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0404

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/180

3:00 p.m., December 14, 1988

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
	C. Enoch
	C. J. Jarvis, Temporary
	Yang J., Temporary
	D. C. Templeman, Temporary
	J.-P. Schoder, Temporary
	L. B. Monyake
	R. J. Lombardo
	M. A. Fernández Ordóñez
	R. Marino, Temporary
	A. M. Othman
M. R. Ghasimi	O. Kabbaj
G. Grosche	K.-H. Kleine, Temporary
J. E. Ismael	E. Kiriwat
	S. P. Shrestha, Temporary
	A. Vasudevan, Temporary
	J. R. N. Almeida, Temporary
	D. McCormack
	K. Yao, Temporary
	M. Al-Jasser, Temporary
	M. Fogelholm
	G. Pineau, Temporary
G. A. Posthumus	G. P. J. Hogeweg
	C. Y. Legg, Temporary
	S. Yoshikuni
	S. Appetiti, Temporary

C. Brachet, Acting Secretary
C. E. Wahlstrom, Assistant

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Also Present

IBRD: Y. Huang, Asia Regional Office. Asian Department: H. Neiss, Deputy Director; C. M. Browne, S. Ishii, S. P. O. Itam, L. Nielsen, W. M. Tilakaratna, H. Vittas. Central Banking Department: O. P. Brekk. European Department: H. Bredenkamp, M. C. Deppler, C. Liuksila, K.-W. Riechel, M. Sabastio, H. O. Schmitt. Exchange and Trade Relations Department: J. T. Boorman, Deputy Director; A. Basu, P. J. Winglee. Fiscal Affairs Department: K. Aramaki. Legal Department: R. H. Munzberg, Deputy General Counsel; P. L. Francotte, A. O. Liuksila, R. S. J. Martha, J. V. Surr. Treasurer's Department: F. G. Laske, Treasurer; T. Leddy, Deputy Treasurer; D. Williams, Deputy Treasurer; M. N. Bhuiyan, D. Gupta, A. F. Moustapha, T. M. Tran, D. V. Pritchett, G. Wittich, T. Voulgaris. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisor to Executive Director: M. Pétursson. Assistants to Executive Directors: R. Comotto, J. Gold, M. A. Hammoudi, C. L. Haynes, J. Heywood, V. K. Malhotra, T. Morita, G. Serre, M. J. Shaffrey.

1. DESIGNATION PLAN AND OPERATIONAL BUDGET FOR DECEMBER 1988-FEBRUARY 1989

The Executive Directors considered the staff papers on the designation plan and operational budget for December 1988-February 1989 (EBS/88/224, 11/30/88; and Cor. 1, 12/13/88; and EBS/88/245, 11/30/88).

The staff representative from the Treasurer's Department said that the staff had indicated in its memorandum on the proposed operational budget (EBS/88/245, 11/30/88) that calculations in accordance with the guidelines on early repurchases had been made for two members, one of which was Korea. However, Korea had initiated a transaction that would eliminate the expectation of early repurchase.

Mr. Fernández Ordóñez commented that the method currently used to calculate the amounts of currencies of the members selected for inclusion in the operational budget, succeeded in assigning absolute amounts, given that its purpose was to base the provision of ordinary resources on official gold and foreign exchange holdings. However, an assessment of the method of calculation in the light of its effects on each member country's contribution to the Fund's ordinary resources, showed that the ratio of Fund resources used to the total amount of resources put at the Fund's disposal by each member had widened considerably between members. For instance, the ratio of utilization of the resources provided to the Fund by the ten biggest member countries currently ranged from 12 percent to 63 percent, compared with a range of 11 percent to 49 percent in April 1988.

Once it had been determined which member countries were sufficiently strong for inclusion in the operational budget, the Fund should use the resources put at its disposal in a balanced way, although temporary deviations from the norm could be admitted, Mr. Fernández Ordóñez remarked. A correction in the method of calculation could be made by using a different mechanism, but it would be better to discuss that issue on the basis of a staff paper that would be distributed before the next operational budget would be brought to the agenda. Even though he had detected some problems in the method of calculation, he could go along with the proposed operational budget.

The Chairman commented that it might be helpful for the staff, at an appropriate time, to circulate a note to Directors, summarizing the principles underlying the calculations of the operational budget. Directors could then discuss the matter and make specific proposals, if they wished.

Mr. Fernández Ordóñez agreed with the Chairman's suggestion, as long as the staff also studied ways for using currencies in the operational budget in a balanced way.

Mr. Legg said that his Australian and New Zealand authorities certainly were not opposed to being included in the designation plan and operational budget. However, recent political developments in New Zealand, including the dismissal of the Minister of Finance and the resignation of another Minister, might have some effect on the foreign exchange market in New Zealand in the week ahead. The authorities did not, however, believe that there would be any long-term implications on the direction of policy. He asked the staff to keep that situation in mind in the inclusion of New Zealand in the designation plan and operational budget.

The Chairman responded that the staff would keep New Zealand's situation in mind with respect to use of its currency under the designation plan and the operational budget. He hoped that New Zealand would remain on its current constructive and interesting path of structural adjustment.

Mr. Grosche remarked that a fresh look at rules and procedures that the Board members had become accustomed to accepting on their face value was often useful. If Mr. Fernández Ordóñez had in mind a more balanced contribution in general of the members to the Fund's operations, he recalled that he himself had in the past been inclined to look favorably on a change in the Fund's financial operations in the direction of basing them all on quotas, including burden sharing of arrears to the Fund. However, that issue had been studied repeatedly in the past, leading to the conclusion, if he was not mistaken, that quotas simply did not reflect the relative strength of members' external positions or their capacity to finance the operations of the Fund. It would be helpful if the staff could provide Mr. Fernández Ordóñez with the background of the decisions leading to the procedures relating to the operational budget, without devoting too many resources to that issue, unless there were was a realistic possibility of radical new ideas for burden sharing. He did not believe that it would be possible to avoid placing more of a burden on those members that were financially stronger and could provide the Fund with the usable currencies that other members needed in struggling with their balance of payments problems. Thus, he did not think that it would be possible to change the current approach to the operational budget.

The Chairman said that he agreed with Mr. Grosche that members' gross reserves were not proportional to their quotas in the Fund, and questions arising from that issue had been discussed in the past. The reason for the approach followed in the budget would be summarized by the staff in due course, and Directors could then reconsider that matter.

Mr. Posthumus said that his Cypriot authorities had been reluctant to accept the proposed designation plan and operational budget, but for quite different reasons than those mentioned by Mr. Fernández Ordóñez. In the light of its strong exchange reserve position, it seemed quite fair to include Cyprus in the designation plan and operational budget. However, Cyprus remained a developing country, which for instance still imported capital on a large scale.

Mr. Templeman said that he could accept the Chairman's suggestion to review the history of the procedures relative to the operational budget, as long as the staff did not have to devote too many resources to the matter.

Mr. Vasudevan suggested that instead of preparing an additional paper the staff should first issue a note citing earlier staff papers.

The Chairman said that the staff would provide appropriate information along those lines.

The Executive Board then took the following decisions:

SDR Department - Designation Plan for
December 1988-February 1989

The Executive Board approves the designation plan for the quarterly period beginning December 14, 1988 as set out in EBS/88/244 (11/30/88).

Decision No. 9044-(88/180) S, adopted
December 14, 1988

Operational Budget for December 1988-February 1989

The Executive Board approves the list of members considered sufficiently strong as set out in EBS/88/245, page 2, footnote 2, and the operational budget for the quarterly period beginning December 14, 1988, as set out in EBS/88/245 (11/30/88).

Decision No. 9045-(88/180), adopted
December 14, 1988

2. NEPAL - 1988 ARTICLE IV CONSULTATION, AND STRUCTURAL ADJUSTMENT FACILITY - SECOND ANNUAL ARRANGEMENT

The Executive Directors considered the staff report for the 1988 Article IV consultation with Nepal, and Nepal's request for a second annual arrangement under the structural adjustment facility (EBS/88/233, 11/16/88; and Sup. 1, 12/12/88), together with a policy framework paper for Nepal (EBD/88/332, 11/16/88). They also had before them a background paper on recent economic developments in Nepal (SM/88/258, 11/23/88).

The Managing Director made the following statement:

Here 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 World Bank and the International Development Association (IDA) in the Committee of the Whole discussion on December 6, 1988 of a paper entitled "Nepal: Policy Framework Paper, 1988/89-1990/91."

1. The Executive Directors of the World Bank and IDA discussed, in a meeting of the Committee of the Whole, the paper entitled "Nepal: Policy Framework Paper, 1988/89-1990/91."

2. There was strong support by the Committee of the Whole for the Government of Nepal's structural adjustment program. The Government's adjustment efforts have resulted in a number of encouraging macroeconomic developments, including an acceleration in the rate of economic growth and marked improvement in the country's external balance and fiscal revenues. While Nepal's economy has performed well recently, the Committee stressed the importance of sustaining and deepening the adjustment program and of designing specific, monitorable targets against which to assess performance in achieving policy objectives.

