0404

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/96

10:00 a.m., June 20, 1988

M. Camdessus, Chairman

| Executive Directors | Alternate Executive Directors |
|---|---|
| | E. T. El Kogali |
| F. Cassell | C. Enoch |
| Dai Q. | |
| | D. C. Templeman, Temporary |
| | E. L. Walker, Temporary |
| J. de Groote | |
| | M. Hepp, Temporary |
| M. Finaish | |
| G. Grosche | |
| | D. V. Nhien, Temporary |
| | L. M. Piantini, Temporary |
| | J. Gold, Temporary |
| | D. Saha, Temporary |
| | I. A. Al-Assaf |
| | E. Ayales, Temporary |
| | M. Pétursson, Temporary |
| H. Ploix | |
| | G. P. J. Hogeweg |
| C. R. Rye | |
| G. Salehkhou | S. Rouai, Temporary |
| | A. Vasudevan, Temporary |
| K. Yamazaki | S. Yoshikuni |
| | S. Appetiti, Temporary |

C. Brachet, Acting Secretary
D. J. de Vos, Assistant

Also Present

IBRD: N. L. Hicks, Asia Regional Office. Asian Department: P. R. Narvekar, Director; U. Baumgartner, D. J. Goldsbrough, B. Gurgen. Exchange and Trade Relations Department: H. B. Junz, Deputy Director; S. Kanesa-Thasan, K. P. Regling. Legal Department: P. L. Francotte, J. V. Surr. Middle Eastern Department: S. H. Hitti, M. F. Melhem, C. Sassanpour, B. K. Short. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: A. A. Agah, M. B. Chatah, K.-H. Kleine, G. Pineau, I. Sliper. Assistants to Executive Directors: N. Adachi, F. E. R. Alfiler, H. S. Binay, F. El Fiky, S. K. Fayyad, B. R. Fuleihan, M. A. Hammoudi, C. L. Haynes, K. Kpetigo, M. A. Kyhlberg, V. K. Malhotra, T. Morita, C. Noriega, W. K. Parmena, S. Rebecchini, G. Seyler, C. C. A. van den Berg, R. Wenzel.

1. JORDAN - 1988 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1988 Article IV consultation with Jordan (SM/88/111, 5/19/88). They also had before them a background paper on recent economic developments in Jordan (SM/88/116, 5/27/88).

The staff representative from the Middle Eastern Department made the following statement:

> Executive Directors may have seen press reports about developments in Jordan's exchange markets and noted a considerable decline in the foreign exchange reserves as reported in International Financial Statistics. The staff has been in touch with the Jordanian authorities, who indicated that the Government's policy stance has not been changed and remains essentially as discussed during the consultation discussions.
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> The authorities attribute the decline in reserves to delays in certain aid receipts, while, at the same time, increased debt service payments had to be met. The authorities expect that there will be a considerable increase in foreign exchange reserves during June, following the receipt of foreign assistance and the repayment of debt that is owed to Jordan. In addition, they note that the summer months constitute a seasonal high for remittances and tourist receipts. They also indicated that they will be implementing a stabilization program aimed at strengthening the reserves position and improving the balance of payments performance.
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> With respect to exchange rate policy, the authorities recalled that since early 1986 they had been pursuing a flexible policy--as described in the consultation reports--which has resulted in a significant real effective depreciation of the dinar. With effect from June 6, 1988, the authorities started to require financial institutions to quote the central bank rate whereas previously (since February 1986), financial institutions had been allowed to quote their own exchange rates using the central bank rate as a guideline.
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> Finally, with respect to interest rates, the authorities have taken a further liberalizing step: certificates of deposits are now excluded from ceilings imposed on deposit rates; and ceilings on commissions of all kinds of direct credit facilities have been eliminated.

Mr. Finaish made the following statement:

> Although Jordan is not an oil exporting country, its economic performance has, since the early 1970s, been greatly

influenced--through heavy reliance on neighboring oil exporting countries for worker remittances, official transfers, and export markets--by developments in the international oil market. On the strength of the regional economic expansion during the decade up to 1983, but supported just as instrumentally by prudent economic and financial policies, a liberal trade and exchange system, as well as a wealth of human resources, the Jordanian economy grew at an annual rate of over 10 percent. However, the subsequent regional economic slowdown, which was precipitated by a substantial reduction in the region's oil export revenues, limited the growth of Jordan's exports while reducing the inflows of private and official transfers. By 1987, incoming worker remittances and official transfers, which over the period 1982-87 financed nearly two thirds of the country's imports on average, had declined to 74 percent of their combined level in 1982. Meanwhile, international demand for Jordan's exports of primary commodities--particularly phosphate and potash--weakened, and their prices declined. Concomitantly, output growth slowed down considerably while, after experiencing nearly full employment over the period 1975-82, by 1987 unemployment had risen to nearly 8 percent of the labor force.

In response to the reduced external resource availability, the authorities adopted a policy stance, which, in addition to coping with the immediate difficulties entailed by the slackening economic conditions, aimed at reviving economic growth in the medium term while maintaining viable budgetary and balance of payments positions. By and large, this policy stance has succeeded in preventing the emergence of the serious financial disequilibria that are generally associated with economic slowdowns. A number of recent economic and financial developments seem to lend credence to this conclusion.

