supported the authorities' intention to use the windfall reserve gains for official debt exchange or buy-back operations.

Mr. Péroz observed that the process of adjustment under Chile's extended arrangement had been a remarkable and convincing success. The economy appeared well positioned at present to receive the full benefits of the policies pursued since 1985. Those benefits were becoming increasingly visible, as indicated by Mr. Donoso's comments that Chile was experiencing rapid growth in production, investments, and exports, with positive repercussions on employment and wages.

Looking ahead to a further year of adjustment under the proposed lengthening of the current extended arrangement, it was clear that some degree of priority would have to be given, again, to savings and investments over consumption, Mr. Péroz noted. The achievements of the past few years in strengthening public finances should make that effort somewhat easier. As other speakers had indicated, it was encouraging that lower taxes in 1988 and 1989 were not expected to lead to a reduction in public savings. Therefore, lower taxes, as well as the maintenance of real interest rates at levels consistent with international rates, should make the achievement of a substantial increase in national savings feasible during the current year.

On the external side, the importance of a continued reduction of Chile's debt, which was still in excess of 80 percent of GDP, could not be minimized, Mr. Péroz remarked. The Chilean authorities were correct in their determination to continue seeking further debt conversion arrangements. However, the other elements of a satisfactory solution to the debt problem, namely, a strong export performance and continued progress toward trade liberalization, would have to continue to play an active role also.

He agreed with Mr. Donoso that the progress made on the macroeconomic management front would justify a shift in emphasis in favor of structural reforms, Mr. Péroz said. The proposed lengthening of the current extended arrangement by one year, to provide support for a deepening of the process of structural reform, should contribute to a strengthening of the adjustment process. He could therefore go along with the proposed decision to lengthen the extended arrangement for the reasons mentioned earlier by Mr. Massé, Mr. Rye, and Mrs. Ploix.

Mr. Enoch made the following statement:

> The Chilean economy has generally performed well so far this year, with continued rapid growth, a moderation of the rate of inflation, and a substantial reduction in the current account deficit.
>
> Fiscal policy remains commendably tight with a nonfinancial public sector surplus of 1.1 percent of GDP projected for this year, along with a zero public sector borrowing requirement. Assessment of the underlying position, however, is complicated in this, as in other areas of the economy, by judgment as to what is the trend rate of the copper price and--given the remarkable divergence between the current price and the trend price--the speed with which the actual price will move toward this trend price. The estimate of the State Copper Company's (CODELCO) additional export revenues from above-trend prices in 1988, as shown in Table 9 of the staff report, would appear to suggest a windfall gain of about 3 percent of GDP this year and an underlying fiscal deficit of nearly 2 percent of GDP. While this fiscal position should in any case be sustainable while copper prices remain at their present high level, the underlying deficit will become increasingly important as they fall. If copper prices fall back to their trend level, as projected, in 1989, it would imply a need for significant additional fiscal measures to meet the fiscal targets envisaged for 1989. Those measures are particularly important because of the impact of the tax cuts implemented this year, whose full effects will not be felt until next year, and suggests a considerable need for prudence on the fiscal side in the Chilean economy.
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> The efforts of the authorities to reduce the extent of the state's involvement and the further progress on privatization reported by Mr. Donoso are welcome. However, I have doubts about some aspects of the implementation of this policy. In particular, with respect to the policy of eliminating two jobs for every new job approved in the public sector, I do not see why their elimination should await the creation of new jobs; if there are no unnecessary jobs, the removal of two necessary jobs to make way for each new employee could well prove counterproductive, and one would expect that some change in this policy might be contemplated.

On the monetary side, the rapid growth rate of narrow money in 1988 is a little worrying. While this might reflect in part an increase in demand for money as a result of lower inflation, there would seem to be a real risk that it might have a lagged effect on inflation in the latter part of the year, as tighter monetary policies late last year helped to bring about the current year's reduction in inflation. The recent substantial increase in the minimum wage would further add to inflationary pressures. I welcome the news that the Central Bank raised real interest rates in July, and there may well be scope for some further increase in real rates.

Externally, the major improvement in the current account deficit this year is welcome. However, given the present high level of external obligations, an even larger improvement, in line with the benefits from changes in the external environment, might have been considered prudent; the actual improvement has been equivalent to little more than half the windfall gains from the unanticipated improvement in the terms of trade, the remainder having financed substantially higher import volumes.

The medium-term balance of payments projections continue to give some cause for concern, in terms of the continuation of large current account deficits and the reappearance of major financing gaps in 1991. In fact, the current account deficits projected for 1990-92 have been raised further since the last review. The major reduction in the debt/GDP ratio now projected over the medium term is a considerable improvement over earlier projections and is very welcome; however, the basis for the improvement is far from clear. Substantially faster GDP growth, and to a lesser extent higher direct investment, appears to account for about half of the improvement, but I would welcome some clarification from the staff or from Mr. Donoso as to what other factors are involved.

There are inevitably some significant downside risks to the projections, notably the risk that copper prices could fall significantly below their projected levels over the next two to four years. According to the IFC paper issued three weeks ago on the Escondida copper project in Chile--to which the staff referred earlier--numerous new mine expansions and start-ups are scheduled for 1988-90. The confluence of a cyclical decline in copper demand and a transitory bulge in supply could produce a deep trough in copper prices. As well as representing a risk to the external projections, this possibility reinforces the need for fiscal caution and suggests a need for more diversification of exports away from copper than envisaged--Tables 7 and 9 suggest that copper will still represent roughly the same share of total exports in 1993 as in 1986.

Regarding the proposed extension of the arrangement, we have some reservations about this approach in general, but in the case of Chile, with its good record of performance under its Fund-supported program and its continuing balance of payments need, we can support the request. While I am not fully convinced of the appropriateness of continuing end-1986 margins in the performance criteria, I can go along with the extension as it will allow sustained policy implementation in a medium-term framework; the conditionality envisaged is tighter than that proposed under our recent extended Fund facility decision, with quarterly targets and a further review in six months; the proposed augmentation of Chile's use of Fund resources is relatively modest--less than the member might have expected to obtain had it sought a stand-by arrangement--and Chile will make net repurchases over the period of the extension. I can therefore support the proposed decisions.

Mr. Vasudevan made the following statement:

The proposed lengthening of Chile's extended arrangement by one year, being the first of its kind, is an important aspect worthy of attention. The idea of lengthening extended arrangements by one year received broad support from both the Board and the Interim Committee, in cases considered appropriate. Chile's request for a lengthening of its current extended arrangement deserves our support because such a step would help consolidate and, in fact, improve upon the gains in adjustment accruing since 1985, further reduce the debt overhang, and stimulate national savings. More important, it would help ensure that the recent major tax reduction measures would have the envisaged impact and that, in case the actual effects differ substantially, compensating actions could be taken. It also provides the opportunity to continue to proceed with the structural measures, such as improving the role of the private sector and increasing the debt buy-back operations. Moreover, it might be argued in favor of the one-year extension that it involves very little use of Fund resources, while the expected gains are likely to be considerable. The proposed purchases amount to about half of the repurchases falling due during the lengthened period. Outstanding Fund credit to Chile is expected to decline as a percent of quota from the existing level.

Generally an approval of a request for the use of Fund resources is followed immediately by a purchase by the member. In this case, assuming that the proposed request for an extension of the arrangement period is granted, such a purchase would not take place. We wonder whether this is because the remaining purchase under the extended arrangement itself would be made after August 9 upon observance of the performance criteria for end-June 1988. If so, is there any reason why a purchase under the extension could not be synchronized with the last purchase under the existing arrangement?

The staff has proposed a purchase of only SDR 75 million for the fourth year, amounting to one tenth of the original commitment of resources under the extended arrangement. We would appreciate any comments that the staff may have on the access for the fourth year.

We generally agree with the staff appraisal regarding the economic program for 1988-89, which envisages a sharp increase in national savings from 12.6 percent of GDP in 1987 to 15.1 percent of GDP in 1988. Private sector savings over the program period are estimated to rise by 3.1 percentage points in relation to GDP. Such an increase will not be realizable unless financial policies are in place with positive real interest rates. The envisaged restraint in fiscal expenditures--in current outlays--is considerable and will give sufficient room for effecting tax reductions, which are important structural measures. The envisaged rise in capital outlays over the program period appears to be largely dictated by the consideration of maintaining growth. The cuts in taxes on gasoline and employers' wage bills and the lowering of the value-added tax rate are welcome, since they will help to reduce the inflation potential while the cuts in import tariffs should promote exports.

The program envisages further privatization, but as the staff notes, this process has tended to raise the underlying public sector deficit. As observed in the background paper, public enterprises in Chile are generally managed efficiently. Their privatization therefore need not imply that the privatized units would affect private savings in a significantly positive way. If the impact on overall savings was large enough, there would be ample justification for privatization; otherwise, the country has to be prepared to face, at least in the short run, a possible deterioration in the fiscal position. We wonder whether this situation could have been avoided by properly planning the timetable of privatization.

In regard to monetary policy, the program targets seem to be broadly consistent with the objective of promoting price stability. However, the rates of growth of both narrow and broad monetary aggregates almost coincide in both program years, 1988 and 1989. If interest rates remain positive in real terms--an objective that needs to be pursued to ensure growth in private savings--growth in broad money should be somewhat higher than that in narrow money, on the basis of the experience of the past four years. We would appreciate any staff comment on this issue.

We agree with the staff that a further real appreciation of the Chilean peso from its current level would not be advisable, from the point of view not only of maintaining external competitiveness but also of promoting price stability. As the copper price windfall is expected to decline in 1989, the external current account deficit will rise compared with that in 1988 but will represent a reduction of the underlying deficit. The medium-term balance of payments outlook appears somewhat manageable, although it is clear that it is sensitive to copper prices and interest rates and is dependent on the refinancing of some of the obligations that will fall due in 1991 through 1993. We note the authorities' use of interest rate hedging as a method of debt management; but this will not be enough. It is important to reduce the stock of debt so as to achieve external viability, and for this reason the authorities' intention to use the windfall reserve gains from the present high copper prices for debt buy-back appears worthy of pursuit. We support the proposed decisions.