3. The emphasis on addressing the impediments to agricultural growth was strongly endorsed. Increased foodgrains production is seen as critical to achieving a higher rate of growth and incomes and continued actions to liberalize fertilizer distribution and reorient irrigation policies are essential to raising agricultural productivity. In view of the delays in implementing policy adjustments in the financial sector and in the divestiture of public enterprises, the Committee stressed the need to intensify actions in these two areas. The Committee noted that financial sector reforms are to be actively pursued under the planned second structural adjustment operation and that the International Finance Corporation (IFC) is to provide assistance to the Government in implementing its plans for divestiture. It was recognized that related measures to improve the efficiency of public expenditures and aid coordination, as well as the revenue system are needed to sustain growth. The importance of developing the hydropower and tourism sectors, and of continued trade reforms in the adjustment process, was also noted. Similarly, the importance of stimulating private sector investment through an appropriate and stable policy framework was emphasized.

4. The Committee praised the Government's attempts at poverty alleviation through its Basic Needs Program with its many positive features, including its focus on increasing agricultural incomes, on improving health, population and education services, and its reliance on the private sector to generate growth. It was noted that the success of Nepal's Basic Needs strategy is critically dependent on strengthening family planning services. The Committee felt that there is a need for flexibility in

interpreting some of the ambitious input and output targets under the program in keeping with the absorptive and productive capacity of the economy.

5. The Committee acknowledged Nepal's efforts at addressing its environmental problems. It was noted that the Government has begun to intensify efforts in this area, including the preparation of a national conservation strategy, legislative changes to encourage better management of forestry, the preparation of a forestry master plan and the undertaking of an important study supported by the World Bank and British official development assistance, with the objective of improving natural resource management.

Mr. Shrestha made the following statement:

Nepal made satisfactory progress in various sectors of the economy in 1985, owing to the implementation of macroeconomic and structural adjustment policies under the stand-by arrangement. In 1985/86 and 1986/87, the output growth averaged 3.5 percent a year, the government financial position improved, monetary expansion slowed significantly, the external current account deficit narrowed, and the overall balance of payments situation remained favorable.

To consolidate the gains achieved under the stabilization period and put the economy on a path of sustained growth, Nepal continued to implement structural adjustment policies in 1987/88, with the financial, as well as technical, support of the Fund and the World Bank. The structural measures implemented in 1987/88 constituted tariff reforms, liberalization of trade and industrial policies, new revenue measures, improvement in project administration, and steps to strengthen tax administration. In addition, measures were taken to activate the role of the private sector in the agriculture, forestry, and tourism sectors. In 1987/88, as a result of these measures, the general performance of the Nepalese economy remained satisfactory. All quantitative benchmarks set in the program were observed at the end of the fiscal year. Real GDP grew by 7.1 percent, agricultural production increased by 18.3 percent, and nonagricultural production by 14.5 percent.

On the external side, during 1987/88, exports increased by 37 percent and imports by 28.1 percent. With the higher rate of increase in exports over imports, the relative proportion of total exports to total imports increased to 29 percent, compared with 27 percent in 1986/87. Despite the trade gap of NRs 9.8 billion, the overall balance of payments position remained positive, amounting to NRs 2.5 billion in 1987/88, compared with a surplus of NRs 460 million in the previous year.

Achievements on the fiscal front were encouraging in 1987/88; a major simplification and rationalization of the tax system was implemented; revenue, as a percentage of GDP, increased by 0.5 percentage point, to 10.5 percent; the overall budget deficit fell to 5.4 percent; and net domestic borrowing narrowed to 0.9 percent.

The high rate of inflation is the Nepalese authorities' major concern at the moment. Although inflation eased somewhat, to 10.9 percent in 1987/88 compared with 13.3 percent in 1986/87, it is still on the high side and has to be contained further in 1988/89. In this respect, there have been some positive developments in the first quarter of 1988/89.

My authorities in Nepal are in broad agreement with the staff's analysis of the developments and prospects for the Nepalese economy. Since the staff's visit in October 1988, five positive developments have taken place: first, the foreign exchange budget for 1988/89 has been revised, and the budget for import auction was raised to NRs 1.5 billion from NRs 1.25 billion; second, the Government has already made the payment of NRs 80 million to commercial banks to reduce the Nepal Food Corporation's arrears to the banks; third, the duty drawback system has been streamlined, and import duties and sales tax paid by ready-made garment exporters are being reimbursed; fourth, the Government has added 22 items to the Open General License list (OGL); and fifth, the first auction of treasury bills was held on November 25, 1988 amounting to NRs 100 million. The interest rate on the treasury bills is currently 6.012 percent, which is an increase of about 1 percent. In view of the higher demand for treasury bills by commercial banks and other financial institutions, auctions have been proposed on a monthly basis.

The structural adjustment program that has been undertaken by the Government since 1987/88 has had a positive impact on the Nepalese economy. The present adjustment program has been designed primarily in a medium-term framework with 1990/91 as the target year. The essential features of the program for 1988/89 include: (1) macroeconomic stabilization; (2) resource mobilization; (3) increased investment efficiency; (4) improvement of public enterprises; (5) financial sector reform; and (6) activation of the private sector in agriculture, forestry, trade, and industry. The measures have been amply reflected in the budget speech for 1988/89, and was in the Government's subsequent actions since then.

Nepal is sincerely committed to implementing the structural adjustment measures in the medium term. As mentioned earlier, the Nepalese authorities have already undertaken policy initiatives in connection with the second-year structural adjustment arrangement. The authorities considered that the adjustment program initiated in 1987/88 laid the foundation for a more sustainable growth and for a viable external balance. With the consolidation and achievements gained during the period under the structural adjustment arrangement, the authorities intend to design a more intensified program for the years ahead, which they hope will be Fund supported under the enhanced structural adjustment facility. To help Nepal maintain the momentum of its structural adjustment efforts and development, I would be grateful indeed to receive the Directors' full support for the proposed decision.

With respect to Nepal's bilateral payments arrangement with Poland, the arrangement was entered into at a time when Poland was not a Fund member. It is the intention of the authorities to bring the arrangement in line with the Fund's rules; the bilateral payments account has already been made inoperative.

Mr. Enoch made the following statement:

Nepal's economic performance over the past year has been encouraging. Output recovered strongly after the 1987 drought and, with appropriately prudent fiscal and monetary policies in place, there was a further deceleration in the rate of inflation. In addition, a number of useful structural reforms were implemented, including a significant liberalization of industrial and trade policies, which contributed to a substantial improvement in Nepal's export performance. These reforms, together with an unexplained increase in net capital inflows, helped to generate a significant overall balance of payments surplus, allowing the level of gross international reserves to rise sharply.

Nevertheless, it is clear that the economy remains structurally weak and highly vulnerable to exogenous factors. Given Nepal's desperately low level of per capita income, and the priority the authorities rightly attach to their ambitious Basic Needs Program, there can be no alternative to the vigorous and sustained implementation of further wide-ranging structural measures, set in the context of continued macroeconomic restraint. In light of the projections in Table 5 of the staff report, it is clear that Nepal's requirement for external concessional assistance is unlikely to diminish over the medium term. That consideration, together with the projected rise in the debt/GDP ratio over the next five years, suggests that the authorities should regard the current program as the minimum necessary to achieve their longer-term objectives.

My authorities were particularly pleased to note the emphasis the staff placed on the close economic linkages between Nepal and India. The existence of an open border between these two countries is, of course, a major influence on economic policy formation in Nepal, and it was very useful to see this important regional dimension explicitly recognized in the staff report. Extending the analysis somewhat further, I would be interested in any staff comments on what impact India's continued rapid growth of agricultural production might have on Nepal's export prospects over the next few years. A more detailed section in the staff report on the authorities' development expenditure program would also have been useful. I would be particularly interested in knowing what measures are included in the development program to promote further export diversification; for example, by increasing the capacity of the tourism industry.

Despite the undoubted importance of the development expenditure program and the measures to reconstruct the economic and social infrastructure following the disastrous earthquake earlier in 1988, the staff rightly stresses the key importance of maintaining budgetary discipline. It is also important to highlight the risks associated with the very large real wage increases granted to civil servants in 1988. As the background paper points out, remuneration of government employees in Nepal tends to guide wage demands in other sectors. While the need to improve morale in the civil service sector is understandable, a more gradualist approach might have carried less of an inflationary threat. A generalized increase in wage levels throughout the economy would simply erode competitiveness and increase the price level, leaving civil servants no better off than before, and the economy considerably worse off.

A key precondition for increasing the sustainable growth rate of Nepal's economy is the need to increase the role of the private sector. In that respect, the authorities' delayed reform of the financial sector should be regarded as a major priority under the second annual arrangement. In this context, we were pleased to learn about the success of the authorities' first treasury bill auction last month. Measures to improve the Nepal Rastra Bank's control over liquidity conditions should allow the phasing-out of direct credit controls, as well as a strengthening of price incentives. In addition, the authorities' intention to improve banking supervision and rehabilitate the major financial institutions will help to increase confidence in the financial system. Together, these reforms should lead to a significant increase in private savings, which is a key medium-term objective of the program.

Slippages were also seen under the first annual program in the area of public enterprise reform, and, in particular, in the privatization program. The staff report and the policy framework paper ascribe the delays essentially to technical factors. However, in the authorities' memorandum, reference is also made to "the need to avoid concentration of economic activity in the hands of a few privileged groups." I would be interested in the staff's clarification of that position. I would also be interested in knowing why the staff believes that Nepal needs gross international reserves covering more than five months of imports, a level which, for instance, is 70 percent higher than the coverage identified as adequate for Bangladesh--a country that is surely no less vulnerable to natural disasters and no less dependent on concessional assistance than Nepal.