First, by 1987 the trade deficit had declined by one third of its level at the onset of the regional recessionary conditions in 1982-83. It is true that--reflecting, inter alia, lower domestic demand and the impact of measures that had been intended to promote efficient import substitution, including a depreciation of the Jordan dinar--the improvement in the trade account over the period 1982-86 had been achieved mostly through a reduction in imports. By contrast, however, the improvement in the trade performance in 1987 had been more than accounted for by a substantial increase in export receipts--a development that becomes all the more impressive when viewed against the backdrop of a continued deterioration during the year in the prices of Jordan's exports. Second, while--mainly reflecting a decline in official transfers and incoming remittances--the external current account deficit rose sharply in 1987, it still remained substantially below its levels during the earlier years of adjustment and is projected to decline significantly in the period immediately ahead and over the medium term, thereby contributing to the attainment of an approximate overall balance in the external accounts. Third, notwithstanding the considerable external financing requirements necessitated by the decline in external resource availability, external indebtedness remained sustainable and the debt service ratio relatively moderate. The Jordanian authorities are certainly mindful of the repercussions of heavy external indebtedness and have accordingly, as suggested by the recent and prospective improvements in Jordan's external position, resorted to external borrowing to support--rather than substitute for--the needed adjustment. In addition, in 1987, they decided to limit foreign borrowing to the amounts necessary to meet foreign repayment obligations. Fourth, notwithstanding the recent decline in Jordan's foreign exchange reserves, the Central Bank's total foreign assets continue to be at a comfortable level. Moreover, the authorities are confident that foreign exchange reserves will increase considerably in the near future. Fifth, while the overall budget deficit has tended to rise somewhat over the past few years, it had not until 1987--and then owing to a large extent to exceptional circumstances partly related to a transition from accrual- to cash-basis budgeting procedures in the capital budget--been a major factor in the expansion of domestic credit. Consequently, the previous few years have seen a negligible rise in the cost of living. After moderating gradually from an increase of over 7 percent in 1982 to 3 percent in 1985, consumer prices remained virtually unchanged in 1986 and had even declined in 1987. Sixth, in 1986 overall consumption expenditure declined for the first time in recent years. As a share of GNP, overall consumption expenditure declined from 97 percent in 1985 to 90 percent in 1986 with a corresponding steep increase in the gross national savings ratio. This development, which--in line with the authorities' objective under the current Five-Year Development Plan (1986-90) of reducing reliance on external resources to finance investment expenditures--significantly contributed to a narrowing of the saving/investment gap, is likely to have continued in 1987. By the end of the Plan period, consumption as a percentage of GNP is projected to decline to 87 percent and the share of national savings is projected to increase correspondingly. It is to be noted that while the improvement in the saving/investment balance was obtained at investment levels that inevitably were substantially below those that prevailed in the decade up to 1983, the decline in investment seems to have tapered off over the past few years, despite the persistence of political strains in the region, which undoubtedly precipitated a cautious attitude on the part of private investors. Finally, the Jordanian authorities have continued to encourage the private sector to take an active role in the restructuring of industry, as the scope of existing laws has been expanded to encourage private sector investments, and a process of privatization has started with preparatory steps for the institutional reform and commercialization of activities in various enterprises.

With respect to fiscal policy, consistent with the authorities' dual objective of moderating the impact of the regional recession on the domestic economy while creating proper conditions for the resumption of sustainable economic growth, capital expenditures--after rising by 17 percent in 1986--rose by 32 percent in 1987, thereby contributing, together with a continued decline in foreign grants, to a widening of the overall deficit from 9.3 percent of GDP in 1986 to 13.1 percent in 1987. On the other hand, paced by rather limited increases in various expenditure categories, current expenditures rose fairly moderately in both years. A notable exception has been budgetary outlays on subsidies which, after falling sharply in 1986 with the elimination of fuel and food subsidies, fell even further in 1987. With respect to government revenues, the long-term steady improvement in the domestic revenue performance that began in 1980 continued in 1987. After rising by 17 percent in 1986, domestic revenues--on account of improved tax collection, inclusive of overdue taxes, as well as some changes in individual tax rates, licenses and fees--grew by a further 7 percent in 1987, thereby rising to 33 percent of GDP compared with only 23 percent in 1980. This remarkable strengthening in the revenue effort becomes all the more noteworthy when one considers that it was obtained in the face of slackening economic conditions and during times of falling per capita incomes and declining standards of living. Indeed, this improvement in the domestic revenue performance could have been even greater in the short run had it not been for the tax exemptions that were granted to promote restructuring of companies and to encourage investments in export-oriented industries. These exemptions were in line with the authorities' objective of encouraging productive private sector activities. As such, therefore, like other facets of the fiscal policy stance, these exemptions--as well as other temporary measures intended to promote efficient import substitution and export growth--are to be seen as having been necessitated by the prevailing recessionary conditions rather than signifying a fundamental shift in trade and commercial policies. The argument that the authorities' fiscal policy stance has not had a significant expansionary impact on the domestic economy pales in relevance when one considers that the persistence of the recessionary conditions in the region severely limited the range of available policy options. Furthermore, had it not been for the authorities' effort to promote economic activity, the economic slowdown would likely have been far more extensive. The sluggish economic performance over the past few years not only reflects adverse cyclical conditions, but also a general political and economic climate in the region that has made investors hesitant and explains, to a large extent, their preference for liquid financial investments. Under these circumstances, the need for fiscal stimulus would seem to have been quite compelling.