Mr. Dallara made the following statement:

I commend the Chilean authorities for the continued progress that they have made in pursuing the growth-oriented adjustment effort of recent years. Not only has the external imbalance been significantly reduced, but this has occurred in the context of steady and what appears to be sustainable economic growth. At the same time, Chile has demonstrated that a combination of a market-oriented approach to debt management along with implementation of prudent macroeconomic and some appropriate structural policies can reduce a country's debt service burden, even in the case of a country as heavily indebted as Chile.

The program for 1988 and 1989 seems broadly appropriate, with continued prudent macroeconomic policies and structural reforms. Achievement of the 5 percent growth target and a decline in the current account deficit from prior years, whether or not one counts the copper price windfall this year, should be feasible. In that connection, we commend the authorities for their continued prudent management of the copper price windfall. However, and despite the staff's earlier comments, we are not fully convinced that the inflation rates of 11 percent and 8 percent in 1988 and 1989, respectively, will be achieved. In our view, this underscores the need for the authorities to continue to monitor money and credit aggregates very carefully and to take further corrective action, if necessary, to avoid any feedback effect on inflation from overshooting currency depreciation.

Past efforts have included substantial structural reforms, including tax reform, privatization, trade and tariff reform, and liberalization of foreign direct investment policies, as well as banking system liberalization. We welcome the continued efforts in many of these areas embodied in the program of the authorities over the next year or two. This includes importantly, a general reduction in the role of Government in the economy, with the revenue and spending ratios to GDP declining significantly, as well as continued important efforts in privatization.

Balance of payments developments continue to show some important favorable trends, with the medium-term outlook looking somewhat better than previously estimated. While a gross financing gap will re-emerge in 1991, when the 1986-87 commercial bank debt rescheduling grace period expires, commercial bank refinancing of maturing principal and the reversion of interest payments to six-monthly periods could be sufficient to cover a large part of this gap.

In part, of course, the medium-term outlook appears favorable not only because of the domestic policies but because of the approach the authorities have taken to debt management. Debt conversions over the past three years have been very substantial. In this connection, we hope that the temporary suspension of normal debt conversions, owing to their effect in widening the spread between the exchange rates, will be short lived. In addition, the idea of utilizing approximately half a billion dollars of the copper windfall for a possible buy-back or official debt conversion does seem, at first glance, to be sensible and definitely worth pursuing.

We continue to be impressed by Chile's economic performance and the broad efforts that the authorities continue to pursue. However, there are some policy and procedural questions associated with the request for a lengthening of the extended arrangement that we, like other Directors, find somewhat troublesome. In particular, we share some of the doubts that have been expressed by Mr. Posthumus, although, with some reluctance, we are able to support the one-year extension. It is clear that this kind of extension, or an extension in these circumstances, was not necessarily envisaged when the Board discussed the possibilities for revitalizing the extended Fund facility in March 1988. Nevertheless, it is clear that a case can be made for such an extension because of the circumstances surrounding this particular instance.

The extension would have been more appropriate if it had been combined with a more explicit incorporation of structural adjustment measures into the performance criteria and/or in the review clause of the program. We were somewhat disappointed not to have seen in the program extension an explicit incorporation, for example, of commitments on privatization. Perhaps, in the circumstances, even an explicit indication that adequate progress on privatization could be incorporated into a review clause would have been appropriate. Alternatively, a commitment on the timing of the phaseout of the minimum import financing requirement might have been appropriate. It is not clear which alternative would have been the most appropriate, but we encourage the authorities and the staff to give attention to these issues in the upcoming review, and we hope that if similar circumstances should arise in the future, a greater effort will be made by the authorities and the staff to incorporate explicitly efforts in these areas into the framework of the extended arrangement.

We also continue to be somewhat bothered by the continued carrying forward of performance criteria margins, and we would appreciate further explanation from the staff of why no rebasing was done in connection with this program.

On the issue of Chile's future relationship with the Fund, we had, in February of this year, expressed some doubts about the need for an extended arrangement beyond August. In the circumstances of Chile's relations with the commercial banks, however, we can see and understand the merits of the case that has been made. Nevertheless, the situation argues perhaps even more strongly for consideration by the authorities of the possibilities of a somewhat different relationship with the Fund following the expiration of this extended arrangement. We hope that consideration of techniques such as enhanced surveillance and/or perhaps a classical stand-by arrangement, if necessary, could be given to change Chile's relationship with the Fund into one which is perhaps more reflective of the substantial and steady progress the country has achieved in recent years toward restoring a viable payments position with continued economic growth.

Mr. Dai made the following statement:

From the staff report and Mr. Donoso's statement, it is encouraging to note that Chile's strong economic performance has continued in the context of further financial adjustments and structural reforms. More progress has been made in tightening fiscal policy, increasing domestic savings, strengthening external competitiveness, and reducing the external imbalances. The Chilean authorities should be commended for their sustained commitment to coherent economic management and their strenuous efforts in implementing economic adjustment. Since I am in broad agreement with the staff's appraisal and the thrust of the economic program proposed by the authorities, I will make only a few comments on Chile's economic development.

Strong growth continued throughout 1987 and into the first half of 1988 as a result of continued fast growth in noncopper exports and, to a greater extent, a price-related surge in copper exports. While the trend of a strong economic performance is welcome, it is also worth noting the economy's continued vulnerability to external developments. Therefore, two areas may warrant continued and closer attention by the authorities: an overreliance on copper exports and a still high level of external debt.

Although much has been achieved in the area of export diversification, the large share of copper exports--accounting for more than 42 percent of total exports in 1987--indicates that the dependence on this one single commodity is still rather heavy. The problem is especially noticeable when viewed in the context of the authorities' medium-term economic program, whose economic targets and policies are centered around the projected long-term trend of copper prices. Certainly, the Copper Stabilization Fund could absorb some of the impact of fluctuations in copper prices. But, as indicated in the staff report, the medium-term outlook is likely to be in jeopardy if variations in copper prices deviate substantially from the projected trend prices, given the high sensitivity of the outlook to assumptions of copper prices.

The same risks exist with regard to prospective interest rate fluctuations. Although remarkable progress has been made in reducing the stock of external debt through various approaches, Chile's outstanding debt in terms of percentage of GDP or exports remains relatively large. In view of this large debt burden and the existing uncertainty in international capital markets, the prospects for the external position would also probably be adversely affected should rising interest rate developments be off track.

It is apparent, therefore, that Chile's economic development and external viability are, to a great extent, subject to changes in exogenous factors beyond the control of the authorities. To redress the structural vulnerability of the economy, it will be necessary for the authorities to deepen the structural adjustment and maintain current policies in order to strengthen further the economy and achieve the goal of sustained growth with a viable external position. However, it is essential at this stage for the authorities' continued adjustment efforts to be supported by the international community. I believe, as Mr. Donoso stated, that a lengthening of the extended arrangement would be greatly beneficial to the country's economic reform program. I therefore fully support the authorities' request and the proposed decision.

Mr. Yoshikuni made the following statement:

I welcome this first opportunity to discuss the lengthening of an extended arrangement up to four years, made possible by the amendment to the extended Fund facility, approved by the Executive Board on June 6, 1988. Considering the central role of the Fund in the overall debt strategy, this chair has attached great importance to the strengthening of the facility. Accordingly, we appreciate the staff's efforts with respect to Chile's comprehensive program, which is the first candidate for a lengthened extended arrangement.

I strongly commend the Chilean authorities for their efficient management of the economy despite some external debt problems. As the staff and Mr. Donoso state clearly, the performance of Chile is conspicuous among Latin American countries with respect not only to major economic indicators but also to Chile's relationship with external creditors as evidenced by the successful implementation of the various debt conversion and debt buy-back schemes. Particularly impressive is the fact that the good record of the economy has been supported by the far-reaching economic and structural adjustment program under the extended arrangement.

Nonetheless, in view of the relatively large external financial gap the authorities will continue to face in coming years, there is no room for complacency. Further adjustment efforts aimed at reducing the current account deficit and the external debt in relation to GDP are needed. Taking account of the points just mentioned, the extension of the arrangement can be considered a proper approach to restoring Chile's external viability. As regards the remarks by Mr. Posthumus, while I have some sympathy with his strict interpretation of the amendment to the decision on the extended Fund facility, I would rather support Mr. Rye's more positive approach. In any case, I would appreciate the staff's elaboration on this point.

Having said that, I would like to touch briefly upon several issues. First, on copper price assumptions, the strong economic performance of recent years is, to a large extent, due to the unexpectedly high price of copper, which accounted for more than 40 percent of total exports of the country. The Copper Stabilization Fund provides a safeguard mechanism with regard to fluctuations in copper prices; nonetheless, considering the uncertainty facing the world economy, efforts should be made to decrease the dependence of the export sector upon copper. The recent remarkable increase in noncopper exports is encouraging and should be promoted further. Also, I fully agree with Mr. Enoch in urging a prudent fiscal policy stance in this regard.

Second, in view of the need to contain the growth of monetary aggregates substantially in 1988 and 1989, the Central Bank should continue to be cautious. Although the reduction in the real interest rate since the end of 1987 was an appropriate measure in light of the decline in world interest rates, a similarly flexible stance should be maintained during periods of rising interest rates in view of the relatively high level of money supply. I welcome the recent staff information that real interest rates have increased. However, while the upward adjustment of ceilings on the net domestic assets of the Central Bank with regard to debt conversion is a very sophisticated mechanism, the possible effects of the debt conversion operation on the growth of the money supply should be examined carefully.