I hope that the authorities will seize the opportunity presented by the second annual arrangement to demonstrate their readiness and ability to undertake an intensified adjustment program that could be supported by an enhanced structural adjustment arrangement in the future. Finally, I regret the absence of any reference in the staff papers to population policy. Given the impact of Nepal's growing population on the country's limited natural resources, the absence of a population policy may vitiate all the authorities' efforts to improve economic conditions. I would be interested in staff comments on this matter. With these remarks, I can fully support the proposed decisions.

Mr. Vasudevan made the following statement:

We fully support Nepal's request for a second annual arrangement under the structural adjustment facility. Mr. Shrestha mentioned in his opening statement that after consolidating adjustment under the structural adjustment arrangement, Nepal intends to design a more intensified program, which the authorities hope will be supported by an enhanced structural adjustment arrangement. We encourage Nepal to pursue that approach. Nepal has had a highly successful first year under its structural adjustment arrangement, and has undertaken structural measures in many different areas--fiscal, monetary trade, and in the public enterprises. Therefore, it is not clear what would constitute more intensified structural adjustment in the case of Nepal. The gains of the first year under the structural adjustment arrangement should have been sufficient to allow Nepal to switch to an enhanced structural adjustment arrangement. Has the staff discussed that possibility with the Nepalese authorities, or does the staff have other ideas? In this connection, we noted that the staff report did not mention Nepal's intention to request an enhanced structural adjustment arrangement.

The high rate of inflation, at 10.9 percent in 1987/88, is a matter of serious concern, given the country's low per capita income levels. It is essential that the authorities make efforts to reduce the inflation rate and alleviate structural constraints to high and sustained growth. This can be achieved with higher levels of investment in areas that have hitherto constrained growth. In this context, we noted with satisfaction that the authorities have not only financed higher levels of investment, but also raised additional revenues and increased development expenditures, particularly in the areas of irrigation, mining, manufacturing, and transportation. These expenditures are timely and necessary, especially since irrigation supplies have been inadequate, capacity utilization in many major industries has been high, and the transportation costs have risen owing to inadequate and poorly maintained roads.

We are impressed by the authorities' determination to use foreign financing to create development potential. The authorities have followed also a generally prudent policy of containing increases in regular expenditures: there has been a freeze on recruitment, and a control system has been introduced on purchases of other goods and services. The recent large salary increase for government employees seemed reasonable, given the considerable erosion in real wages in the last three years. In addition, there is very little evidence that the once-for-all increase entails risks for inflation and external competitiveness. In fact, the latest data show that the inflation rate has tended to decelerate--despite the salary increase.

We congratulate the authorities for introducing two new monetary and credit measures--the auctioning of 91-day treasury bills and the assurance that a certain proportion of bank credit will flow to the priority sectors. In light of the considerable demand for bank credit, achieving the monetary program targets might not appear easy, but this should not be very difficult if credit expansion to the public sector is kept under restraint--a point with which the authorities seem to agree.

Given the authorities' determination to adopt a flexible exchange rate policy and to continue with the policy stance of containing inflation while promoting growth, it should be possible to achieve a viable external position. The further liberalization of the trade system in 1988 will help reduce bottlenecks in procuring the necessary inputs. As to external debt, we encourage the authorities to concentrate on concessional forms of assistance. In this context, an enhanced structural adjustment arrangement would be helpful not only to reduce the debt service ratio, but also to help provide a cushion of reserves that are necessary for undertaking economic and trade diversification.

Mr. Templeman made the following statement:

Nepal's economic performance over the past year has been quite good. Most macroeconomic targets were achieved, most quantitative benchmarks under the first year of the structural adjustment arrangement were met, and at least fair progress was made in meeting structural reform benchmarks. We particularly welcome the modest increase in the domestic savings ratio in 1987--an important point stressed by Directors at the time of the 1987 Article IV consultation. On the other hand, inflation, although down from the 1986/87 level, overshot the 1987/88 target, but we hope that the one-time price effect of drought in India was the principal reason. Slippages on financial reform and tax administration were regrettable and have to be made up in the 1988/89 program year. We also note that there was some overshooting of credit to the public enterprise sector, and we hope that that will not be repeated.

Some elements of the 1988/89 program are already supposed to have been introduced. The new budget, for example, contained some revenue measures which were aimed at achieving a revenue/GDP ratio of 11.2 percent in 1988. However, the actions taken seem to be rather diffuse, and do not address basic features of the tax system. We recognize that more fundamental reforms of the income tax system and the possible establishment of a value-added tax are to be embodied in reform programs in subsequent years. Nevertheless, we would welcome some staff comment on these latest revenue actions. According to Mr. Shrestha's opening statement and the supplement to the staff report, the structural benchmark actions specified for October and November 1988, listed on page 46 of the staff report, have been taken. However, we wonder whether any quantitative benchmark data are available yet for the October 15 deadline.

In light of the clear need for economic growth and diversification of the economy, we remain somewhat puzzled by the continued existence of an industrial licensing system. The system seems to be related to a desire to anticipate the demand for imports, as suggested by the partial liberalization of the system in the past year. We notice that no further liberalization is planned for 1989--only for 1990. We would welcome staff comments on the rationale for such a system.

Some good progress has been made in reducing the budget/deficit ratio, including better than targeted performance in 1987/88. The increase in the revenue ratio and the shift in the mix of expenditures were also appropriate. However, there would be some increase in the deficit ratio in 1988/89, despite a further strengthening in revenue performance. It may well be that the 25 percent public wage concession was necessary to compensate for the previous decline in real wages, and that earthquake-related expenditures on the order of 1 1/2 percent of GDP needed to be taken into account. Nevertheless, care needs to be taken in order to avoid eroding past gains in fiscal adjustment. The limit of 1.5 percent of GDP on domestic bank financing of the deficit in 1988 should help to prevent any crowding out of credit to the productive sector.

Apart from the overshooting of credit to the public enterprises, it appears that progress is being made in the reform of these enterprises, including the granting of greater management autonomy, the introduction of penalties and bonuses to management, the inclusion of explicit subsidies in the budget for reasons of transparency, and initial steps toward some privatization--although the latter seems to be moving rather slowly. In that connection, we welcome the technical assistance to be extended by the International Finance Corporation.

While progress is being made in strengthening the public savings effort, financial market reforms will also be crucial to prevent inflationary financing of the deficit and to foster mobilization and efficient investment of private savings. The expansion of a treasury bill market, the broadening of the range of maturities of public debt instruments, and the strengthening of the financial position of banking institutions and of the bank supervision system--with the help of technical assistance from the Fund, the World Bank, and others--are all steps in the right direction. However, we wonder what the prospects are for developing a market for private securities. We also hope that the emergence of a system of open market operations will soon allow an end to direct credit controls.

The existence of real positive interest rates on both the lending side and the deposit side should help in mobilizing capital for investment, and also function as a source of strength for the balance of payments. However, we were somewhat surprised at the relative lack of attention to foreign direct investment. A flexible exchange rate policy will be important in influencing capital flows. In that connection, the unexpectedly large overall surplus in the balance of payments of SDR 72 million in 1987/88, compared with an expected surplus of SDR 7 million, deserves more attention. The staff suggests that the large positive errors and omissions item may include some underreporting of exports. We would welcome further comment on that phenomenon.

When the Board initially approved the structural adjustment arrangement, this chair expressed doubts about whether Nepal was really facing the "protracted balance of payments problem" required for eligibility for financing under the structural adjustment facility, and concerns about the adequacy of the evidence presented in the staff paper at that time. While the assessment and presentation of Nepal's balance of payments situation is better in the current staff report, the outlook for the external accounts does not allay the concern that we originally expressed. Poverty and structural problems alone do not necessarily demonstrate a protracted balance of payments problem, nor justify an entitlement to use the resources of the structural adjustment facility. Instead, those problems might show a developmental problem that could be dealt with by other means. Nepal's medium-term outlook, for example, shows an acceptable rate of economic growth, an overall surplus in the balance of payments with a corresponding maintenance of reserves at about five months of imports, fairly modest debt and debt service ratios, and the receipt of much larger official financing flows on more concessional terms from other sources of financing than from the Fund. The large unexpected overall surplus in 1987/88 provides an additional reason to raise questions about the appropriateness of financing under the structural adjustment facility. While we can go along with the second year of the structural adjustment arrangement, these factors underline the importance of the staff's providing clear justification for eligibility for all structural adjustment arrangements and enhanced structural adjustment arrangements at the outset, including any future enhanced structural adjustment arrangement for Nepal.

Finally, we would like to stress the importance of the trade liberalization effort, both with regard to the expansion of the open general license list in 1987/88 and the intention to expand the list further in 1988/89 and 1989/90. In addition, the study of import protection levels, which is to be conducted under the second structural adjustment loan, is very important.