In the period 1986-87, monetary policy continued to provide support to the authorities' objective of mitigating the impact of regional recessionary conditions on the domestic economy. Meanwhile, the authorities continued to pursue a pragmatic and flexible policy of monitoring monetary aggregates, the exchange rate, and interest rates, with a view to ensuring that their evolution was consistent with the realization of sustainable economic growth and continued price stability, while contributing to the external adjustment process. Moreover, the authorities implemented a number of measures with the aim of augmenting the liquidity and profitability of the banking sector and stimulating the reorganization of the nonbank financial sector to enhance Jordan's role as a regional financial center. In the period ahead, the conduct of monetary policy will continue to be guided by the aforementioned considerations, as well as by the authorities' commitment to pursue a policy of increased interest rate flexibility. The implementation of this policy began in 1987 with the removal of interest rate ceilings on deposits of not less than JD 200,000. Earlier this month, the Central Bank considerably broadened the scope of interest rate flexibility by abolishing the ceilings on certificates of deposit and freeing banks to set their own commissions on lending. Moreover, to alleviate interest rate pressures and to improve the efficiency of the financial market while enhancing the Central Bank's ability to conduct its policies, the Bank began in February 1988 to engage in open market operations on a daily basis and has taken measures to expand the secondary market for government securities.

To achieve the objectives of promoting exports and efficient import substitution, increasing the inflow of worker remittances, as well as encouraging the inflow of foreign investment, the Central Bank has adopted a greater degree of flexibility in exchange rate management. Reflecting this increased flexibility, after narrowly fluctuating in the period from 1983 through late 1985, the real effective exchange rate fell by 17 percent in 1986-87 largely on account of a depreciation in nominal effective terms. The apparent loss of export competitiveness in some agricultural products in 1987 has for the most part reflected difficulties with regulations in importing countries.

With respect to the medium-term projections, the Jordanian authorities regard as pessimistic the illustrative scenario prepared by the staff. In particular, on account of the lagged effects of export-promoting measures, including the depreciation of the dinar in real effective terms, the authorities expect receipts from exports to grow at a faster pace than is assumed under the scenario. Likewise, the assurances they have received for enhanced support should result in higher than assumed levels of official transfers. Additionally, partly owing to an intensification of the authorities' efforts in promoting the use of Jordanian labor abroad and the flow of incoming remittances, the growth in these remittances--with which imports had historically been closely associated--could also be higher. These greater flows on the receipts side should permit imports to rise at greater than the rate of 2-3 percent assumed in the scenario while avoiding a rise in the debt service ratio or an emergence of financing gaps. The above, however, should not be construed to suggest that the authorities do not see some serious challenges in the period ahead. To be sure, they do. However, they also see opportunities both within and outside the region. As they approach these challenges and opportunities, the Jordanian authorities will continue to strive to lay a sound foundation for the resumption of economic growth at a rate which, albeit less than that which prevailed during the boom years, will nevertheless be sufficient to absorb the country's rapidly expanding labor force.

Mr. Al-Assaf made the following statement:

Since the early 1980s, the authorities have had to cope with a difficult economic environment. As a result of the regional recession, Jordan's main economic lifelines have been markedly constrained. Nonetheless, the authorities were able to maintain a positive but marginal rate of growth, despite a fall in foreign aid and worker remittances and a contraction in Jordan's export markets. This, in itself, is a significant accomplishment.

The situation that the authorities continue to face is clearly a difficult one: on the one hand, they need to provide employment opportunities for the rapidly expanding labor force, which requires a revitalization of the economy, while on the other hand, they need to maintain economic stability in the face of an uncertain external environment. Therefore, I sympathize with the authorities' decision to increase fiscal expenditures in an attempt to accelerate economic growth. However, this policy is unsustainable over the medium term as it could also adversely affect Jordan's external account; hence, it may be the appropriate time to consider reducing the fiscal deficit. Reducing the fiscal deficit is important as government expenditure has yet to be adjusted to the lower rate of capital inflows.

A cause of some concern to me is the growing foreign debt incurred by the authorities to finance budgetary expenditures.

Even though the current debt service ratio is not too high, the fact that interest payments are the fastest growing component in the budget is somewhat worrisome. It is encouraging to note from Mr. Finaish's opening statement that the authorities recognize the importance of the problem of growing interest payments and regard foreign borrowing as supportive of, rather than a substitute for, needed adjustment. They have also decided to limit foreign borrowing to amounts that are necessary to meet external obligations. Nonetheless, the decline in external debt should not be replaced by an increase in domestic financing through the banking sector, which would offset price stability, reduce confidence in the economy, and complicate any efforts by the authorities to mobilize domestic savings and to channel them into productive investments. The authorities' recent efforts in the latter direction are heartening.

The authorities have continued to emphasize the strengthening of the financial sector by encouraging the consolidation of financial institutions and by improving management. They have also strengthened the provisioning requirement of commercial banks, and, more importantly, they have developed a secondary market for government securities along with an appropriate institutional framework. Recognizing that further efforts to increase domestic savings and to induce domestic and foreign investment will be needed, the authorities are planning to implement further measures, as was indicated in Mr. Finaish's opening statement.

Looking ahead, the basic challenge facing the authorities is to diversify and expand the economy's productive base. While the natural-resource-based industries will continue to play a significant role in the economy, the scope for expansion in this area seems to be limited. The authorities have therefore correctly emphasized the development of small- and medium-scale export-oriented and import-substituting industries and have provided the private sector with a wide array of production incentives. For this effort to succeed, however, the authorities need to increase domestic savings and crowd in the private sector by reducing the Government's heavy credit demand.

The authorities have managed the economy well in light of the difficult circumstances that they have faced. However, if the prevailing economic environment persists, adjustment on a wider scale may be needed; and, in that event, one area that would require further attention is the fiscal one. The fiscal question could be approached in the context of a broad and clear strategy that would bring about a decisive shift away from consumption and toward productive investment. I am certain that the authorities will live up to this challenge, and I support the proposed decision.