Third, I agree with the staff that further real appreciation of the Chilean peso would not be advisable. The continuation of multiple currency practices is not encouraging, however. As Mr. Posthumus pointed out, the opportunity of the lengthening of the extended arrangement could have been taken to incorporate into the program the elimination of such practices along with the acceleration of the elimination of the minimum financing requirement for imports as suggested by the staff. Perhaps the staff could elaborate on this point.

I commend the authorities for their excellent management, and I look forward to further improvement of the Chilean economy under the four-year extended arrangement. I support the proposed decisions.

Mr. Ovi commented that on the issue of a one-year lengthening of the current extended arrangement, the staff report was brief. Basically, the staff stated that the policies followed would contribute to the attainment of the objectives of the program and thus it supported the authorities' request. He asked the staff to state more explicitly the grounds on which it had arrived at that conclusion.

At the Board's discussions earlier in 1988, he had been among those prepared to show flexibility regarding the scope of the extended Fund facility, Mr. Ovi recalled. Following several rounds of discussions, however, the Board had reached a compromise, as reflected in the Chairman's summing up of the March 31, 1988 meeting. Without denying the beneficial effects to Chile, he wondered whether the suggested lengthening fully conformed to the intentions behind that summing up. More generally, he wondered whether the Board was taking a decision that day to accept the lengthening of all extended arrangements from three years to four years, if a country so requested.

Moreover, it had been pointed out during the Board's discussions in the spring that the emphasis on structural reform increased the importance of close collaboration between the Fund and the World Bank while respecting their specific areas of competence, Mr. Ovi said. He wondered whether there had been any consultation with the Bank on the specific structural reforms planned for the fourth year. In that area also, the staff report could have been more explicit. He would appreciate hearing the staff's reaction to both issues.

Mr. Goos said that he could associate himself with the staff's analysis and recommendations. He could also go along with the proposed lengthening of the extended arrangement. Although he shared some of the concerns expressed by Mr. Posthumus and Mr. Ovi, in the final analysis he could go along with Mr. Rye's views.

He shared Mr. Enoch's concerns regarding the viability of the medium-term projections in the context of the financing gaps envisaged for the years beginning in 1991, Mr. Goos said. Those gaps underlined the utmost importance of continued financial restraint.

The staff representative from the Western Hemisphere Department said that the staff agreed that the existence of a wide spread between the parallel and official exchange rates could have a perverse effect if it persisted for a long period. The authorities believed that the parallel market could serve as a shock absorber for short-term capital outflows that might be provoked by, for example, political perceptions, and over the lifetime of the extended arrangement the spread between the parallel market and the official market had widened for brief periods. In 1985, when approval of the extended arrangement had been delayed pending finalization of a financing package, including financing from the World Bank, there had been a short period during which the parallel market rate had depreciated to about 20 percent below the official market level. However, when the financing package accompanying the extended arrangement had been put in place, the gap had been closed. The staff had emphasized in discussions with the authorities that the persistence of a large spread led to leakages between the markets and that macroeconomic policies should be oriented toward keeping the spread narrow. In the future, the authorities would possibly open up the capital account and eventually eliminate the existence of the parallel market, but meanwhile, they would prefer to retain it as a safety mechanism.

One of the basic factors behind the impressive growth of domestic savings in Chile in the past few years had been the policy of maintaining positive real interest rates, particularly for longer-term instruments, the staff representative continued. That policy, together with a relatively low inflation rate--at least by South American standards--had been reflected in the strong growth of monetary aggregates and a restoration of confidence in the banking system. Thus, the interest rate policy had been a strong pillar of the successful performance of the economy.

In economic terms, revenue from the privatization of public enterprises over the past two to three years had been about the equivalent of 1 percent of GDP a year, and there was scope for that pace to continue for some years to come, the staff representative remarked. The privatization process had occurred mainly through sales of shares to the Chilean general public; but in some cases there had been direct bids, including bids for companies or for blocks of shares, by foreign investors. For example, recently an Australian investment group had purchased 30 percent of the telephone company in a single block.

It was because the policy of eliminating two jobs for one in the public sector could lead to undue rigidity that the rule had been applied selectively, the staff representative said. Nevertheless, the rule gave the Chilean Treasury power to enforce discipline among all government agencies.

Several Directors had commented on the medium-term risks to the program, especially those arising from the copper price cycle, the staff representative noted. The staff agreed that there was a probability that copper prices would be affected by the large increase in world capacity expected to go onstream in the next few years. A good proportion of that increased capacity would in fact be located in Chile; the Escondida project was equivalent to about 4 percent of the world's total supply of copper, and other projects in Chile would also increase copper supplies. Because of the copper price cycle risk, the authorities had been and would continue to be conscious of the need to promote export diversification as quickly as possible. The policies put in place under the extended arrangement were producing such a result: in particular, a competitive and predictable exchange rate policy and the low, uniform external tariff policy were resulting in rapid growth of nontraditional exports.

The question had been raised about the feasibility of maintaining a strong fiscal position in the future, particularly through further reductions in current expenditures, the staff representative said. To date, the strengthening of the current position of the budget had resulted mainly from restraint on the wage bill. That policy, which had produced a growth dividend each year, was expected to continue. Another aspect was that, with the elimination of the public sector deficit, the growth of interest payments was low, thus creating room for maneuver not found in other countries. There would likely be continued scope in the future for further tax reductions, and the authorities would monitor the situation closely.

As to the phasing of purchases, the requested lengthening had been conceived as an extension of the existing arrangement, the staff representative explained. The last purchase under the present arrangement would take place in August, based on June performance criteria. The staff saw no reason for any front-loading of the extension, and the next purchase would take place three months later on the basis of end-September performance criteria, continuing the phasing of the existing arrangement. The staff considered that access during the 12-month period would amount to about half of the repurchases falling due, or about SDR 75-80 million. The arrangement would support the process of structural diversification and underwrite the Chilean program for a further year, although in circumstances in which the balance of payments position was temporarily strong. It was therefore reasonable to expect that during that period, although Chile did not yet have fully restored access to the international financial market, there should be a net repayment to the Fund.

The program projections expected the rate of growth of narrow money to slow down to about the same as the rate of growth of broad money, the staff representative said. At present, the demand for narrow money was strong because inflation was slowing down; therefore, the opportunity costs of holding currency and demand deposits were less than in the past.

On the question of performance criteria, again, as the present arrangement was an extension and the Board decision on lengthening provided for some flexibility in applying performance criteria and benchmarks, the staff had considered it simpler and more logical to maintain the same process of monitoring as had been the case for the existing arrangement, especially as the Chilean authorities followed the program according to quarterly financial benchmarks, the staff representative from the Western Hemisphere Department explained. Chile's record of implementing structural reform benchmarks--particularly with respect to privatization--gave assurance that there was no pressing need to formulate structural benchmarks in terms of, for example, specific progress in privatization, since the process was complex and involved a subscription on shares on the market and timing constraints. In view of Chile's track record, the staff considered that the structural policies would be implemented within the time frame of the program without the need for such a benchmark. The phasing of the elimination of the 120-day financing requirement for imports had already been agreed, and it was hoped that during the next program review, the authorities would agree to accelerate the established timetable. The argument for rebasing the program had not been compelling because experience indicated that Chile had operated a program with existing margins. The design of programs usually included a certain amount of explicit or implicit margins. In the present case, the staff had built on the existing program's structure, which included margins as well as features like the Copper Stabilization Fund, and the staff had found no valid reason to change that procedure.

The Deputy Director of the Exchange and Trade Relations Department observed that the present discussion had re-emphasized that, despite the progress made, Chile continued to have a serious payments imbalance, as recognized by external creditors. For that reason, the possibility of finding voluntary financing to cover the financing gap that would re-emerge in 1990 was not assured. Furthermore, the current strong position was nevertheless fragile as it depended on high copper prices which could turn around, particularly as at the trend copper price the current account was still in substantial deficit. Thus, the need for continued Fund support was clear. The emphasis on the strong structural components of Chile's program, together with the need to strengthen confidence in the financial markets in order to restore more normal relations with creditors, made a lengthening of the extended arrangement a much more natural progression in the relationship between Chile and the Fund than other steps might have been.

The question then arose whether the lengthening followed the policy guidance provided by the Board during the discussions on the extended Fund facility, the Deputy Director continued. The staff believed that it did. Perhaps an extension of the present kind had not necessarily been envisaged during the March discussions, but it had been discussed and had not been ruled out. When the Board had discussed the proposed decisions on the extended Fund facility on June 6, that view had become much clearer. In considering the appropriate reasons for extending an arrangement, there had been some emphasis on interruptions that might entail policy shifts, and the Acting Chairman had said that there could be a case--and he had referred to the Chilean case--when extension for one year could help the authorities not only sustain the domestic policy adjustments that had been begun under the three-year extended arrangement but also could facilitate external financing. The Acting Chairman had also stated at that time that it was not the Board's expectation that all extended arrangements would be lengthened by one year at the request of the country concerned but that there could be circumstances that would require lengthening.

The Acting Chairman said that it was useful to emphasize that extended arrangements would continue to be approved for a three-year period. A decision to lengthen an extended arrangement would be made only toward the end of that period.

Mr. Dallara commented that Chile's broad array of structural adjustment efforts in recent years was impressive, and he could understand the staff's reaction that there was little sense of urgency to build in structural performance targets exclusively as performance criteria. Nevertheless, Chile had been almost equally impressive in other aspects of its macroeconomic performance, but consideration had not been given to deleting certain macroeconomic targets that were an essential part of the Fund's conditionality. Therefore, he had not been fully convinced by the staff's argument, particularly when the lengthening was occurring within the context of the Board discussion on the revitalization of the extended Fund facility in March 1988. He could see the dilemma facing the staff: on the one hand, there was a risk that, because of the unique situation surrounding the present lengthening, only certain elements of the revitalization would apply; on the other hand, techniques were being followed that had evolved over the course of the three-year extended arrangement and that were comfortable and effective. Although he understood the conflicting considerations that might have been brought to bear on the agreed approach, he nevertheless hoped that the revitalization of the extended arrangement could be viewed as a package that included reinforcement of the emphasis on sustained implementation of policy, particularly in the area of structural reforms.