Mr. Yoshikuni made the following statement:

Nepal's economy has undergone a significant adjustment process during the past several years. First, to address the problem of a deteriorating external position caused by expansionary financial policies in the early 1980s, the authorities implemented a strong macroeconomic adjustment program supported by a stand-by arrangement in 1985/86 and 1986/87. Having successfully completed the stand-by arrangement last year, the authorities embarked on far-reaching structural measures aimed at increasing the standard of living, and realizing a viable external position in the medium term. These measures were supported by a structural adjustment arrangement and a structural adjustment loan from the World Bank. According to the staff report, the performance under the first year of the structural adjustment arrangement seems to be broadly satisfactory, which underscores the importance of sound macroeconomic policy as a basis for structural adjustment. In this connection, I very much appreciate the Nepalese authorities' efforts to establish a good precedent.

However, Nepal is still faced with serious economic difficulties, such as a low per capita income and inefficient allocation of resources. In addition, the country has suffered heavily from the recent earthquake. Accordingly, there is no room for complacency, and the authorities' task continues to be formidable. In light of these considerations, I believe that the second annual structural adjustment arrangement would help the authorities to implement further structural adjustment in 1989.

While I broadly share the staff's view on the second-year program, I wish to touch on a few areas for emphasis. First, on macroeconomic policies, I share the staff's concern about the possible adverse effect of the recent modest relaxation of fiscal policy. As I noted earlier, a sound macroeconomic policy is an essential prerequisite for the structural adjustment process. In this context, there have been several cases in which the transfer from a stand-by arrangement to a structural adjustment arrangement resulted in lax macroeconomic policies that, in turn, made the structural adjustment program difficult to implement. While I sympathize with the country's difficult situation after the recent earthquake, I urge the authorities not to spoil the success achieved so far in the adjustment process in exchange for short-term considerations.

Second, with regard to fiscal measures, I am impressed by the rapid progress in raising government resources--mainly by broadening the tax base and improving the tax collection process rather than raising the tax rates. In this connection, I want to stress that the technical assistance extended by the Fiscal Affairs Department has been very helpful in coming up with comprehensive revenue measures. That assistance, together with assistance from the Central Banking Department on monetary policy and bank supervision, underlies the Fund's strong ability to address these issues. Nonetheless, a delay in the establishment of the unified revenue service suggests a lack of an efficient personnel management system in the public sector. Therefore, it is advisable to continue and intensify technical assistance in this area.

Third, I note with pleasure that the first auction of a 91-day treasury bill was satisfactory. Together with the Nepal Rastra Bank's initiative to develop an efficient money market, the auction system will greatly facilitate the authorities' efforts to improve resource allocation. On the other hand, I have to add that monetary policy should continue to be conducted carefully in view of the inflation rate, which is still on the high side. I am encouraged by the authorities' strong commitment to contain inflation, which Mr. Shrestha expressed in his opening statement.

With these remarks, I support the proposed decision.

Mr. Kleine made the following statement:

Overall, we share the relatively favorable assessment of Nepal's recent economic performance, as expressed by previous speakers and by Mr. Shrestha in his opening statement. We commend the authorities for the close collaboration Nepal has maintained with the Fund over the years.

However, Nepal's performance under the first annual structural adjustment arrangement was not fully satisfactory. I am somewhat concerned that the momentum of structural adjustment was not fully sustained--particularly with respect to reform measures in the financial sector and in the area of tax administration. Clearly, decisive steps in these areas are crucial to the eventual success of Nepal's structural adjustment program. Accordingly, we urge the Nepalese authorities to step up their efforts.

The second annual arrangement seems to include steps in the right direction, and some of its measures have already been put in place. Nevertheless, we would have liked to see concrete steps leading to privatization of some public enterprises. Intentions to that effect were already formulated in 1987. While we, of course, recognize the many difficulties involved, we encourage the authorities to push ahead with their privatization plans. In general, weaknesses in administrative capacity may continue to act as a significant bottleneck. Therefore, technical assistance from the Fund and the World Bank appears to be appropriate.

On Nepal's intention to request an enhanced structural adjustment arrangement after successful completion of the second annual structural adjustment arrangement, I believe that my authorities would consider such a request favorably. However, more ambitious efforts in the fiscal and external areas would be required.

We noted Mr. Shrestha's statement concerning Nepal's bilateral payments arrangement with Poland. We hope that Nepal will soon be in a position to set a firm date for its elimination.

I endorse the staff appraisal and support the proposed decisions.

Mr. Ghasimi made the following statement:

The Government of Nepal has achieved the main objectives of the first annual adjustment arrangement. The implementation of the program resulted in the strong recovery of output, an improvement in exports and external payments, the abatement of inflationary pressure, and a decline in the budget deficit. These achievements have put the economy on a track of sustained growth, and have prepared the authorities for the implementation of structural development under the second year of the structural adjustment arrangement.

We believe that the second part of the program is fairly well designed, and we are in broad agreement with the staff's views; if the program is carried out rigorously, it would help mitigate the prevailing structural obstacles to economic growth. Moreover, we feel that effective implementation of the program would improve the external payments and overall reserve position and, thus, enable the authorities to service the country's financial obligations. On this basis, we can support the request for the second annual arrangement. However, we wish to make a few remarks--mostly as a matter of emphasis on the authorities' approach to alleviate constraints to the growth of the economy.

Despite the preliminary estimate of a slowdown in the rate of increase in the general level of prices, the potential inflationary pressure remains a most serious threat to the structural adjustment program and the growth of the economy. It is encouraging to note in Mr. Shrestha's opening statement that despite some deceleration in the rate of inflation, the authorities are duly concerned about this matter. We believe that the major forces behind the inflationary pressure--as shown in the staff papers--are the 25 percent increase in envisaged development expenditure, considerable rehabilitation and welfare-oriented outlays, and the 25 percent general salary increase for government employees. Given the time lag between development expenditures and their effects on output, and owing to the heavily inflationary impact on other expenditures, we feel that the adoption of a persistent and effective demand management policy, aimed at controlling the undue increase in consumption demand and at reducing the excess liquidity of the banking system, is of vital importance to the steady growth of the economy.

As to the control over liquidity conditions, we wish to compliment the authorities for the measures already taken, or that are proposed to improve the supervisory function of the Nepal Rastra Bank, and to review its procedures for refinancing commercial banks. We also commend the authorities' efforts in expanding the organization of the existing money market by improving the techniques and instruments of domestic debt management. However, it is worrisome that, despite the prevailing high interest rate, the demand for credit by the private sector is increasing sharply. In this connection, the recent auction of 91-day treasury bills was definitely a move in the right direction in dealing with the excess liquidity of the economy. This situation demonstrates that a strong and well-organized banking system could be very advantageous in mitigating many of the structural constraints to growth, while maintaining relative stability in the economy.

As to the inflationary impact of a sharp increase in development expenditure, we agree with the authorities' views that the emerging inflationary pressure could be relieved by improving the utilization of labor resources through the implementation of new labor-intensive projects--provided that these measures are able to invigorate the supply side of the economy in a short period of time.

On the fiscal side, we endorse the staff's views that the authorities' tax policy should be reinforced in order to reduce the overall budget deficit.

With regard to the agricultural sector, it is disheartening to note that its share in GDP has fallen considerably over the recent past, owing mainly to low productivity. It is also rather unfortunate that manufacturing accounts for less than 5 percent of GDP. We hardly need to emphasize that this situation might cause some imbalances in the process of growth. The objectives of agricultural policy, as set out on page 22 of the staff report, and as indicated in Mr. Shrestha's statement, are encouraging. In addition, agricultural production has increased by as much as 18 percent recently. However, we feel that a more comprehensive structural reform than has been envisaged in the second annual program for 1988/89 is necessary, because efforts to augment productivity and maintain a high rate of growth in the agricultural sector are of paramount importance for the even growth of the economy.

Finally, in light of Nepal's development and reform program, we warmly endorse the proposed structural adjustment arrangement.

Ms. Yang made the following statement:

The Nepalese economy recorded an impressive performance in 1987/88. Economic growth recovered strongly, while other macroeconomic targets were basically observed under the first year of the structural adjustment arrangement. It is obvious that the Government's continuous adjustment efforts, particularly in the structural field, played an important role. The Government's net claims on the domestic banking system were sharply reduced, which contributed to a reduction in overall domestic credit to a level well below that programmed. Prudent fiscal and monetary policies, combined with firm structural measures, should lay a solid foundation for further improvements in the balance of payments position and more sustainable growth in the economy. I am in broad agreement with the staff appraisal and Mr. Shrestha's opening statement.

I am very impressed by the authorities' determination to alleviate Nepal's poverty. Mobilization of domestic resources is obviously of paramount importance in the authorities' efforts to achieve this objective. As the staff points out, rapid growth of public investment is much needed in the authorities' long-term poverty alleviation program, which in turn requires substantial real and financial resources. The Government has introduced a set of measures to raise revenue, and the banking system is undergoing financial reforms to encourage financial savings. However, given the limited domestic resources and shortages of infrastructure, priorities for public investment projects should be established if undue reliance on foreign financing is to be avoided.

Gross international reserves increased significantly owing to a substantial increase in the overall balance of payments surplus. While the increase is an encouraging sign in terms of import financing, such a level may not be sustainable, as it is built on a weak balance of payments structure. The accumulation of international reserves in recent years, for example, is mainly constituted of net capital inflows and a large amount of positive errors and omissions. To stabilize the balance of payments position and narrow the current account deficit, it is essential to adjust the balance of payments structure. Continuous efforts should be made to widen and promote the non-traditional export base, while diversifying traditional exports.