Mr. de Groote said that Jordan had a high population growth rate and was poorly endowed with natural resources compared with other countries in the region. The country had also suffered from the effects of a regional recession and from political turbulence in neighboring countries. Nevertheless, since 1983, Jordan had managed to make a commendable adjustment to those new conditions. The inflation rate had remained stable--and had even dipped in 1986--the current account had improved steadily, and government revenues had increased in real terms each year, except in 1984. However, the growth rate averaged less than 1 percent a year in the period 1983-86.

In that respect, he had some reservations about the tone of the staff report and especially about the tone of the appraisal, Mr. de Groote continued. First, although the staff had repeatedly stated during consultations with Jordan that further adjustment was a precondition for sustainable growth and had assailed the authorities for delaying that process, those exhortations and criticisms were not accompanied by many recommendations about the specific content of such an adjustment. Under present circumstances, it was difficult to see how Jordan was deviating from traditional and well established Fund recommendations. The country had a market economy led by the private sector, real deposit and lending rates were positive, the exchange system was wide open, the exchange rate had been well managed until the turbulence of the previous few weeks, and the external debt position was indeed sustainable at about 18 percent of export earnings. He would therefore be interested to learn from the staff, in somewhat greater detail, their views of the direction and content of Jordan's further adjustment, bearing in mind the need to avoid endangering the country's already low growth rate.

Moveover, he had some difficulty in agreeing with the staff when it contended that the current level of interest rates was too high, Mr. de Groote remarked. In countries with an open exchange rate system and massive domestic borrowing, interest rates had to be sufficiently high to resist the twin pressures of currency substitution and the need to finance the public sector deficit. In Jordan's case, financial sector inefficiencies had to be reckoned with also; in that light, the authorities' decision to improve the financial system seemed to be quite reasonable. He agreed with the staff that the envisaged structural changes could obviously, and after a while, allow some reduction in real interest rates.

A different problem, but one that was a great cause for concern was the low disbursement ratio of about 50 percent for Jordan's World Bank loans, Mr. de Groote pointed out. Speeding up the implementation of Bank projects in Jordan might offer a way of stimulating growth and sending signals that could help to reverse the destructive erosion of business confidence. It would be interesting to know if the staff felt that there were some weaknesses in the macroeconomic medium- and long-term development options of the country. In the framework of the Article IV consultations, it would be quite legitimate for the staff to speak out on those issues, especially given the Chairman's concern with growth and development, not only in the framework of Fund-supported programs, but also in that of Article IV consultations.

Several specific features seemed to be unique to Jordan's case and would affect the future course of its economy Mr. de Groote observed. More than 60 percent of Jordan's GDP came from the service sector, while the shares of the mining and manufacturing sectors were not very substantial. Given the size of the population and the continuation of liberal trade policies, it was not feasible for Jordan to encourage heavy industry; but, light manufacturing might offer greater potential for change. Jordan's adequate supply of skilled workers with appropriate levels of education favored the country's transformation from a service-dominated economy to one that was led by light manufacturing. Of course, there were risks involved in such a course: competitiveness in light industry depended largely on advances in production technology, and investor nervousness about the political risks posed by Jordan's geographic location was an obstacle to necessary technological transfers. In any event, those were the kinds of problems that the Fund should consider with a view to suggesting solutions.

Jordan deserved some support with respect to the appropriate direction that its structural, medium-, and long-term policies should take, Mr. de Groote concluded. During an Article IV consultation, Jordan deserved more than the usual sermons on "adjustment," which was a very common word in the staff appraisal in contrast with the lesser use of the word "development." The Fund was capable of providing more reflection on growth-oriented strategies for Jordan, which had a very good record of cooperation with the Fund.

The Chairman commented that each time the staff used the word "adjustment" it had to be understood as meaning adjustment for sustainable growth; if not, the term did not make sense.

Mr. de Groote said that that was exactly his point: he had not criticized the staff for using the word adjustment for that was the very purpose of the staff's review at the time of Article IV consultations, but he did feel that too much attention had been directed at traditional instruments and not enough at those measures that Jordan could consider taking to improve its growth rate, which was very limited at about 1 percent a year in real terms. The staff report could be made more useful for the authorities by providing more content along the lines that the Chairman himself had stressed so rightly, especially as the authorities had shown such a great desire to cooperate with the Fund.

The Chairman noted that a 1 percent growth rate was a clear sign of maladjustment.

Mrs. Walker made the following statement:

Since the previous Article IV consultation, the authorities have reacted pragmatically to the prolonged regional recession and some progress has been made, at least, in preventing the financial and economic problems facing the country from worsening. In that respect, I note Mr. Finaish's statement highlighting the progress made. However, my chair's general impression of Jordan's economic situation has changed little from the 1986 Article IV consultation. While the fact that there has not been a considerable worsening of the situation may be due in part to the measures adopted by the authorities, one must point out that the financial and economic position of the country remains weak, and that the outlook for the region remains negative. This situation warrants more comprehensive attention by the authorities. The authorities, while recognizing the economic difficulties facing the economy, are attacking the problems in somewhat of a piecemeal fashion, relying more heavily on intervention and protectionism than on market approaches in the hope that the regional economic outlook will be brighter in the near future. Such an approach will not necessarily bring about the kind of economic revival that the authorities desire. Therefore, I concur with the staff that while adjustment is still manageable, more market-oriented adjustment, in the context of a comprehensive program, is the best course of action.