Mr. Donoso said that the lengthening of the extended arrangement had been requested because of the delicate financial situation in Chile. On the previous day in New York, modifications to the country's contracts with commercial banks had been signed. They included a reduction in the spreads in the case of new money contracts and some other contracts, allowing Chile to cover its indebtedness, and they provided flexibility so that Chile could have access to new financing on the basis of instruments issued with special collateral; moreover, the authorities could spend reserves on buy-backs or utilize resources to purchase insurance against interest rate increases. In general, the contract modifications reflected the banks' perception that Chile remained in a difficult position and that it would require special treatment in overcoming its indebtedness. The country continued to need the support of the Fund, because it did not have access to financing on a voluntary basis. Of course, he hoped that soon Chile would not require that support. For example, investment intentions of private enterprises were encouraging, as information on 18 projects to be developed in the following three years showed that investment would amount to US$4.2 billion, raising exports by US$1.4 billion a year. Other factors, such as Chile's access to markets, general world economic conditions, and interest rates, were also important, but the scenarios indicated that Chile must continue its major efforts during the period and would require special support. The test, with respect to the debt problem and access to financing, would arise in 1991. Foreign investment indicated that the country had recovered its access to certain segments of the market, but while a supply of credit was available, bank financing rates were not reasonable.

In the external sector, the current account deficit of 1.8 percent of GDP indicated for 1988 was projected to rise to about 2.7 percent of GDP in 1993, Mr. Donoso continued. Moreover, it could not be assumed that the amortizations falling due in 1991 could be faced easily. While reserves currently amounted to ten months of imports, they included all repurchases to be made to the Fund, amounting to about SDR 1 billion. Those reserves would also be used to buy back debt as part of the country's approach to solving its indebtedness, and to reduce the current account deficit.

In sum, while progress had been made, difficulties remained, Mr. Donoso stated. It was important to incorporate explicit performance criteria, but in the area of structural reforms, it was difficult to define criteria. Reaching a political consensus to implement structural reforms could be hampered by opposition from sectors that would be directly affected. For example, privatization of enterprises could result in changes in administration and staffing, which could weaken support for those reforms, despite their obvious value in increasing exports and the trade surplus. Similarly, if the Chilean people were aware that to increase the surplus in the trade balance it would be necessary to raise the savings rate and consequently to cut wages or reduce employment, support for the structural reforms would weaken. Thus any action in the area of privatization would require caution to avoid opposition to the reform. The ongoing privatization process of the electrical companies allowed the authorities to continue to determine the tariffs and thus to inspire the confidence of prospective purchasers; by providing stability to the system, their participation in that market was encouraged. To reduce the size of the public sector and to promote investments, many fields had to be opened to private sector participation. Much had been accomplished in recent years to the point where at present the private sector was providing infrastructure for health services, education, irrigation, and so forth. Nevertheless, it would take time to reduce public sector wages, and it was not feasible to include the reduction as a performance criterion within a six-month time frame.

Since 1981 the social security system had been administered by private enterprises, following complex legislation that ensured the system's stability, Mr. Donoso continued. In 1987, reforms had been required to change the tariff structure to ensure coverage of the real costs of operating the system. Obviously, privatization was an ongoing process that required monitoring, and the establishment of specific targets for a certain period was difficult.

In the context of the World Bank's structural adjustment loan, structural reforms had been defined--but not as performance criteria--for specific variables such as the rate of growth of noncopper exports, including a review of the policies to stimulate their growth, saving in the public sector, and exchange rates, all of which pertained to the area of macroeconomic policy, Mr. Donoso said.

With respect to fiscal policy, it had been asked whether it would be possible to maintain the level of investment indicated in the staff report, Mr. Donoso noted. Because of the privatization of enterprises, investment in many areas--including health, social security, and education--would take place without public sector involvement. Of course, the authorities would strive to increase efficiency in the administration of the public sector so as to allow the possibility of lowering taxes and reducing expenditures. But other considerations arose in that connection: for example, the infant mortality rate in Chile was perhaps the lowest in Latin America, following two decades when it had been among the highest in the region. It was important to consider what measures the economy could sustain in the present difficult situation.

Chile had undertaken an enormous adjustment, Mr. Donoso remarked. For example, in 1981 the trade deficit had amounted to US$2.7 billion, and in 1983 the trade balance had shifted to a surplus of US$1 billion, a change amounting to 20 percent of GDP. Moreover, figures on the components of demand from 1985 to 1987 showed that gross domestic savings in real terms had increased by 40 percent, gross domestic investment had risen by 38 percent, while net exports had increased by 45 percent. As GDP was growing by about 12 percent, consumption was the residual variable, and it was growing moderately, although slower than projected in spite of the high price of copper during the past year. Lower consumption and higher expenditures at the aggregate level had resulted from investment in diversification.

The staff had reported that the exchange rate during the year had not appreciated, Mr. Donoso continued. The staff used consumer price indexes for Chile and its trading partners to calculate real exchange rates. The Central Bank had a different methodology; using wholesale price indexes, an additional depreciation of about 3 percent in the exchange rate was noted for the first four months of the year as a result of lags in incorporating external inflation, indicating that the authorities had not relaxed their posture on exchange rates.

Short-term interest rates were defined in nominal terms and therefore if inflation was higher than had been expected when banks set those rates, the result was a negative real interest rate on short-term instruments, Mr. Donoso said. But for central bank instruments with 90-day, 180-day, and one-year terms, real interest rates had been maintained at a positive level; for example, they had been increased when pressures had arisen in the parallel market.

Public sector controls were oriented toward maintaining adjustment by supporting increased investment and a higher trade surplus, Mr. Donoso remarked. In the private sector, the US$1 billion Escondida copper project would raise exports by more than US$3 million a year. Those figures implied that Chile's economic situation would remain heavily dependent on copper prices.

With regard to Chile's performance criteria margins, the country remained vulnerable, Mr. Donoso commented. Under its rescheduling agreement with commercial banks, if the country did not comply with targets, not only would the next quarter's new money be lost, but the contract would require Chile to revert to six-monthly payments of interest, and arrears would accrue on a daily basis. The authorities had decided to generate their own resources to avoid that situation. Another argument was that it was difficult to avoid overperformance; to do so the country's efforts would become constrained and Chile would not have the flexibility to achieve its goals in a timely manner.

The Acting Chairman made the following summing up:

> Executive Directors were in broad agreement with the staff appraisal. They commended the authorities for the significant economic progress made since the inception of the extended arrangement in 1985. In particular, they noted that GDP growth has recovered to a rate of about 5 percent a year, external debt has continued to decline, and inflation has come down significantly, especially in recent months. Directors noted that the substantial improvement in domestic savings and investment since 1985 reflected not only improved fiscal and monetary policies

and a more competitive exchange rate, but also the wide range of structural reforms that had been implemented. The strength of foreign direct investment also provided evidence of improved confidence in the Chilean economy.

Directors observed that fiscal, credit, and exchange rate policies continued to be handled in a prudent manner and that the windfall from the high copper prices was being absorbed by the Copper Stabilization Fund. Directors noted that the application of this mechanism in 1988 would lead to an overall public sector surplus and a sizable gain in net international reserves, thus sterilizing the expansionary impact of high copper prices. They added that it would be important to retain this feature in future programs to help maintain the conditions for stable and balanced growth.

A number of Directors commended the efforts of the authorities to diminish the size and scope of the public sector in order to enhance incentives for private savings and investment. The lowering of the import tariff this year would help exports and reduce economic distortions, while the decline of the value-added tax rate was in accord with the objective of reducing the pressure of taxation and also would contribute to a better price performance this year. Nonetheless, Directors urged the authorities to be prepared to take action if needed to ensure the attainment of the targeted increases in domestic savings and investment.

Many Directors noted the rapid growth of narrow money and thus welcomed the recent interest rate increases; they emphasized the importance of the authorities' readiness to tighten credit conditions if inflation or import growth should accelerate, or if the pressures on the parallel exchange rate persist.

Directors were impressed by Chile's progress in reducing its total outstanding external debt through the narrowing of the current account deficit and large-scale use of market-oriented debt conversion mechanisms. They noted that the new agreement with commercial banks gave Chile the flexibility to use a limited amount of reserves to buy back external debt, which would help to reduce the debt burden further. Nonetheless, they commented that Chile's external position remained vulnerable to fluctuations in interest rates and in copper and oil prices, and significant financing gaps are projected to emerge after 1990. Therefore, Directors welcomed the authorities' commitment to maintain sound financial policies and to continue the process of structural change, with the aim of further strengthening the external position while achieving sustained economic growth.

Directors noted that Chile had taken the first step in its plan to phase out the 120-day minimum financing requirement for imports, and they encouraged the authorities to continue the process of eliminating this restriction.

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

The Executive Board then took the following decisions:

Extended Arrangement - Review and Lengthening

1. Chile has consulted with the Fund in accordance with paragraph 12 of the extended arrangement for Chile (EBS/85/122, Sup. 3) and paragraphs 3 and 4 of the letter of December 29, 1987, from the President of the Central Bank of Chile and the Minister of Finance, in order to review the implementation of the measures described in that letter and attached memorandum.