Finally, I find the 1988/89 macroeconomic targets contained in the economic and financial program for the second annual structural adjustment arrangement generally appropriate, as well as the policy measures that will support that program. I fully support the proposed decisions.

Mr. Al-Jasser made the following statement:

When the Board considered Nepal's request for a structural adjustment arrangement on October 14, 1987, we expressed concern about the attainability of the growth target of 4-5 percent a year. That concern was based on the fact that a significant proportion of economic growth would be provided by the agricultural sector, which seemed most vulnerable to the vagaries of the weather. The staff report and Mr. Shrestha's opening statement have allayed our fears. The Nepalese economy has rebounded. It is heartening to observe that real GDP grew by 7.1 percent in 1987/88, compared with only 2.4 percent in the preceding year. This improvement was made possible, thanks to an 8.7 percent increase in agricultural production and a 5 percent growth in nonagricultural production. Notwithstanding the improvement in weather conditions, the measurable gains in agricultural yields, and increases in absolute amounts produced of grains and cash crops, are noteworthy achievements. The Nepalese authorities are to be commended for these achievements and encouraged to persevere in their efforts to expand their agricultural production qualitatively and quantitatively. This is the more imperative, since the agricultural sector employs more than 90 percent of the Nepalese population.

An efficient mobilization of domestic economic resources to finance economic development is crucial, and I am glad to note that the growth of domestic savings has not only been sustained in 1987/88, but also increased slightly. I am also pleased to note that last year's growth target for the net domestic assets of the financial sector led to a crowding-in effect rather than a crowding-out effect.

The authorities' efforts to achieve further financial deepening are welcome--especially the issuing of treasury bills last November. However, from footnote 1 on page 20 of the staff report, it appears that the Government meets any shortfall in domestic finances by drawing on its overdraft facility with the central bank, which is repaid first at the end of the fiscal year through the issuance of government securities and savings certificates. I would appreciate staff comments on whether or not this arrangement is inflationary owing to the lag between the infusion of liquidity by the Government and the siphoning-off of any resulting excess liquidity thereafter. I hope that the recent auctioning of treasury bills will prove to be a useful monetary instrument in managing the Government's cash flow, particularly in restraining any inflationary pressures. Furthermore, if the economic benefits of financial deepening are to be realized, the Government should give precedence to enhancing the efficiency of the financial system through its institutional development, and to developing its supervisory and regulatory functions, such as the Credit Risk Bureau.

Although disheartened by the destruction caused by last August's earthquake, I am encouraged by Nepal's achievements in improving its external accounts through the promotion of exports, import substitution, and improvements of its fiscal stance through the broadening of revenue-generating measures. I sincerely hope that Nepal will be able to maintain its courageous structural adjustment program, and that the fiscal slippage, caused by the need to increase government expenditures in the aftermath of the earthquake, will not become a permanent appendage to the Nepalese budget. I also hope that the failure to meet some of the policy benchmarks in the areas of tax administration and financial sector reform will not dissuade the authorities from pursuing even more vigorous efforts in the months to come.

I am in general agreement with the thrust of the staff appraisal. I support the proposed decisions.

The staff representative from the Asian Department said that there were several indications that Nepal's balance of payments difficulties were indeed structural in nature. Export earnings covered less than 30 percent of import requirements, and the export base remained narrow and vulnerable to exogenous shocks. Despite large external assistance, there was a chronic shortage of foreign exchange, which necessitated the maintenance of tight import restrictions and exchange controls. Moreover, the current account deficit in relation to GDP was quite high for a protracted period of time. Some other indicators, such as the debt service ratio, gave less clear-cut signals about the balance of payments problem, and in the recent past the current account deficit was more than fully covered by capital inflows, including aid flows. In that connection, however, a key question was whether or not external assistance would have been the same without the structural adjustment arrangement. The staff believed that the arrangement had had a significant effect in catalyzing donor support for Nepal's adjustment efforts.

Nepal needed to maintain reserves at a high level, partly because the variability of exports had been quite high, the staff representative stated. Over the past four years, the rate of growth of exports in volume terms had fluctuated from a deficit of 15 percent to a surplus of 40 percent. The variation in import volume growth had been less pronounced but still significant, while gross inflows of foreign assistance had ranged from about 6 percent to 8 percent of GDP. In addition, a relatively high level of reserves was needed to provide a cushion while the authorities continued with their efforts to liberalize the trade system and pursue other structural reforms, because the short-term effects of such reforms on the balance of payments were difficult to predict. Although it was probably not absolutely essential for Nepal to maintain reserves at the equivalent of five months of imports, as at present, the authorities considered that a reserve/cover ratio of about six months of imports was appropriate; it should also be noted that in the late 1970s and early 1980s, Nepal had had a reserve/cover ratio well above that figure.

The errors and omissions item in the balance of payments had been extremely large in 1987/88, the staff representative remarked. One factor that might have contributed to that was unrecorded exports to India, which had probably been higher than usual. Although the authorities had imposed a ban on exports of rice in early 1988 in order to ensure adequate domestic supplies and mitigate the impact of the drought in India on domestic prices, the ban was unlikely to have been fully effective. In addition, data on tourist arrivals suggested that earnings from the tourism sector might have been higher than had been indicated in the preliminary balance of payments statistics. Unrecorded current account receipts probably accounted for about SDR 15 million of the total errors and omissions item of SDR 94 million.

The balance of payments statistics also seemed to understate the net inflows of foreign assistance, the staff representative said. Data from the budgetary accounts suggested that the understatement was in the order of SDR 17 million in 1987/88. The balance of the errors and omissions item was probably accounted for by private capital inflows; with the reduction in the rate of inflation, domestic interest rates had become significantly positive in real terms. That development, together with improved confidence engendered by the authorities' adjustment program, were likely to have contributed to increased capital inflows.

The staff did not have any data yet on the quantitative financial indicators for October, the staff representative commented. The 1988 tax package represented a good effort to raise the revenue/GDP ratio further in 1988/89, and to broaden the tax base and improve the tax structure. However, there were a few weaknesses in the package; for example, while the advance income tax on importers should help to bring in taxes from people who had previously avoided paying taxes, it was also likely to bring forward tax payments that would otherwise have been collected in 1989/90. To that extent, the income tax on importers would not have a permanent effect on revenue collections. Some of the other measures in the tax package tended to exacerbate the problem of exemptions and preferences--for example, the exemption of taxes on profits from exports. Another problem was that the preferential tax treatment of the agricultural sector had not been addressed in the 1988/89 budget, although the authorities were encouraging the local governments to introduce a property tax as an alternative to a tax on agricultural income.

The staff had provided some details on the functional classification of development expenditure in Table 19 of the background paper (SM/88/258, 11/23/88), the staff representative noted. The main priority had been to increase allocations for the productive sectors, which should have a positive effect on exports in the future. However, there were no specific measures included in the development budget to directly promote exports.

Technical factors were the most significant reasons for the failure of the privatization efforts, the staff representative said. The main explanation was that enterprises whose shares were offered for sale were not profitable. The authorities' asking price had also been too high in some cases. In addition, the authorities had imposed some constraints on the terms of sale, which had contributed to the program's lack of success; block sales had been banned and tight limits had been placed on the number of shares that any individual investor could acquire. Those restrictions had been imposed owing to the authorities' concern about the emergence of private monopolies, but political considerations had no doubt also been a factor.

In principle, the Government's heavy reliance on its overdraft facility with the central bank, in order to meet its borrowing requirement in the course of the financial year, was inflationary, the staff representative observed. But, in practice, that effect was attenuated through the use of direct credit controls. Accordingly, the main disadvantage of the arrangement was that it distorted resource allocation.

There were two reasons that, according to the authorities, justified the maintenance of the industrial licensing requirement, the staff representative remarked. The main reason was that industrial licensing provided a basis for establishing legitimate users of import licenses for intermediate inputs and capital goods, but it was also seen as a useful instrument to prevent the emergence of excess capacity in the industrial sector.

The staff agreed that the authorities' efforts to improve economic conditions could not succeed in the absence of a policy to slow population growth, the staff representative continued. The official objective was to reduce the annual rate of population growth from 2.7 percent to 2.2 percent in the 1990s, and to 1.5 percent by the year 2000; however, that objective was probably too ambitious. Nevertheless, Nepal was receiving assistance from various international agencies to help develop an appropriate population policy, and the Basic Needs Program also emphasized family planning and female literacy.

The Nepalese authorities' preparatory work on the next development plan, together with studies on trade liberalization and financial sector reform--which would be undertaken under the World Bank's second annual structural adjustment loan--should provide a useful basis for designing a program that would qualify for an enhanced structural adjustment arrangement, the staff representative from the Asian Department said. However, it was impossible to tell whether that work would be sufficiently advanced to enable the authorities to present a program for an enhanced structural adjustment arrangement by 1989/90.

The Chairman said that it had been obvious to him, when he had visited Nepal at the end of October, that the authorities would have to implement additional structural measures in order to fulfill their ambitious objective of meeting the basic needs of the population by the year 2000. While an enhanced structural adjustment arrangement could help the authorities in their efforts, he believed that they were well aware of the prerequisites in terms of further structural adjustment.