Further action to reduce the fiscal deficit should be at the core of any additional adjustment effort. While the authorities' projections show that there will be a significant improvement in the fiscal position, I note the staff's concern that this improvement may be difficult to realize through the pursuit of current policies. The authorities' major policy objectives--to cover current expenditures with domestic revenue and not to cover shortfalls with external borrowing--are welcome. However, to achieve the deficit reduction target for 1988, expenditure discipline and revenue performance will need to be better than in 1987. Despite the fact that revenues have played a significant role in containing the budget deficit in the past, further efforts to raise revenues will be necessary in 1988. In that respect, I urge the authorities to accelerate work on the value-added tax and consider other areas for broadening the resource base. In addition, while there was little room for current expenditure reduction, additional expenditure rationalization measures could be undertaken on the capital side of the budget. The World Bank may be able to play a helpful role in analyzing capital expenditures and in pointing out areas in which expenditure reduction could be realized.

A reduction in the fiscal deficit would reduce government borrowing and release credit for private sector use. In that respect, the authorities' continued commitment to increasing the role of the private sector in the economy is welcome, particularly in light of the continued economic dominance of the public sector. The initial steps toward privatization of some public enterprises are also welcome, although more rapid progress on this front may be appropriate. In addition, I urge the authorities to continue to pursue other means of encouraging the private sector, and would look to the staff to provide more specific measures that might be taken in this respect.

A further improvement in the fiscal sector should reduce pressure on interest rates. And while the recent measures to increase the flexibility of interest rates are welcome, a significant improvement in the fiscal deficit should contribute to further progress in this area.

With respect to the external sector, I note the somewhat pessimistic medium-term scenarios presented by the staff. While I would like to believe, as the authorities do, that those scenarios are too pessimistic, it was probably more prudent to take actions based on the downside--while room for maneuver was still present--than to assume that the situation will be better than expected. I urge the authorities to consider a more comprehensive plan of action, one that does not rely on protectionism, subsidies, or intervention in individual sectors, but on maintaining an open economy and a market-based approach to addressing the current economic problems. Flexibility in the exchange rate will continue to be an important part of this effort.

I note the authorities' wish to remain on a 12-month consultation cycle, which my chair will obviously respect. However, both Jordan and the United Arab Emirates, which are under consideration by the Board this morning, are requesting 12-month cycles. Not many countries seem to wish to go on the bicyclic cycle, which should provide the authorities with adequate staff analysis. I am wondering whether the reason for not wanting to be placed on the bi-cycle has more to do with the lack of Board involvement in it. I would be interested in Mr. Finaish's comment on why the authorities do not see the bicyclic procedure as appropriate or beneficial.

The Chairman said that he shared Mrs. Walker's views on the question of the bicyclic versus the annual consultation procedure, and he wondered whether there was not a misperception of the bicyclic procedure. Like Mrs. Walker, he would be interested to hear Mr. Finaish's comments on the matter.

Mr. Enoch said that he had no difficulty in endorsing the staff appraisal. It provided the Board with a helpful analysis of the policies that had been undertaken by the authorities in response to the deterioration in the external position, and focused on further measures to support the authorities' demonstrated commitment to structural adjustment.

Jordan generally had a good record of economic management, which had enabled the country to weather the regional recession relatively well, Mr. Enoch continued. For some time, the authorities had recognized the need for adjustment, and the gradual depreciation of the currency had been a reflection of that recognition. However, while exports had grown strongly as a result, that expansion had been more than offset by continued declines in worker remittances and in aid receipts. As a result, and as the staff report clearly described, external debt had risen rapidly--almost doubling since 1982.

Some of the policies that had been adopted thus far unfortunately seemed to have been predicated on the assumption that the regional recession would be over fairly soon, Mr. Enoch pointed out. Hence, in addition to the exchange rate adjustment, the authorities had introduced a number of ad hoc measures, including greater protection and subsidies, which had created or added to structural inefficiencies without having any demonstrable effect on stimulating growth. However, there was no evidence yet that the regional recession had ended, and it would certainly not be prudent to assume that any revival would occur soon. At the current stage, therefore, the authorities had to make a more thoroughgoing adjustment, as was indicated in the staff report. In that connection, their decision to avoid further acquisition of external debt was welcome.

At present, with the low rates of growth and the declines in investment, the ambitious targets for the 1986-90 plan seemed to be out of reach, Mr. Enoch considered. The proposed review of the plan therefore seemed timely, as did the authorities' intention to implement "far-reaching" policies to rectify the structural imbalances. The management of the fiscal deficit was central to that effort. Current and capital expenditures had increased markedly since 1985, and with the decline in foreign grants that increase had led to a substantial budgetary overshoot that might well be repeated in 1988. While the burden of high unemployment and a rapidly rising population made the pressure for expenditure increases strong, such a strategy had considerable dangers given Jordan's vulnerable economic position. On the revenue side, the announced increase in tax revenues was a step in the right direction, but further measures were needed--both in terms of widening the tax base and of improving revenue collection--if the authorities' stated aim of covering expenditure was to be achieved. In that connection, further consideration of the possible introduction of a value-added tax would clearly be appropriate.

A tighter fiscal policy would also help to control monetary growth, Mr. Enoch considered. Despite the low inflation rate in 1987, there was a risk that the higher rate of monetary growth would lead to a higher inflation rate in 1988, although the slack in the economy might help to contain the latter rate. Changes in the domestic monetary system, such as the development of the secondary bond market and the greater flexibility in the interest rate structure, should enhance domestic investment. Those moves, and the further steps being taken to strengthen the banking law and the internal financial system were welcome.