2. The letter dated July 12, 1988 from the President of the Central Bank and the Minister of Finance, together with the annexed Memorandum on the Economic Policies of Chile, shall be attached to the extended arrangement, and the letters dated July 9, 1985, January 20, 1986, June 18, 1986, December 15, 1986, June 30, 1987, and December 29, 1987, together with the respective annexed Memoranda on the Economic Policies of Chile, shall be read as supplemented and modified by the letter dated July 12, 1988, together with its annexed Memorandum on the Economic Policies of Chile.

3. At the request of Chile, its extended arrangement is lengthened through August 15, 1989. Accordingly, paragraph 1 of the extended arrangement for Chile is amended by substituting "four" for "three," and by substituting "SDR 825 million" for "SDR 750 million."

4. Chile will not make purchases under the extended arrangement:

(a) during any period after August 15, 1988 in which the data at the end of the preceding calendar quarter indicate that:

(i) the cumulative limit on the overall deficit of the nonfinancial public sector, as specified in paragraph 5 and Table 1 of the memorandum annexed to the attached letter of July 12, 1988; or

(ii) the target on the international reserves of the Central Bank, as specified in paragraph 6 and Table 3 of the memorandum annexed to the attached letter of July 12, 1988

is not observed; or

(b) during any period after August 15, 1988 in which:

(i) the ceiling on the net domestic assets of the Central Bank, as specified in paragraph 6 and Table 2 of the memorandum annexed to the attached letter of July 12, 1988; or

(ii) the ceiling on the contracting, rescheduling, and guaranteeing of external debt by the public sector, as specified in paragraph 9 and Table 4 of the memorandum annexed to the letter of July 12, 1988; or

(iii) the ceiling on the stock of short-term external debt owed by the nonfinancial public sector and the Banco del Estado, as specified in paragraph 9 and Table 5 of the memorandum annexed to the attached letter of July 12, 1988;

is not observed; or

(c) after February 14, 1989, until the review contemplated in paragraph 3 of the attached letter of July 12, 1988 has been completed and performance criteria have been established for the remaining period of the extended arrangement, or having been established, while they are not being observed.

5. Purchases under this extended arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 750 million until November 15, 1988, the equivalent of SDR 768.75 million until February 15, 1989, the equivalent of SDR 787.50 million until May 15, 1988, and the equivalent of SDR 806.25 million until August 10, 1989.

Decision No. 8946-(88/124), adopted August 5, 1988

Exchange System

Chile maintains multiple currency practices relating to the dual exchange market system, and exchange restrictions relating to import payment deferment requirements, as described in EBS/88/139, that are subject to approval under Article VIII, Sections 2(a) and 3. In view of the intention of the authorities to eliminate these measures, the Fund grants approval of them until February 15, 1989.

Decision No. 8947-(88/124), adopted
August 5, 1988

2. MALI - 1988 ARTICLE IV CONSULTATION, STAND-BY ARRANGEMENT, AND STRUCTURAL ADJUSTMENT ARRANGEMENT

The Executive Directors considered the staff report for the 1988 Article IV consultation with Mali and requests for a 14-month stand-by arrangement in an amount equivalent to SDR 12.70 million and for an arrangement under the structural adjustment facility (EBS/88/140, 7/15/88). They also had before them a background paper on recent economic developments in Mali (SM/88/161, 7/27/88) and an economic and financial policy framework paper for 1988-92 (EBD/88/182, 7/6/88).

In addition, the Executive Directors had before them a statement by the Managing Director, which read as follows:

> There follows for the information of Executive Directors the text of a memorandum that I have received from the President of the World Bank to serve as the basis for my statement on the matter to the Board. This text summarizes the main points covered by the Executive Directors of the Bank and IDA in their July 21, 1988 discussion in Committee of the Whole of a paper entitled "Mali: Medium-Term Economic and Financial Policy Framework (1988-92)."
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> 1. The Executive Directors of the Bank and IDA discussed, in a meeting of the Committee of the Whole, the paper entitled "Mali: Medium-Term Economic and Financial Policy Framework (1988-92)."
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> 2. The objectives and action program in the paper were well received. The Executive Directors noted that Government's vigorous and far-reaching efforts over the past year have resulted in an important start in redressing major imbalances in the economy, and that commitment to the program was evidenced in Government's strong participation in the preparation of the policy framework paper. Executive Directors welcomed progress in reforming agriculture, the public enterprise sector, public finances and public investment selection, and incentive structure for the private sector. Noting too great an emphasis on public economic activity in the past, some speakers felt nonetheless that too much was expected in the short term from the private sector, despite interest expressed by some Malian citizens.

3. Regarding long-term growth and development prospects, the Executive Directors noted that Mali's resource base is limited and vulnerable to environmental and structural factors, and that the economy lacks diversity. For these reasons it is imperative that economic reforms should be put in place quickly to enhance the economy's supply response. The staff noted that agricultural growth could be raised substantially as a result of policy improvements, especially for cotton and basic foods. Trade and fiscal reforms could induce a favorable supply response from small and medium enterprises.

4. Commenting on the social impact of the adjustment program, the Executive Directors emphasized maintaining resources for human resource development during a period of adjustment, since these sectors underpin longer-term growth. There was support for maintaining efforts in health and education, and the desirability of agreeing on budget targets for social expenditure was noted.

5. Regarding resource mobilization and public resource management, improved coordination of recurrent and development expenditures and better control of extrabudgetary expenditure were urged. The Executive Directors noted that Government should move ahead rapidly with its tax restructuring policies to achieve an expanded tax base, though taking into account the country's widespread poverty. There was support for increased cost recovery efforts.

6. The Executive Directors noted that Mali required substantial external financial support to ensure timely implementation of the adjustment program and eliminate payment arrears. Although the requirements outlined in the policy framework paper are substantial, Mali's growth prospects would be considerably enhanced if additional financing could be mobilized beyond the amounts stated. In this respect, expanded access to bilateral cofinancing through the Special Program of Assistance for the Debt-Distressed Countries of Sub-Saharan Africa would be a hopeful sign for timely implementation of the adjustment program.

7. Failure to present significant environmental programs in the face of desertification was considered by some a regrettable omission in the policy framework paper.

Mr. Mawakani made the following statement:

Economic developments in 1987

The economic and financial performance of Mali in 1987 was mixed. Benefiting from past adjustment efforts, the economic recovery that began in 1986 continued, albeit at a moderate pace, while fiscal performance improved and the external current account deficit was reduced. However, the rate of inflation edged upward and the liquidity problems of the banking system worsened. The economic expansion resulted mainly from the continued improvement in the agricultural sector, which expanded by 6.1 percent. However, activity in the industrial and commercial sectors, which accounts for a smaller share of GDP, was adversely affected by the compression in domestic demand and partly by the difficult financial situation of public enterprises.

Developments in the fiscal area were characterized by a decline in total revenue, which fell by 5.5 percent partly as a result of a slowdown in commercial and industrial activity. On the expenditure side, total outlay was reduced through the freezing of the wage bill and significant curtailment of expenses on scholarships and travels. Although these efforts contributed to the reduction of the budget deficit, the inadequacy of external financing led to a further accumulation of domestic and external arrears.

Monetary and credit policies were formulated to support the efforts in the fiscal sector and were restrictive in part to compensate for excessive monetary expansion in 1986. The slow growth in the monetary aggregates also reflects the increasing liquidity problem of the banking system.

My Malian authorities continued their restructuring efforts in 1987. In the agricultural sector, the liberalization of cereal marketing was completed, thereby increasing the role of private traders in the distribution of cereals. Moreover, OPAM--the cereal marketing agency--reduced its role as a price stabilizing agency in order to focus on the management of the national security stock of cereals. Regarding the public enterprise sector, a new law was enacted to enhance the autonomy of public enterprises; furthermore, a decree was issued, opening up the capital of seven public enterprises to private investors, and SOMIEX--the state trading agency--and BDM--the Development Bank--reduced their labor force significantly.

Medium-term structural program

In view of the deteriorating economic and financial situation confronting the country, the Malian authorities have decided to implement a comprehensive macroeconomic adjustment program in a medium-term context.

Structural policies

The program places considerable emphasis on structural measures in the agricultural sector, the public enterprise sector, as well as the pricing and marketing system.

In the agricultural sector the thrust of policies is to foster agricultural diversification while achieving self-sufficiency in food production. To this end, steps are being taken to liberalize the marketing of cereals and to allow market forces to determine prices. Thus, the role of OPAM--will be limited to the management of the national security stock of cereals. Furthermore, with the assistance of the World Bank, the Office du Niger--the public irrigation system--and the rural development agencies will be restructured with a view to increasing the responsibility of the private sector in their management. The cotton sector will also continue to undergo major reforms in order to increase its efficiency, particularly by adopting a flexible producer pricing policy.

The Government will undertake a comprehensive reform of the public enterprise sector. To that end, several actions, as detailed in the policy framework paper and summarized in Table 3 of EBS/88/140, are contemplated. For instance, out of 36 state enterprises, only 6 will be rehabilitated and maintained under government control; the remainder will either be privatized or liquidated. It is also worth mentioning that plans are under way to settle cross-payment arrears.

Marketing and pricing policies will be further liberalized to enhance economic efficiency. In addition to reducing the number of products subject to price control, the Government has removed the import quota on products accounting for 40 percent of total imports. Further liberalization of import procedures is under consideration.

Demand-management policies

The Government will implement the appropriate fiscal and monetary policies in support of the structural policies. In the fiscal sector, the authorities intend to further reduce the budget deficit. This objective will be achieved through substantial changes in the tax system to enhance revenue and through the strengthening of expenditure controls.

As described in the policy framework paper, the measures to achieve the above objective include: the conversion of specific taxes to an ad valorem basis; the introduction of a value-added tax; the strengthening of tax administration; the recovery of a greater proportion of the cost of public services; a limit on hiring and reinforcement of the voluntary retirement program; and the reduction of the level of subsidies and transfers.