Mr. Shrestha remarked that Nepal was one of the least developed countries in the world. Many adjustments had to be made simultaneously to transform the country's traditional economy into a modern one. However, owing to the lack of resources and manpower, everything could not be done simultaneously; the process had to be gradual. In the two years 1986-87, stabilization measures had been the main thrust of economic policies in Nepal, but since then, measures to strengthen the management of development projects and resource mobilization had been given highest priority.

Directors had recognized, in their deliberations, that Nepal had already made substantial progress in achieving more stable macroeconomic conditions and more rapid economic growth, Mr. Shrestha remarked. Growth with equity and control of inflation were the main economic objectives of the program for 1988/89. To achieve those objectives, various policy measures had been adopted, such as giving top priority to the Basic Needs Program, strengthening institutional arrangements, increasing private sector participation, and introducing measures for efficient allocation of resources through liberalization measures and financial sector reforms. Increased resources had already been allocated to some areas, such as agriculture, irrigation, industry, health, education, and water projects.

Since a large segment of the Nepalese population lived below the poverty line, activities relating to employment opportunities, such as development of small farms and enhanced opportunities for women had been proposed for extensive implementation, Mr. Shrestha noted. A Lead Bank Scheme had been introduced to increase the flow of resources to the productive and priority sectors, which would benefit the poor segments of the population.

In respect to an enhanced structural adjustment arrangement, following the structural adjustment arrangement in 1990, a new Five-Year Plan would be launched with a 7 percent growth target, compared with the current 4.3 percent growth target, Mr. Shrestha commented. To achieve that target, Nepal certainly needed large amounts of resources and carefully planned programs. In that context, it would be appropriate for Nepal to request an enhanced structural adjustment arrangement after the completion of the present structural adjustment arrangement. Finally, he appreciated Directors' valuable comments, and would communicate those suggestions to his authorities in Nepal.

The Chairman made the following summing up:

> Executive Directors commended the authorities for Nepal's macroeconomic performance since the last consultation, noting the substantial acceleration in economic growth, the strong performance of nontraditional exports, the significantly improved fiscal position, and the large accumulation of international reserves. Directors were of the view that these developments could be attributed to a large extent to the favorable impact of policy measures implemented under Nepal's structural adjustment program. However, some speakers noted that in a few areas the policy targets set for 1987/88 had not been met. Concern was expressed, in particular, about the substantial delay experienced in setting up the closed and unified revenue service, as well as the slow progress that had been made in financial sector reform,

in strengthening the performance of public enterprises, and in promoting the Government's privatization program.

Directors agreed that Nepal still faces major impediments to growth and needs to press ahead with further structural reforms in several areas if medium-term prospects are to be strengthened and dependence on external assistance is to decline somewhat. They therefore welcomed the new policy initiatives for the current fiscal year, in particular the steps taken to increase domestic resource mobilization, widen the scope of financial sector reforms, and ease trade restrictions. Directors agreed with the staff that vigorous implementation of the structural measures embodied in the program supported by the structural adjustment facility, and perseverance with structural adjustment over the medium term, would be essential to promote economic diversification, strengthen the external position, sustain a good growth performance, and facilitate the attainment of the objectives of the Government's Basic Needs Program. Indeed, several Directors observed that these structural measures might have been more ambitious than those contemplated in the second-year program under the structural adjustment facility.

At the same time, Directors stressed the need to complement the structural adjustment efforts with appropriate demand management policies. In this connection, although speakers understood the constraints imposed by the need to finance reconstruction expenditure following the earthquake, some concern was expressed about the relaxation of fiscal policy in 1988/89, and the authorities therefore were urged to strengthen the fiscal position as soon as possible. They also emphasized the need for greater prudence in wage awards to assist in further moderating inflation. Many Directors stressed the need for monetary policies that would encourage savings and lead to improved resource allocation. In this connection, they remarked on the importance of technical assistance in the area of financial intermediation. They also remarked that it would be important to continue with a flexible exchange rate policy in order to preserve external competitiveness.

Directors observed that Nepal's debt service ratio was comparatively low but rising. In Nepal's circumstances, primary reliance on external assistance on highly concessional terms was indicated so as to keep the debt service burden at a manageable level. Directors welcomed the authorities' intention to initiate procedures for terminating the bilateral payments agreement with Poland, and hoped that a date would soon be agreed for such termination.

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

The Executive Board then took the following decisions:

1988 Consultation

1. The Fund takes this decision relating to Nepal's exchange measures subject to Article VIII, Section 2(a), and in concluding the 1988 Article XIV consultation with Nepal, in the light of the 1988 Article IV consultation with Nepal conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Nepal's exchange restrictions as described in EBS/88/233, are maintained in accordance with Article XIV, Section 2, except that the restriction on payments and transfers for current international transactions arising from the bilateral payments arrangement with a Fund member is subject to approval under Article VIII, Section 2(a). The Fund urges Nepal to eliminate the restrictive features of this bilateral payments arrangement as soon as possible.

Decision No. 9046-(88/180), adopted
December 14, 1988

Structural Adjustment Facility - Second Annual Arrangement

1. The Government of Nepal has requested the second annual arrangement under the structural adjustment facility.

2. The Fund has appraised the progress of Nepal in implementing the policies and reaching the objectives of the program supported by the first annual arrangement, and notes the updated policy framework paper (EBD/88/332).

3. The Fund approves the arrangement set forth in EBS/88/233, Supplement 3.

Decision No. 9047-(88/180), adopted
December 14, 1988

3. KINGDOM OF THE NETHERLANDS - ARUBA - 1988 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1988 Article IV consultation with the Kingdom of the Netherlands - Aruba (SM/88/250, 11/15/88). They also had before them a background paper on recent economic developments in Aruba (SM/88/260, 11/30/88).

Mr. Posthumus made the following statement:

The authorities of Aruba highly appreciate the staff report for the Article IV consultation with Aruba, as well as the discussions with the staff on October 12-19, 1988. In 1986, the financial and economic situation in Aruba was described by my Alternate as follows: "The economy of Aruba has undergone dramatic changes in the recent past; a contraction of GDP of a quarter, a halving of foreign exchange earnings and a large loss of employment." These developments, caused by the closure of the oil refinery, prompted the authorities to take strong adjustment measures, which later proved to be successful. The economy of Aruba has undergone dramatic changes in the recent past; real GDP grew by 10 percent in 1987, and by 14 percent in 1988; foreign exchange earnings increased by almost 50 percent between 1986 and 1988; and the unemployment rate dropped during the same period from 19.6 percent to 4.7 percent.

The discussions with the staff were held at a moment when the authorities had realized that the Aruban economy had reached a stage of overheating. A turnaround in financial and economic policy, as well as in the acceptance by the public of such a policy change, is indeed required, and the authorities are committed to complete this task. As to monetary policy, measures were taken in the summer of 1988, at the time when the central bank's loss of foreign reserves accelerated. The central bank concluded an agreement with the commercial banks to limit the growth of their loans in 1988, but no decisions have yet been taken for 1989. The authorities fully agree with the staff that the fiscal prospects for 1989 are not satisfactory; the fiscal deficit is much too high. They intend to put the emphasis on a restriction of budgetary expenditures in 1989, as they are afraid that tax increases and, in particular, increases in import duties might lead to price increases as well, which in a tight labor market could lead to wage increases. The authorities expect that owing to higher economic growth and better tax collection, tax revenues will be Af. 10-15 million more than estimated by the staff for 1988, which would carry over into 1989. In 1989, the deficit on the current account of the budget is likely to decrease somewhat, but the deficit on the capital account will indeed show an increase.

My Aruban authorities are well aware of the problems and risks associated with the one-sided orientation on the tourist sector. Although efforts are being undertaken to diversify the economy, tourism is a sector in which Aruba has a clear comparative advantage, perhaps the only one. In 1986 and 1987, substantial efforts were made to attract new investments in this sector, for example, through partial guarantees on investments. This particular policy has been discontinued, and given the good prospects in the tourist sector, efforts are under way to refinance some of these investments--without guarantees from the Government. Nevertheless, the number of hotel rooms will triple, to 6,500 by 1991, which will require continued government investment in the infrastructure.

The staff's suggestion to diversify the economy, which is indeed a way to defend the economy against extreme fluctuations, deserves careful consideration. However, it is fair to point out that the turnaround in financial and economic policy has been so fast that a substantial increase in savings--both in the government private sectors--including investments in financial assets abroad, is likely to take time. Nevertheless, the authorities have stated that they welcome the idea of income diversification, which they will take into account in their policymaking.

Extending his remarks, Mr. Posthumus said that his authorities--both the Netherlands and Aruba--were grateful for the direct contribution that the consultation had made to Aruba's policymaking. He hoped that Directors would agree with him that Aruba was a good example of a sharp and strong policy of adjustment to an external contingency that had led to early and successful results.

Mr. Marino said that Appendix I and II of the background paper on Aruba, dealing with the tourism sector and contingency planning, respectively, were particularly interesting. It was gratifying to discuss the case of Aruba, because, as the staff had put it, the problems facing the Aruban authorities were currently those of success. Only two years earlier, Aruba had faced a severe contraction of economic activity, a severe loss of jobs, and sharp cuts in foreign exchange earnings. The remarkable turnaround resulted from the authorities' determined adjustment efforts, particularly strong fiscal measures and the establishment of a central bank.