Nevertheless, as was shown in the staff projections for 1989-92, the outlook for the external accounts did not look favorable, Mr. Enoch observed. World prices for phosphates and potash continued to be depressed, and the prospect for any revival in worker remittances after the significant falls during the previous few years looked uncertain. The staff's estimate, in its current account projections for 1989-92, of aid flows of over $600 million a year also looked ambitious. Beyond that, no allowance had been made for a possible crop failure. While, of course, the outcome might be better than shown in the projections, there were serious downside risks. Therefore, the authorities should err on the side of caution and maintain a firm fiscal and monetary stance to ensure that external aid flows and grants could be used to finance new investment and to improve the external balance, rather than to finance a further accumulation of external debt.

Over the shorter term, at least, the outlook for trade was looking yet more uncertain following the suspension of payments at the end of April on Iraqi letters of credit under bilateral trade arrangements, Mr. Enoch noted. That suspension was reportedly prompted by the substantial buildup of Iraqi arrears and by the heavy drawings on the facility in the first quarter of 1988. The outlook for trade with Iraq was clearly uncertain, and knock-on effects could damage growth prospects further. The recent loss of reserves, as explained in the staff's opening statement, was further evidence of those uncertainties.

He endorsed the staff's view that under present conditions, import growth could only be marginal if external borrowing was to be avoided, Mr. Enoch stated. The temptation to seek to restrict imports through the use of protectionist measures should nevertheless be strongly resisted; and, indeed, a revival of growth over the medium term toward the levels that Jordan enjoyed during the previous decade would require the forceful removal of the subsidies and protectionist measures that were introduced during the previous few years. That requirement was particularly true for certain agricultural schemes; for instance, in the wheat sector where the procurement price was almost three times the world price.

He had noted the concern of the Chairman and Mrs. Walker with the reluctance of authorities to move to the bicyclic consultation procedure, Mr. Enoch concluded. In general, he understood that reluctance. In view of the adverse external situation and the problems that the Jordanian would authorities face in implementing the difficult strategy ahead of them, and given the strong cooperation with the Fund, he strongly endorsed their request for annual Article IV consultations, if they continued to feel that those were useful.

Mrs. Walker said that while she recognized the authorities' record of cooperation with the Fund and the difficulty of their situation, she still wondered what was lacking in the bicyclic consultation procedure.

Mr. El Kogali said that to clearly understand the present course and future evolution of economic developments in Jordan, it was appropriate to give a certain perspective to the country's circumstances. Since its inception as one of the Arab frontier states, Jordan's economic and sociopolitical development had been fundamentally influenced by political and economic events in other countries of the region. The staff report had acknowledged that fact in attributing the decline in economic activity during the previous two years largely to the depressed regional economic conditions that were caused by the softening of the oil market. Export receipts had declined and there had been shortfalls in worker remittances and in external aid flows from the oil rich neighboring countries.

Jordan had often suffered from political and military conflict owing to the unstable regional political situation, Mr. El Kogali continued, as had happened when the country lost a large portion of its territory, the West Bank. That loss had had profound consequences on the economy as had the conflicts that Jordan had been drawn into in the past; the country had been forced to spend a considerable amount of its resources on defense, which continued to have severe implications for the fiscal budget. Moreover, the current unrest in the West Bank was having adverse effects on the country's financial position.

Jordan was not well endowed with natural resources, but it did have a population that was hard working and industrious, Mr. El Kogali observed. The country had even become the food basket for countries in the region. Moreover, its highly qualified personnel provided much needed manpower for many neighboring countries. In that connection, the staff should comment on the rising unemployment rates among skilled personnel and university graduates. A possible reason for that rise might be the dwindling employment opportunities in neighboring countries during recent years, but he was confident that more job opportunities would soon appear with the recent expansion of economic activity in some of those countries--including Yemen, where new oil fields had been discovered--and/or in areas where hostilities had ceased or had been contained.

The authorities were correct to view the staff's baseline scenario as being somewhat pessimistic, Mr. El Kogali noted. As had been indicated in Mr. Finaish's opening statement, workers' remittances should rise by more than the amount estimated by the staff; furthermore, the authorities' steps to promote exports should also yield higher receipts.

In the past, the authorities had met many adversities with great vigor, had managed to raise living standards significantly, and had been able to keep an open and quite free economy, Mr. El Kogali concluded. He was confident that the economy would soon be placed on its original path of rapid and sustained development. In line with Mr. de Groote's comments, he hoped that the staff would give the authorities more innovative ideas on adjustment with growth in the future and that Jordan would receive greater funding and more aid.

Mr. Rouai said that he fully shared the thrust of the staff appraisal. External factors, particularly the sharp drop in oil prices in neighboring countries and the decline in workers' remittances, were the main reasons for Jordan's current difficult economic and financial situation. The authorities were to be commended for the courage that they had shown in facing those problems.

Continuing their efforts to streamline the fiscal process, the authorities were committed to addressing the budgetary problems, in order to contain domestic liquidity, to maintain domestic price stability, and to avoid the emergence of any pressures on the balance of payments, Mr. Rouai pointed out. In that connection, the planned introduction of a value-added tax--which could help the authorities to reduce further the budget deficit--was welcome.

The prudent management of the monetary sector was also welcome, Mr. Rouai indicated. The authorities were strengthening the financial sector by restructuring and expanding the banking system throughout the country, even in rural areas. Monetary instruments had been introduced into, and developed in, the banking system to create an active secondary market for government securities. Furthermore, the review of the public debt law would increase flexibility in the purchase and sale of securities.