To further improve public finance management, the Government is taking steps to establish a system for expenditure programming and budgeting that better reflects the Government's priorities. In this connection, the World Bank has been assisting the Malian authorities to improve the efficiency of investments and to integrate investment projects in a macroeconomic framework.

Monetary and credit policies will be designed so as to be consistent with the overall medium-term objectives of the adjustment program. In this regard, the Government will improve the allocation of credit to productive enterprises, particularly agriculture, livestock, and small-scale industries, while keeping a tight rein on the expansion of liquidity in the economy with a view to containing domestic demand. To achieve these objectives, the authorities have given high priority to the rehabilitation of Banque de Développement du Mali, the largest commercial bank. Furthermore, the reform of the postal checking system will contribute to efforts to mobilize domestic savings.

Program for 1988-89

In accordance with the orientation of the medium-term framework, the authorities have set the following objectives for the 1988-89 adjustment program:

- to limit the decline in real GDP in 1988 and to achieve an economic expansion of 5.0 percent in 1989;

- to contain the rate of inflation at about 4.3 percent in 1988 and 3.7 percent in 1989;

- to reduce the external current account deficit in relation to GDP to 7.8 percent of GDP in 1988 and to 7.5 percent in 1989.

These targets will be achieved through the implementation of the structural and demand-management policies described in the staff report and in line with the medium-term strategy. It should, however, be stressed that under the program for 1988-89, the authorities will gradually reduce the weight of the public sector in the economy, promote private initiatives, and eliminate domestic and external arrears.

Finally, my Malian authorities are fully aware that the adjustment program embarked upon is ambitious. The adoption of prior actions in the public enterprise sector underscores their commitment to the adjustment process. They also recognize that barring unforeseen adverse exogenous factors, the medium-term viability of the external sector hinges on the firm implementation of appropriate structural and demand-management policies. However, the support of the international financial community will greatly facilitate the restructuring of the Malian economy.

Mr. Rieffel made the following statement:

My authorities have been impressed by Mali's efforts since 1982 to transform its economy in order to improve the living standards of its rapidly growing population. Our interest is reflected in the selection of Mali in 1985 as one of 16 beneficiaries of the U.S. Economic Policy Reform Program created to support serious reform efforts in Africa through quick-disbursing grant assistance.

We are pleased that Mali has now decided to pursue its reform efforts in the context of a three-year framework, and we strongly support the structural adjustment arrangement requested by the Malian authorities. Furthermore, we hope that policy implementation during the next year will be sufficiently strong to justify continuing Fund support after the middle of 1989 in the form of an arrangement under the enhanced structural adjustment facility. With regard to the stand-by arrangement, payment obligations to the Fund in 1988 and 1989 represent almost one third of Mali's total debt service obligations in those years, reflecting Mali's use of Fund credit in 1982 and 1983. In the particular circumstances of this case, we can support the stand-by arrangement request, but we hope that the Malian authorities will forgo any drawings that may not be needed to achieve the objectives of the program in order to lighten the burden of repayment obligations to the Fund in the 1991-93 period.

As we agree generally with the staff appraisal, I will comment only on the policy framework paper and on Mali's policies for the coming year.

As the staff report reminds us, Mali began more than six years ago to shift the orientation of its economy from a highly regulated structure dominated by public enterprises to a more liberal structure in which private enterprise could flourish. The progress made over these six years has been impressive by some standards, but disappointing in certain respects. In particular, we were disappointed by the policy slippages in 1985 and 1986, and the disorderly situation that developed in 1987. We hope the Malian authorities recognize the heavy costs to the economy of relaxing their reform efforts, and that the policy framework paper will help them to avoid slippages in the future, thereby shortening the path to balance of payments viability.

From this perspective, we regard the objectives for 1991 as realistic but not ambitious. The alternative scenarios presented by the staff help to highlight the impact of relatively small changes in assumptions and underscore the importance of focusing on the medium-term objectives and adjusting policies as necessary to achieve them. We hope the authorities will set their sights on somewhat more ambitious objectives than those presented in the policy framework paper in order to increase the probability that they will actually surpass the objectives of the program and lift the economy into a virtuous circle in which success breeds success.

We are pleased to see the emphasis placed in the program for 1988-89 on strengthening the financial position of the Government. We place particular importance on the Government's adherence to its policy of not paying for expenditures incurred without prior authorization.

With regard to structural policies, we commend the authorities for their difficult decision to liquidate Air Mali and SOMIEX, and their commitment to privatize or liquidate 30 other public enterprises. We also place considerable importance on the progressive elimination of import quotas, fixed price ceilings, and preset profit margins; we would like to see these eliminated for all categories of products before financing under the enhanced structural adjustment facility is provided to Mali.

The first measure listed under policies to increase revenues is strengthening customs administration. I did not find in the staff papers, however, any explanation of how the customs administration would be strengthened, and I would appreciate more information from the staff on this important area. Also, the summary of the adjustment program for 1988-89 contained in the staff report includes the elaboration of a restructuring program for the cotton sector by 1991. The policy framework paper refers to the elaboration and implementation of this program by 1991. The objective in the policy framework paper strikes us as being more ambitious and still reasonable, and I hope the staff can confirm that this is indeed the objective.

My authorities are pleased to be in a position to contribute to closing the financing gap identified in the staff paper. We sense a new determination on the part of the Malian authorities to persist in their adjustment efforts.

Mrs. Ploix made the following statement:

After almost two years of standstill in Mali's adjustment program--years marked by a significant deterioration in the financial situation--the conclusion of a new adjustment program is a most welcome development.

I will not dwell on the economy's performance in 1987, since the unfolding of the financial crisis is described in the staff report, I prefer to underline the elements of the program which make it, in my view, a good and realistic one.

First, the main ingredient for any success is present, namely, the commitment of the Malian authorities to proceed with a wide range of measures. Some of these were long overdue and required a lot of political courage. The liquidation of 15 public enterprises, among them Air Mali and SOMIEX, is, in this respect, a tangible indication of the authorities' determination.

The second essential element of this program is the integration of these measures in a medium-term framework, since, given Mali's limited productive base and the level of existing imbalances, its return to a sustainable balance of payments position can be achieved only in the medium term. The focus placed in this framework on the liberalization of the economy to provide adequate incentives to the private sector, on the reduction of the scope of public enterprise sector activities combined with the improvement of the remaining enterprises, on the strengthening of public finances, and finally, on the promotion and diversification of agriculture points to a consistent and convincing program.

The third element is the strength of the adjustment program for 1988-89, as it appears to be much stronger and more specific than those supported by previous arrangements. All important issues will be addressed in detail. The long list of actions provided in Table 3 of the report is eloquent in this respect.

The fourth element for the success of this program is the identification of adequate levels of external financing. In this respect, the strength of the present adjustment program will indeed be a key factor toward reversing the decline in external assistance experienced in the past two years. The contributions from the Fund, the World Bank, the Special Facility for Sub-Saharan Africa, and bilateral sources will make it possible to finance the prospective financing gap for 1988-89. In addition, in recognition of its efforts, Mali should in the future be able to benefit from the program in favor of low-income debt-distressed countries recently established by the World Bank, in collaboration with several bilateral cofinancers.

> Having listed the elements that give this program the best chances of success, it is also fair to mention that the task will be a difficult one. For instance, the large increase in revenues and tight control of current expenditures will require strong actions and close monitoring of the budget. The reform of the public enterprise sector involves the complete remodeling of the relationship between the state and the public sector, thus requiring, within a short period, the training of a large number of managers to run these enterprises efficiently. In addition, the outlook for growth and the balance of payments will remain very sensitive to external factors or slippages in policy implementation on the fiscal, credit, and monetary fronts. All of these factors point to the need for the authorities to be extremely vigilant and, if warranted by circumstances, to adjust their policies quickly. In this respect, the *close monitoring provided by the existence of a stand-by* arrangement can be an essential asset for the success of Mali's program. This is one of the reasons why we strongly favor the principle of combining a stand-by arrangement and a structural adjustment arrangement. We support the proposed decisions.

Mr. Kleine expressed satisfaction that the Malian authorities had mapped out a comprehensive medium-term adjustment strategy. The firm and sustained implementation of the key policy measures under the adjustment program for 1988-89 could pave the way over the medium term toward the alleviation of the difficulties arising from the persisting financial imbalances and the improvement of the living standards of the population.

As indicated by the five alternative scenarios, the program was fraught with many uncertainties and risks that should not be underestimated, Mr. Kleine observed. The balance of payments scenario showed financing gaps for a number of years to come. At the same time, the implementation of the program measures might be hampered by the relatively weak administrative capacity of the authorities. Technical assistance from the World Bank, the Fund, and other institutions could be helpful.

In any event, if adverse factors emerged, the authorities should be prepared to readjust their policies promptly in order to keep their program on track, Mr. Kleine commented. A renewed interruption in the adjustment effort would undoubtedly threaten to produce a major setback and would have serious repercussions on the willingness of external donors and creditors to make available the necessary external financial assistance. Mali's resource gap, although decreasing over the next few years, would remain relatively large. Additional efforts, preferably in public finance, should be undertaken to increase gross domestic savings beyond what was currently contemplated.

Because of Mali's very low stage of economic development, the country was a prime candidate for official development assistance, including credits from the World Bank, Mr. Kleine said. In general, it appeared that the Fund's ordinary resources were too costly and too short term for Mali. Accordingly, ordinary Fund resources could at best supplement concessionary resources. In that respect, the access under the stand-by arrangement was appropriate.

He welcomed the intention of the authorities to develop and implement a family-planning program, Mr. Kleine noted. Finally, he could support the proposed decisions; however, his support rested on the assumption that the financing gap for 1988 would be fully covered within the next few weeks.