Some signs of overheating had emerged in Aruba's economy, such as a deteriorating fiscal position, a tight labor market, and very rapid monetary growth, Mr. Marino remarked. However, he was confident that the measures that had been adopted to cope with those trends would quickly restore equilibrium conditions and arrest the recent loss of foreign exchange reserves. It was comforting that, according to Mr. Posthumus's opening statement, the authorities were well aware of the current demand management problems and were in broad agreement with the staff's recommendations.

The authorities had developed innovative approaches to the structural constraints that the Aruban economy was facing, Mr. Marino noted. To address the emerging labor shortages, the authorities had financed a school to train workers in skills necessary for hotel services, conducted a recruitment drive among expatriate Arubans, placed a ceiling on social security payments, provided incentives to increase female participation in the labor force, and designed a new system to help match the demand for and supply of labor.

Aruba's main challenge in the medium term would be to safeguard the economy from major fluctuations in the tourism sector, in which it had a clear comparative advantage, Mr. Marino said. He cautioned the Aruban authorities against economic diversification that depended on permanent or artificial fiscal incentives. He considered that the diversification efforts should be directed toward reducing Aruba's dependency on tourists from only a few countries. In view of the volatility of the tourism sector, the authorities should consider promoting public and private savings during periods of strong economic growth. He suggested that the authorities examine the possibilities of establishing a contingency fund, as other countries had done in similar circumstances. Finally, he believed that many valuable lessons could be derived from the case of Aruba.

Mr. McCormack made the following statement:

> Aruba's economy has made a remarkable recovery since the sharp decline associated with the closure of the Lago refinery in 1985. This recovery was made possible through determined fiscal adjustment and fiscal concessions to the private sector. As indicated in the staff report, there is a prospect of further acceleration of economic activity for at least another two years. However, given the economy's limited resource base, its extreme vulnerability to external shocks, and the potential for inflationary pressures, we believe that the authorities should attempt to consolidate and strengthen the gains of the recovery through adopting less expansionary policies than those in place during the last two years.
>
> Recent economic developments have been based in large measure on the authorities' focus on tourism and associated infrastructural improvements. Fiscal stimulus has been unsustainably high, but appears to be on a downward trend according to projections for 1989. We agree with the staff that fiscal adjustment could be somewhat faster, since the economy appears in danger of overheating. We would add that tourism is a highly competitive industry--particularly in the Caribbean region--and rising labor costs or reduction in the quality of service, resulting from labor shortages, could erode some of the gains previously achieved. In this connection, we welcome the authorities' efforts to address the problems associated with the quantity and quality of labor.
>
> The decision not to encourage further tourism development at this time appears prudent and one may question legitimately whether too much expansion has already been planned in this area. The experience of other Caribbean countries during the late 1970s and early 1980s was that overexpansion made it

difficult for individual enterprises, especially at the lower end of the market, to cope with the economic downturn. The planned efforts to diversify markets and seek up-market tourists are commendable. However, competitiveness is essential, even in this niche of the market, since many other islands in the region are trying to tap the same source.

As the staff suggests in the background paper, the authorities should consider the creation of contingency funds, given the country's dependence on the volatile tourist industry. Contingency funds would serve to diversify income, act as a complement to product diversification, and smooth economic fluctuations. This move appears to represent prudent management, which would of necessity entail higher reserve holdings and correspondingly tighter financial policies. Clearly, the authorities are reluctant to bring about a sharp reduction in demand, but quite apart from standard macroeconomic and stabilization objectives, the risks associated with current public sector loan guarantees call for more cautious policy than would otherwise be necessary. I note from Mr. Posthumus's opening statement that the authorities welcome the idea of income diversification, and I urge them to explore this suggestion further with a view to implementation as early as practicable. More work obviously needs to be done on modalities, but the essential idea is compelling.

The staff appears less optimistic on the prospects for the intended product diversification efforts. While such efforts should be encouraged in the longer run, product diversification is an uncharted area in Aruba and requires careful evaluation before public funds are invested. More particularly, the provision of new guarantees in this area should be avoided--especially if the authorities are having difficulties in refinancing existing guarantees. Extensive reliance on such guarantees seems to question the frequent assumption that a stable macroeconomic environment is a sufficient condition for the creation of investor confidence, particularly in very small countries. I would be interested in finding out the staff's assessment of the potential of the offshore sector, in view of its already high level of development in other Caribbean countries.

As part of the strategy to restrain demand in the economy and arrest the decline in foreign reserves, resulting from the current strength of economic activity, the authorities have initiated credit controls in lieu of an active interest rate policy. While having some sympathy with the authorities on this matter, we agree with the staff that over the medium and long term, controls of the type imposed tend to impair the efficiency of credit allocation. The Central Bank is still in a learning stage, but consideration soon will need to be given to the development of other policy instruments. On interest rates, we urge the authorities not to ignore any emerging differential between domestic and foreign interest rates, and to be prepared to pursue a more active interest rate policy to test the degree of autonomy that they may have in practice.

Finally, we would welcome the staff's comments on the elements of a proposed tax reform for Aruba. We note that direct tax rates appear high and in need of reduction, though the timing of the reform has to fit into the Government's overall fiscal stance. We would appreciate further elaboration by the staff on two points. First, would the authorities' suggestion to tax tourism expenditure at a higher level provide significant additions to revenues, or would it have an adverse impact on demand for Aruba's product in view of the presumed relatively high price elasticity for tourism? Second, would the elimination of tax holidays add to revenues significantly, or would it act as a disincentive to private investors and therefore be self-defeating? I believe that such tax holidays erode the tax base and are undesirable in the long run, and perhaps also in the medium and short term.

Mr. Kleine commented that the staff appraisal deserved a particularly strong endorsement. The staff had very adequately addressed the many challenges that Aruba faced. In the past, ambitious adjustment policies had brought about strong growth, but currently the economy was overheating and decisive demand management measures were required--particularly a tightening of fiscal policy. He was confident that the Aruban authorities were fully aware of the problems and risks associated with an expansionary policy, and that they would give careful consideration to the staff's suggestions.

Mr. Fogelholm asked why a consultation was being held with Aruba, given that it was not a Fund member.

Mr. Jarvis made the following statement:

The transformation of the Aruban economy has been truly remarkable, owing in no small part to measures taken by the authorities. The combination of adjustment through the emergency fiscal package and measures to promote the tourism sector was clearly the right policy. The economic situation was desperate only two years ago; now, the economy is booming and Aruba has experienced substantial GDP growth and a reduction in the level of unemployment.

A question that arises is whether Aruba will be able to deal with the problems created by a booming economy as well as it dealt with the problems of economic recession. As the staff report points out, there are strong indications of overheating in the economy. In particular, consumption and credit have been growing very fast, and the problem of unemployment has been replaced by that of a shortage of labor.

In this situation, a cautious fiscal policy becomes particularly important. I can sympathize with the authorities' desire to cut taxes--especially to eliminate the solidarity tax--as Aruba now is reaping the benefits of its successful adjustment. I would hesitate to recommend, as the staff does, raising import duties. However, the fall in the ratio of tax revenue to nominal GDP from 0.29 in 1985 to 0.24 in 1988 is a source of concern. I note that indirect taxes appear to be much easier to collect than direct taxes, and I wonder whether a switch from direct to indirect taxes would be a useful means of addressing this problem. I would welcome the staff's comments on this issue.

The authorities will also need to exercise restraint in both current and capital expenditure. In this connection, I am pleased to learn that the authorities are planning rationalization in the public sector. This seems to be a particularly good time for rationalization, as any reduction in employment will actually help to alleviate the labor shortage. The Government should also be very careful in its plans for capital expenditure. It is important to rigorously evaluate new projects in order to avoid a waste of resources, or worse, the incurring of future liabilities.

I am a little concerned about the authorities' decision to use credit control measures to restrain monetary expansion. While Aruba's case is rather special, owing to the restraints on its pursuit of an independent interest rate policy, I agree with the staff's analysis that if credit controls are applied in the long term, they are likely to impair the efficient allocation of credit and also discourage savings. Tighter interest rate management and higher reserve requirements would be a better way of dealing with this problem.

The authorities are correct in seeking to diversify the economy and reduce its dependence on tourism. However, they face some difficult decisions in this endeavor. Many countries that have experienced rapid growth owing to the rise of one particular sector have attempted ambitious diversification schemes--often with disastrous results. Therefore, it is important that the authorities evaluate new projects carefully. Among the projects discussed in the staff report, the sale of oil exploration rights and the creation of light manufacturing industry seem to be some of the more promising suggestions. However, I have some doubts about the project for establishing Aruba as a center of new offshore banking activities, and I wonder whether the authorities have really thought this proposal through.

I found the staff's ideas on income diversification extremely interesting and of possible use to Aruba, in mitigating the effects of the inevitable fluctuations in income from the tourism sector. The suggestion of fixed coupon securities as a recession-proof asset depends on the assumption that interest rates will be procyclical, but is this something that we can be completely confident about? While the choice of dollar-denominated assets seems sensible, is there not a danger of vulnerability to external shocks which could affect both U.S. tourism and the value of the dollar?

Generally, the position in Aruba is very satisfactory. The adjustment undertaken by the authorities has been highly successful, and the prospects for sustained growth are good. The labor constraint is probably the major concern that the authorities face at the moment, and it may be that the encouragement of immigration is the only solution to this problem. The measures that the authorities have taken in the second half of 1988 prove that they are conscious of the dangers of overheating in the economy, and I am confident that they will be able to tackle them with the same skill and resolution as they dealt with the problems of recession.