Despite the increase in exports, the situation in the external sector remained difficult owing essentially to the fall in workers' remittances and to the decline in foreign grant receipts, Mr. Rouai observed. It was heartening to note, however, that all of those difficulties did not lead to the imposition of restrictions in the exchange and trade system and that the authorities continued to favor a liberal and open system in that field.

The medium-term prospects would be promising if political uncertainties were not the main obstacle to Jordan and the region's progress, Mr. Rouai concluded. The recession in the oil industry of neighboring countries also hampered the Jordanian economy's prospects for growth. In that respect, he hoped that Jordan's commitment to adjustment would be matched by a firm commitment from the international community to help the country achieve its objective of sustaining growth. He supported the authorities' request for the standard annual consultation cycle.

The staff representative from the Middle Eastern Department said that it was correct that the authorities had an excellent record of economic management up to the early 1980s. The staff had differed with the authorities on some aspects of the policies that they had adopted in response to the adverse external environment, and had so cautioned them during the consultation discussions. The authorities had unfortunately taken a risk in maintaining a less than full adjustment effort and had allowed fiscal policy to continue to be somewhat expansionary. Recent developments in the foreign exchange market seemed to point to the insufficient adjustment efforts. A clear indication of possible foreign exchange problems had become evident some time ago when a preference for foreign deposits began to supersede the demand for domestic currency deposits. On the whole, developments since the consultation discussions, in particular the disturbances in the foreign exchange market, as well as the substantial decline in foreign exchange reserves, suggested that instead of having given too strong a warning in the staff appraisal, the staff had perhaps not cautioned the authorities strongly enough.

It had been noted in the staff report that the World Bank staff was in broad agreement with the Fund staff's analysis, particularly on exchange rate issues, the staff representative continued. He did not know why the disbursement of World Bank loans to the country had been slow, and there was no additional information to that in the staff report on how to enhance the role of the private sector. However, it was possible that the profitability of investing in certain projects might have been adversely affected by the current level of the exchange rate. In addition, if the private sector was to play a greater role in the economy, the current high real interest rates would have to be reduced somewhat. The staff did not think that such a reduction would be feasible as long as the public sector's demand on the credit market was so great; and, under those conditions, neither was it desirable to increase the total amount of credit.

It was the first time that Jordan's consultation cycle had been discussed by the Board since the introduction of the bicyclic procedure, the staff representative from the Middle Eastern Department concluded. At the time of the 1987 Article IV consultation with Jordan, the staff had recommended that the authorities remain on the standard 12-month cycle, for which some support had been expressed in the Board. After a discussion of whether the cycle should be 18 months or 12 months, a 15-month period had been agreed to, which was then extended to 18 months owing to a conflict with a summit meeting being held in Amman. The staff had since discussed with the authorities the options for a 12-, 18-, or bicylclic consultation cycle, which they had then considered; in the end, the authorities had opted for the standard 12-month cycle. Since the staff had previously recommended that the authorities adopt the standard 12-month cycle, it had no problem in agreeing with their request for that cycle. Of course, the real difference between the annual and bicyclic consultation procedures was the Board's full discussion of a country's situation in the former, which the authorities valued.

Mr. Finaish said that he agreed with the staff representative's comments on the consultation cycle. The matter had been discussed extensively, perhaps too extensively, by the Board on the occasion of past consultations with Jordan with some Directors suggesting that the standard cycle was appropriate in the case of Jordan. The authorities had asked for an annual cycle at the time of the 1988 consultation, and it would therefore be appropriate to accede to their wishes and devote more time to the substance of the consultation process and less to the form. It was clear that whether the country was Jordan, the United Arab Emirates, or any other, the authorities valued the staff visits and the Board's discussion of their country's circumstances.

The authorities were closer to Mr. de Groote's views than to the staff's, Mr. Finaish continued: they felt that the staff report had a negative tone, as it seemed to downplay the significance of their achievements and failed to highlight adequately the exceptionally difficult environment in which policies were formulated and implemented. They would also wish to see more elaboration on the question of growth, on trends in Jordan, and on where the country should go. To such questions, the staff would usually respond that development and growth were World Bank issues. But, unless such issues were addressed in a meaningful manner in the staff reports, which they were not in the case of Jordan, the staff's policy advice would, for the most part, be devoid of substantive content and lacking in specificity. At previous consultations with countries in the region, the staff had generally judged that those countries were going in the right direction, and had tended to praise them, particularly during the 1970s, but when the bases of staff assessments were questioned and when the staff was asked about its views on the content of development plans in the region, it typically answered that those were Bank issues on which they could not say much. Therefore, considering that the staff tended to praise the whole picture, but refused to address some specific issues, he wished to encourage the staff--like Mr. de Groote and Mrs. Walker had--to pay more attention to the question of growth when analyzing adjustment issues.

The difficulties confronting Jordan were closely and inextricably linked to a regional political and economic climate that had for a number of years been quite unsettled, Mr. Finaish pointed out. That unsettled climate was reflected in the sharply reduced availability of external resources, which had been the main factor behind the current economic slowdown in Jordan. Indeed, the intensification of the unsettled security situation in the region had brought the Jordanian economy under increased strain by, among other things, weakening investors' confidence. In response to that increased strain, the authorities recently moved to enhance the efficacy of their adjustment policies by adopting a concerted and coordinated framework, at the Cabinet level, for the formulation and execution of policies.