Mr. Enoch said that he welcomed the resumption of adjustment by the Malian authorities after the unfortunate hiatus of the past two years. In particular, he welcomed the fact that balance of payments viability could be envisaged over the medium term and that external financing had been largely assured for the first two years of the program. He endorsed the measures proposed in the program under consideration, which correctly targeted the key weaknesses of the economy, notably fiscal policy and parastatal reforms.

He had some concern that the comprehensiveness of the program would seriously stretch Mali's limited administrative resources, Mr. Enoch stated. Clearly, the Fund had an important role to play in bolstering Mali's policy management, both within the framework of the stand-by arrangement and structural adjustment arrangement and through technical assistance. He fully agreed with the staff that the weak administrative capacity of Mali called for meticulous monitoring of program performance. The tight framework provided by the stand-by arrangement was, in that respect, a welcome complement to the structural adjustment arrangement, and, given the modest size of the stand-by arrangement, the use of ordinary resources did not present difficulties.

It should be emphasized that Mali had little room for maneuver, and that it could not afford to repeat the lapse in adjustment seen over 1986 and 1987, Mr. Enoch remarked. Beyond that, the external risk to Mali's program was obviously critical. Charts 1 and 2 of the staff report illustrated the wide range of plausible outturns around the baseline program path for 1988-92. It would have been inappropriate, even if feasible, for the staff to factor in volatility. The compromise of offering several alternative scenarios was therefore most useful in illustrating the sensitivity of the situation facing Mali.

Given the obvious exogenous risks to the program, he strongly endorsed the staff appraisal in arguing that "the authorities will have to react quickly and readjust the policies to ensure that the program remains on track," Mr. Enoch said. But as that was the case, he wondered what contingent policies had been outlined. The staff had not offered any indication that the authorities had either accepted the probability of having to adapt their program or identified any areas of flexibility; he would appreciate any details that the staff could provide.

Within the program, his main concern was the feasibility of the growth projections, given the planned reliance on the private sector, particularly in agriculture and small to medium-scale industry, Mr. Enoch commented. The program dealt largely with improving public sector resource management, while a number of welcome moves were made toward liberalization of trade and prices. Erosion of price incentives to exporters resulting in part from the fixed exchange rate raised doubts as to whether the private sector would respond as vigorously as expected. Those doubts were reinforced by experience in other similar countries that had seen private enterprise systematically disadvantaged over more than two decades. Neither the staff report nor the policy framework paper gave much information about the feasibility of longer-term plans for diversification, which was a vital condition for growth. The scope for diversification would depend on regional markets, as he had mentioned in similar cases, and he looked to the staff to provide some regional perspective. The problem of Mali's pegged exchange rate had had to be taken on trust by the staff. In future, in such cases, Directors should at least have the benefit of some estimation of the inflation differential with trading partners needed to contain the real effective exchange rate, if not to restore competitiveness.

One area where Mali might find that its prospects were understated was external debt relief, Mr. Enoch noted. The staff projections did not appear to take account of the additional relief that might be forthcoming from official creditors as a result of the recent summit decision on the debt of low-income countries. He wondered whether the staff had any tentative indication of what that decision might mean for Mali. Finally, he could support the proposed decisions.

Mr. Finaish made the following statement:

Mali's financial position over the recent past can best be characterized by continuing severe fiscal imbalances, serious liquidity shortages, and a rapid buildup of its overdue obligations to both domestic and foreign creditors. Because of some slippages in the adjustment process--particularly in 1986--that were partly caused by developments not entirely within its control, Mali once again finds itself in a financial bind that can be redressed by prudent fiscal management, timely implementation of structural reforms, and adequate support from the international financial community.

As Mr. Mawakani has indicated, the performance of the economy in 1987 was mixed. The external position improved further, owing mainly to the effects of the financial contraction on imports and the expansion of exports caused by a combination of improved weather conditions and an upsurge in the international price of cotton. Mali's real GDP expanded further by about 4 percent in 1987, reflecting largely the positive effects of previous adjustment efforts and favorable weather conditions on agricultural production. At the same time, however, inflationary pressures returned because of increases in cereal and cotton prices.

Notwithstanding a significant drop in revenue, the overall fiscal performance improved noticeably in 1987, as the Government implemented several cost-cutting measures to reduce expenditures. The overall fiscal deficit narrowed from 7.5 percent of GDP in 1986 to 4.9 percent of GDP in 1987. But, as noted in the staff report, the available financing was not sufficient to cover this deficit and, as a result, there was a buildup of both domestic and external payments arrears.

The financial situation in 1987 was exacerbated further by problems facing the largest government-owned commercial bank, which experienced serious liquidity problems arising partly from its heavy lending to the financially ailing public enterprises, and by the subsequent tightening of credit by the monetary authorities.

In the light of the foregoing, it would be fair to say that since the interruption of Mali's previous stand-by arrangement with the Fund, the authorities have attempted to adjust to changes in the external environment and to continue the process of structural reform. Indeed, the adjustment process did not come to a standstill after late 1986, as stated in the report, but rather it continued in some policy areas. These efforts have been partially successful, and I welcome the fact that the authorities have recently embarked on a more comprehensive medium-term adjustment strategy with the support of the Fund.

I am in broad agreement with the objectives and the general thrust of the underlying policies of the proposed medium-term structural adjustment program. As indicated in the staff report, some of these reforms have already been put in place while others are in the process of being implemented. In particular, I note the progress that has already taken place in reforming the agricultural sector, public enterprises, public finances, and the incentive system for the private sector.

The main objectives of the policies outlined in the medium-term policy framework paper are to promote economic growth, contain inflationary pressures, and achieve a viable external sector position by 1992. However, the success of the program would hinge primarily on three critical factors, namely, the evolution of the price of cotton, changes in weather conditions, and the timely implementation of the adjustment policies.

In addition to the baseline medium-term scenario, the staff has presented alternative scenarios to capture the potential impact of the above-mentioned factors. Although the staff's presentation does not cover what might be a worst-case scenario, which would be based on a drought and a fall in the price of cotton occurring simultaneously--a combination of Scenarios II and V--it should be clear that such a scenario, which incidentally is similar to the situation that existed in 1986, would entail considerable implications for the adjustment and financing needs; Mr. Enoch raised a useful point in this regard.

I concur with the staff that the success of Mali's medium-term program would also depend on a number of other factors, such as its institutional capacity to monitor the public investment program, its ability to readjust quickly to any exogenous shocks to ensure that the program remains on track, and the availability of external financing on concessionary terms.

Given the fact that in the staff's view Mali's adjustment program merits the Fund's support both under the structural adjustment facility and in the upper credit tranches, I wonder whether consideration has been given to an arrangement under the enhanced structural adjustment facility. In conclusion, I support the proposed decisions.

Mr. Fuleihan made the following statement:

The recent experience of the Malian economy clearly illustrates the crucial importance of sustained adjustment policies. Any relaxation of adjustment efforts endangers the hard-won achievements of the past and may entail significant start-up costs. This is particularly true if a country suffers, as Mali does, from endemic balance of payments problems.

The relaxation of adjustment in the second half of 1986 contributed to severe fiscal imbalances, mounting external and domestic payments arrears, and serious liquidity problems in the banking system. I am heartened by the authorities' recognition that such a policy stance devoid of significant corrective measures is unsustainable, and by their embarkation on a comprehensive adjustment program. The program addresses the basic challenges facing the Malian economy and strikes an appropriate balance between growth and adjustment. If it is faithfully implemented, it could lead Mali into an era of sustained growth and balance of payments viability.

The public enterprise sector in the Malian economy is inefficient and significantly overextended, resulting in a continuous depletion of scarce public resources. I can therefore strongly endorse an overhaul of this sector, as envisaged in the program. However, I wonder whether privatization schemes in small domestic markets could possibly lead to the transformation of public monopolies into private monopolies and therefore impose indirect efficiency costs on an economy.

A major overhaul of the public enterprise sector will greatly improve the fiscal outlook. Nonetheless, efforts to enhance revenue collection and to contain expenditure will be needed. Indeed, the authorities clearly recognize the need to further reduce the fiscal deficit and to settle outstanding payments arrears. The settling of arrears will help normalize Mali's relations with its creditors and thereby facilitate further financing. The deficit reduction should entail special emphasis on high-quality investment expenditure, since the program envisages an 18 percent growth in development expenditure in 1988. In this context, I welcome the strengthening of the programming and implementation of public investment through the setting up of a rolling three-year public investment program system.

A reduced and financially sound public sector will also allow the authorities greater flexibility in extending credit to the private sector. This, along with the envisaged tax incentives, should permit the private sector to become the main locomotive for growth. One area where this can be realized is agriculture. Hence, I endorse the agricultural reforms in the program, particularly the continued liberalization of pricing and marketing policies, as experience indicates that the supply response could be significant.

To translate these measures into further economic growth, Mali's export competitiveness needs to be maintained. Given the limited role for exchange rate policy, I support the authorities' attempt to reduce the domestic price of exports through a policy of wage moderation and the maintenance of an appropriate inflation differential vis-à-vis their trading partners. This illustrates the point that measures in addition to exchange rate actions are appropriate to preserve a country's competitiveness.

The authorities' medium-term program provides light at the end of the tunnel. However, the economy remains susceptible to weather and international price fluctuations, underlining the importance of not only stronger adjustment efforts but also flexibility to do more if the need arises. Above all, a sustained commitment to adjustment is crucial and may well lead Mali out of the tunnel. Finally, I can support the proposed decisions.

The staff representative from the African Department said that the staff had attempted in the medium-term scenarios to show the sensitivity of the economy to various external shocks. As Mr. Finaish had correctly pointed out, different scenarios dealt with the fall in cotton prices and with the drought; if those two different factors were to come into play simultaneously, the situation would become much more difficult than envisaged in the separate scenarios.