The staff representative from the European Department explained that the reason why the staff was more hesitant about the scope for economic diversification than the authorities was twofold. First, given the available labor, the staff did not believe that Aruba possessed a comparative advantage in many areas outside tourism. To produce consumer electronics on the island was not a very promising suggestion, because it was hardly imaginable that Aruba, with its limited labor force, would be able to compete with countries such as Korea or Taiwan. Second, emerging labor shortages were a matter of particular concern, and any further economic diversification would imply that resources would have to be channeled away from the tourism sector, in which Aruba possessed a comparative advantage, to other sectors.

It would be premature to make any definite statement on fiscal reform, as the Fiscal Affairs Department had not yet completed its discussions with the authorities, the staff representative remarked. Nevertheless, the authorities intended to reduce the high dependence on direct taxes--especially income taxes--and raise the reliance on indirect taxes. Given the very low threshold before taxes were levied and the extremely progressive tax rates, the reform would encourage increased participation in the labor market, especially for women, and would give incentives to improve work performance. In the case of Aruba, the collection of wage taxes was simple and effective, while the collection of other direct taxes, especially profit tax, was very difficult. Taxes in the form of import duties were currently very low, but efficient. Accordingly, it would be preferable to start collecting taxes at the import level.

The social and economic infrastructures were being used very heavily by foreign tourists, but taxation in the tourist sector was very low, the staff representative noted. Accordingly, it appeared that the tourists were not paying in proportion to their use of available infrastructure. It was difficult to tell whether increased tourist taxation would provide a significant addition to revenue, or have an adverse impact on tourist demand. The staff had not been able to identify clearly the price elasticity with respect to tourism. However, there seemed to be scope for increased tourist taxation without undermining competitiveness, and price elasticity was likely to decline somewhat once the tourists were on the island.

Tax holidays were being applied both to well-established and recently opened hotels in order to attract businesses to the island, and it would not be possible to eliminate the tax holidays without a breach of contract, the staff representative said. In the past, when a hotel had been in operation for ten years, it would simply change names in order to benefit from a new tax holiday. However, it seemed like that argument could be disallowed without too much risk; once established on the island, it appeared unlikely that a business would close down on the grounds of not being given any further tax holidays.

As to fixed coupon securities as a way of investing financial assets, while the staff had worked out the broad concept of contingent reserves, it did not have the experience to recommend how they should be invested, the staff representative noted. But, fixed coupon securities had come to mind as a good way of investing financial resources that would be generated through domestic savings.

There were two principal reasons why the staff had been less optimistic about the possibilities of developing an offshore center on Aruba, the staff representative from the European Department commented. First, there was already a proliferation of offshore centers in the region. Second, it was not clear how the country would be able to benefit from an offshore center without offering considerable concessions, either in the form of fiscal concessions, or in the form of ease of the conditions under which the offshore activities could operate. In the latter case, the trust and confidence that the island had gained over the past years through its adjustment policy could easily evaporate if the offshore activities were not operating in line with internationally agreed conventions. However, the new offshore activities would come under the close scrutiny of the central bank, which had established a good reputation during its two years of operation.

The staff representative from the Legal Department noted that the Fund had long acceded to a request from the Kingdom of the Netherlands for complementary but separate consultations to be held with the Netherlands, the Netherlands Antilles--and, later, with Aruba--which were currently the three autonomous parts of the Kingdom of the Netherlands, the member of the Fund. Aruba, as an autonomous part of the territory of the Kingdom of the Netherlands, did not qualify for membership with the

Fund on its own, as it did not meet the Fund's criteria for membership with respect to full control of its external relations, notwithstanding the fact that Aruba had its own currency and central bank. On the occasion of the review of the Fund's Article IV consultation procedures in 1987, the staff had enumerated a number of reasons why the three consultations with the Kingdom of the Netherlands could not be consolidated into one.

The question of separate consultations with the three different parts of the Kingdom of the Netherlands had arisen for the first time in the context of the Dutch authorities' request in 1974 for Suriname to become an associate member of the Fund, the staff representative from the Legal Department recalled. The conclusion had been that Suriname's need at that time was one of technical assistance only, and that need was accommodated by extending the Fund's consultation procedures to include Suriname, which had later become a Fund member. The same approach had then been adopted in respect to the consultation procedures with Aruba, as well.

Mr. Fogelholm said that he questioned the basic difference between the case of Aruba and that of other territories in similar positions, such as Hong Kong, Bermuda, and Cayman Islands, for example. He had in mind the need to husband the Fund's resources.

The Deputy Director of the Exchange and Trade Relations Department remarked that the difference between Aruba and other territories in similar situations was that the Kingdom of the Netherlands had requested that the Fund hold consultations with Aruba whereas the other authorities had not made that kind of request. He noted that the Fund's consultation procedures were reviewed every year to reaffirm that they were acceptable to the Board.

Mr. Templeman noted that a related matter--that of the Fund's experience with respect to technical assistance to nonmembers--would probably be covered in the report to be issued shortly to the Board on technical assistance.

Mr. Posthumus observed that Mr. Marino's points with respect to product diversification not being allowed to have an adverse impact on the budget was well taken. On financial diversification, the question of refinancing investments without guarantees from the Government was an important step toward making the economy less vulnerable, by relieving some of the burden on the Government. Short-term hotel financing with guarantees could result in costs for the Government, especially during periods when the tourist sector was doing less well.

On monetary policy, the authorities agreed that credit restriction should not be maintained very long, but given the fast turnaround in the economy, it was the best approach in the short term, Mr. Posthumus remarked. He confirmed that the solidarity tax--a temporary tax--finally had been abolished after a one- or two-year postponement.

As to the legal aspect of the Fund holding a consultation with Aruba, Aruba was part of the territory of the Kingdom of the Netherlands, but it was completely independent in its economic policymaking, including exchange rate policy, Mr. Posthumus commented. The island was to a large extent in the same position, in the economic and financial sense, as any independent country. The Fund consultations were extremely helpful to Aruba because it was hard to obtain the kind of high-quality technical assistance that the Fund staff provided from other sources.

The Chairman remarked, on the question of continuing Article IV consultations with Aruba, that despite the demands placed on the staff, there was a certain educational value in keeping an open dialogue with Aruba. Obviously, the staff's assessment of the economic situation and its policy recommendations had been extremely helpful to the authorities. Moreover, the contribution of adjustment policies to the remarkable recovery of the Aruban economy had been important. This experience could be useful to other member countries, especially members in the Caribbean region.

The Chairman then made the following summing up:

Executive Directors commended the authorities for the remarkable turnaround in the Aruban economy, which had yielded double-digit growth rates and had virtually eradicated unemployment. Directors attributed this achievement to the decisive and swift action taken by the authorities in the wake of the economic crisis that followed the closure of the Lago refinery.

Directors believed that the outlook for the Aruban economy was promising, but that a number of important policy decisions would be required to take full advantage of the potential for economic expansion and to stabilize income over time. First and foremost, there was a need for a shift in the stance of demand management from stimulus to restraint. The economy showed signs of overheating, which needed to be kept in check at an early stage to prevent unsustainable growth in demand and an acceleration of wage inflation with its adverse consequences for competitiveness. To this end, fiscal policy in particular had to be tightened considerably, with a slowdown in expenditure and reforms of the tax system, so that taxes would bear more heavily on consumption.

Concerning the medium term, Directors welcomed the authorities' efforts in promoting economic diversification, but believed that those efforts needed to be complemented by building up a stock of financial assets as contingency reserves. Economic diversification was constrained by scarce resources, although efforts to increase availability of labor were noted with interest. A further constraint on economic diversification was the limited areas in which Aruba possessed a comparative advantage. Directors also noted the limits on the growth potential of the tourism industry as well as its vulnerability. In this connection, Directors expressed serious concern about the large government guarantees extended in the past to private projects. Given those arguments, establishment of financial contingency reserves would help to stabilize future income streams, and would have the added advantage of cooling the economy during the upcoming years of buoyant private sector activity.

Directors felt that the focus of monetary policy on the preservation of the link to the U.S. dollar and on an adequate level of reserves was well placed. The present policy of quantitative credit restrictions was seen as appropriate in the short term given the circumstances, but in the somewhat longer term a more active use of interest rate policy would be preferable, and it would also foster domestic savings.

It is expected that the next Article IV consultation with the Kingdom of the Netherlands - Aruba will be held on the 24-month cycle.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/88/179 (12/12/88) and EBM/88/180 (12/14/88).

4. ASSISTANT TO EXECUTIVE DIRECTOR - DISCRETIONARY SALARY ADJUSTMENT

The Executive Board approves the recommendation to adjust the salary of an Assistant to Executive Director as set forth in EBAP/88/301 (12/9/88).

Adopted December 14, 1988

5. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to Executive Director as set forth in EBAP/88/302 (12/9/88).

Adopted December 14, 1988

6. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/88/300 (12/9/88) and EBAP/88/305 (12/12/88) is approved.

7. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director as set forth in EBAP/88/304 (12/12/88) is approved.

APPROVED: June 22, 1989

LEO VAN HOUTVEN
Secretary