The authorities had indicated in the policy framework paper their willingness to readjust policies in light of changing circumstances, the staff representative continued. The contingent policies that could be put in place would depend on the nature and magnitude of the shock to which the economy had been subjected. At the end of 1985, when there had been a 40 percent fall in cotton prices, major measures had been taken, particularly to offset the revenue shortfall, to compress imports, and to attempt to restructure the cotton sector.

As to the ambitiousness of the targets, the program provided for a 17 percent increase in revenue in 1988 and a further 9 percent increase in 1989, the staff representative stated. Thus, over the two-year period, the increase in revenue would be significantly higher than the increase in nominal GDP. For that reason, the authorities had put in place specific actions, as detailed in Table 8 of Appendix VI.

Several elements were involved in the reinforcement of customs administration, the staff representative remarked. The authorities were in the process of computerizing customs administration, training the agents, and speeding up collection of customs duties. Another key element was the stricter enforcement of payment for customs before the removal of goods, thus preventing revenue losses, and every attempt was being made to tighten customs exemptions.

The envisaged restructuring of the cotton sector would extend from 1988 to 1991, the staff representative commented. A seminar had been held in Mali in May 1988 to develop such a medium-term reform strategy. The seminar had indicated the need to link producer prices to world prices and to rationalize the structure of taxation. The cotton sector was almost in virtual balance, following the measures that had been taken in 1985 and 1986 after the drop in cotton prices. Based on the introduction of a new seed variety, a surplus was expected to emerge in 1989-90.

The resources needed to close Mali's financing gap had been mobilized with the exception of those pertaining to the Paris Club, the staff representative noted. Under the new initiative for debt discussed at the economic summit, the working hypothesis was a 100 percent rescheduling of interest, principal, and arrears. In that event, the impact on debt relief would be relatively marginal in the current year but would be more significant in future years.

The authorities were aware that the program would require careful monitoring in view of Mali's limited administrative capacity, the staff representative observed. They were working closely with both the Fund and the Bank to monitor the implementation of the program to ensure that no slippages took place, and if they occurred, to quickly readjust the policies involved. The design of the program relied very much on policies aimed at promoting economic activity. For example, the reform of the public enterprise sector aimed at improving the enterprises' productivity and increasing their efficiency. The public investment program involved projects that supported directly productive sectors. The reform of the agricultural policy, in particular the liberalization of cereal pricing and marketing, was an important ingredient in providing the impetus for agricultural producers.

The phasing out of price controls was critical to increasing development of the industrial sector, the staff representative said. The liberalization of trade policies would also open the economy further and increase the efficiency of domestic production. Moreover, a restructuring of the tax system was under way--supported by the United States--that aimed to improve incentives for production in the private sector. The improvements in the budget were designed to release resources to the private sector, and the provision of credit would be reoriented toward the productive sectors in the economy. Furthermore, the envisaged reform of the banking system under the program would enhance financial intermediation and promote economic growth. While it was difficult to quantify the effects of those measures, they should generate the conditions necessary for growth of the private sector.

Mali was a member of the West African Monetary Union, and its currency was pegged to the French franc, the staff representative noted. In 1987, the real effective exchange rate had dropped by 6.6 percent, but some rise had taken place in the first months of 1988. The program design had taken the exchange arrangements into account, and the objective was to increase efficiency and productivity and to enhance competitiveness by keeping inflation down and by restraining wage policy in Mali. The authorities were aware that the exchange arrangements placed greater weight on other policy instruments to achieve the adjustment objectives, but they considered that the benefits of convertibility offset any rigidities in the exchange rate.

As for the possibility that the conversion of public enterprises into private enterprises could carry with it the monopolies of those public enterprises, the staff representative from the African Department assured Directors that all monopolies had been officially abolished in Mali. None of the public enterprises that were being identified for privatization were sufficiently large to impose a monopoly situation in the country.

The staff representative from the Exchange and Trade Relations Department noted that several speakers had commented that the present Fund-supported program was useful for its monitoring aspects, and they had highlighted the past evidence of slippages in maintaining adjustment. The staff's objective had been to seek progress toward the establishment of a stable financial environment, following which the possibility of an arrangement under the enhanced structural adjustment facility could be assessed. In that context, a firm timetable for more ambitious policies could be considered.

Mr. Mawakani recalled that his Malian authorities had participated in negotiations in 1985 and 1987 on the possible use of Fund resources. Although the request had not been finalized and presented to the Board for consideration, the authorities had implemented most of the features provided in the program. When confronted with a decline in revenues, they had reduced expenditures on wages, scholarships, and travel expenses significantly, thus showing their determination to make an important adjustment effort. His authorities had already taken several prior actions, in particular reforms in the agricultural sector and in the public enterprise sector. In respect of the latter, the authorities had decided to liquidate Air Mali and SOMIEX.

The success of the program would depend on several key elements, Mr. Mawakani stated: the evolution of the price of cotton, changes in weather conditions, and the pace of adjustment policies. While the authorities could not control the first two, they were prepared to maintain their adjustment efforts. Indeed, they had already undertaken actions in the context of the Fund-supported program.

The Acting Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They noted that Mali had achieved significant progress in reducing economic and financial imbalances from 1982 to mid-1986; however, adjustment efforts had come to a virtual standstill in 1986, and the financial situation had deteriorated rapidly in late 1987.

Directors welcomed the authorities' decision to implement a medium-term structural adjustment program for 1988-92 aimed at redressing the deteriorating economic situation and alleviating Mali's protracted budgetary and balance of payments problems. They considered that the thrust of the Government's medium-term strategy focused appropriately on effecting improvements in the efficiency of public resource management and on promoting private sector activity. Directors were of the view that the wide-ranging measures already implemented and those envisaged in the context of the 1988-89 adjustment program were essential for restoring a process of orderly adjustment and for making progress toward Mali's medium-term adjustment objectives. It was recognized that a number of factors, including exogenous developments, could affect Mali's progress. The authorities were encouraged to develop contingency actions to be taken should the economy experience negative developments.

Regarding the structural reforms envisaged for 1988-89, Directors stated that the public enterprise reform program, supported by the World Bank, was a critical element in enhancing public resource management and opening up opportunities for the private sector. In that context, Directors noted with satisfaction the liquidation of Air Mali and the progress made in liquidating the state trading company (SOMIEX). They remarked that the envisaged reinforcement of public investment programming was essential for maximizing the returns on capital outlays and expanding the productive capacity of the country. Directors observed that the reductions in the scope of price controls and of import quotas, as well as the liberalization of cereal pricing and marketing, were essential to reduce distortions and enhance production. They commended the authorities on the progress made in restructuring the cotton sector and encouraged the authorities to achieve the objectives set out in the policy framework paper.

In commenting on financial policies for 1988-89, Directors indicated that they attached considerable importance to the achievement of the targeted improvement in the budgetary position and the programmed reduction in the Government's net indebtedness to the banking system. Also, importance was attached to the steps being taken to restructure the tax system, as well as to those to reduce the share of the wage bill and increase the shares of maintenance and capital formation in total expenditure. They urged the authorities to closely monitor budgetary developments to avoid any slippages. In particular, Directors encouraged the authorities to follow revenue developments carefully and to give priority to further strengthening tax administration. They welcomed the efforts being made to integrate the investment budget in the regular budgetary and expenditure control processes. Directors urged the reinforcement of expenditure control to prevent the incurrence of extrabudgetary expenditure and any further accumulation of arrears. The strengthening in credit control was welcomed, and Directors emphasized that it was critical that every effort be made to ensure the observance of the credit targets.

Directors pointed out that the success of Mali's medium-term adjustment program would depend on an effective, timely, and sustained implementation of the requisite policies, and their prompt readaptation in light of changing circumstances. They understood that the adequate availability of external financial assistance, on appropriate terms, and its timely disbursement were essential to enable the authorities to implement the program in an orderly manner. At the same time, Directors cautioned that any fallback in the implementation of strong adjustment measures would weaken the willingness of donors to provide support. Directors also pointed out that success in moderating wage increases and efforts to control inflation would be necessary to support Mali's external competitive position, given Mali's exchange arrangements. The importance of technical assistance was underscored, as was the need for close monitoring of the program and for efficient deployment of the administrative resources of the public sector. In this connection, Directors encouraged recourse to Fund and Bank technical assistance to help in the implementation of the economic program.

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

The Executive Board then took the following decisions:

Stand-By Arrangement

1. The Government of Mali has requested a stand-by arrangement in an amount equivalent to SDR 12.70 million for a period of 14 months from August 5, 1988 through October 4, 1989.

2. The Fund approves the stand-by arrangement set forth in EBS/88/140, Supplement 1.

Decision No. 8948-(88/124), adopted
August 5, 1988

Structural Adjustment Arrangement

1. The Government of Mali has requested a three-year structural adjustment arrangement, and the first annual arrangement thereunder, under the structural adjustment facility.

2. The Fund approves the arrangements set forth in EBS/88/140, Supplement 2.

Decision No. 8949-(88/124), adopted
August 5, 1988

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/88/123 (8/3/88) and EBM/88/124 (8/5/88).

3. ANNUAL REPORT, 1988 - TRANSMITTAL TO BOARD OF GOVERNORS

The Executive Board approves the transmittal of the 1988 Annual Report to the Board of Governors under cover of the letter set forth in EBD/88/75, Supplement 1 (8/1/88).

Adopted August 4, 1988

4. EXECUTIVE DIRECTORS' OFFICES - TEMPORARY STAFFING

The Executive Board approves the recommendation of the Committee on Executive Board Administrative Matters relating to the request for a temporary staff position in an Executive Director's office as set forth in EBAP/88/191 (8/2/88).

Adopted August 3, 1988

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/88/192 (8/3/88) is approved.

6. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director as set forth in EBAP/88/194 (8/3/88) is approved.

APPROVED: February 21, 1989

LEO VAN HOUTVEN
Secretary