The temporary measures undertaken to promote efficient import substitution and export growth were to be seen as having been necessitated by the prevailing recessionary conditions instead of signifying a fundamental shift in trade and commercial policies, Mr. Finaish commented. In addition, several points should be taken into account when evaluating Jordan's trade and commercial policies. First, the authorities had a long-standing tradition of promoting entrepreneurship and avoiding the expansion of the role of the public sector in the economy. In that respect, it was to be noted that some steps had recently been undertaken with the aim of encouraging the private sector to take an active role in the restructuring of industry. Moreover, a process of privatization had started with preparatory steps for the institutional reform and commercialization of activities in various entities. The privatization process would take the form of gradual transformation of those entities into companies initially owned by the public sector, but subsequently opened to public shareholding. The authorities had established a committee headed by the Prime Minister to study each case individually and ensure that the transformation involved would not be directed to the benefit of interest groups and would not compromise on essential services. Second, the authorities had avoided creating subsidies by suitably pricing electricity, petrol, and the water supply. Third, Jordan's trade and exchange system continued to be liberal.

Although one could not infer, based on conventional indicators, that the dinar was overvalued, there was every indication that the authorities would continue to manage the exchange rate with flexibility to achieve the objectives of promoting exports and efficient substitution of imports, increasing the inflow of workers' remittances, and encouraging the inflow of foreign investment, Mr. Finaish observed. Reflecting that policy stance, the dinar had depreciated in real effective terms by 17 percent over the period 1986-87.

The emergence of unemployment in Jordan had been one of the most adverse consequences on the country of the regional economic slowdown, Mr. Finaish added. The outward migration of workers, particularly to the Gulf Cooperation Council (GCC) states, which had grown by 2-3 percent a year over the period 1975-82, had since been stagnant. As a consequence, after experiencing nearly full employment over the same period, unemployment had risen to nearly 8 percent by 1987. Among the major factors aggravating the unemployment situation in Jordan were the age composition of the population, as 50 percent of the population was below the age of 15, the increasing female participation in the labor force, and a mismatch between the skill mix produced by Jordan's education and training system and that needed in the economy. To alleviate the unemployment problem, the authorities had adopted a number of policies, among the more important provisions of which were the concentration on vocational training, strengthening and updating statistical data about the labor market and job opportunities, rehabilitation of university graduates, and coordination with Arab countries to increase the absorption of Jordanian workers in their markets.

While difficult, the problems confronting Jordan were certainly not insurmountable, Mr. Finaish concluded. The authorities had demonstrated in the past a distinct ability to steer the economy to a viable course under exceptionally difficult circumstances, including those related to the unsettled security situation in the region. In facing the difficulties that lay ahead, the authorities would be, as they had been in the past, aided by a number of strengths, including a well-developed infrastructure, a relatively diversified economic base, a profitable natural-resource-based industrial sector, and, perhaps most important, a wealth of human resources. It was on the basis of those strengths, as well as their ongoing efforts to enhance the country's adaptability to a constantly--and at times erratically--changing external environment, that the authorities were confident that the Jordanian economy would be well positioned to take advantage of opportunities both within and outside the region. In addition, Jordan's long-standing record of putting external assistance to good use should provide every assurance that a continued and hopefully expanded assistance would be so utilized in the future as well.

The Chairman made the following summing up:

> Directors were in broad agreement with the thrust of the staff appraisal and noted that the recent downturn in Jordan's economic and financial performance reflected in part the prolonged recession in the region. Directors were of the opinion that the initial policy responses of the authorities to the changed external circumstances had eased somewhat the emerging difficulties, but that the external position would be unsustainable in the medium term if further corrective actions were not taken. In particular, the policy response should be strengthened considerably and cast in the context of a comprehensive adjustment effort. Corrective measures were needed to resume sustainable growth, rectify the structural weaknesses in the budget and the balance of payments, and lessen the vulnerability of the economy to external developments.
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> Directors recognized that the Jordanian authorities faced a difficult dilemma in striking an appropriate balance in their economic and financial policies. While understanding the authorities' desire to stimulate the economy, they did not believe that, given the uncertain outlook for foreign demand and for private and official transfer receipts, firm adjustment, including structural policies to promote efficiency, could be delayed.
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> Directors stressed that policy initiatives should involve measures to promote growth and tighten demand management. On the supply side, policies needed to be aimed at improving resource allocation and reducing administrative intervention in the production process to make room for the growth of the private sector. Further progress in expanding and diversifying exports was deemed essential to a sustainable medium-term growth strategy. Directors were of the opinion that budgetary restraint should be at the core of demand management policies. While commending the authorities for their efforts to increase revenue collections, particularly in the context of slack economic activity, Directors believed that the budget deficit should be reduced to a sustainable level through a widening of the domestic revenue base--including, for instance, the introduction of a value-added tax, as mentioned by several speakers--but even more through expenditure containment. Reductions in

the financing needs of the budget, if accompanied by effective structural measures, were likely to reduce the upward pressure on interest rates and stimulate private sector investment. In this context, Directors welcomed the move toward strengthening the financial system.

Directors viewed the recent developments in reserves, and the balance of payments prospects, as worrisome; hence, they called for an improved domestic policy stance to strengthen confidence and encourage inflows of remittances and official transfers.

The next Article IV consultation with Jordan will be held on the standard 12-month cycle.

The Executive Board then adopted the following decision.

1. The Fund takes this decision in concluding the 1988 Article XIV consultation with Jordan, in the light of the 1988 Article IV consultation with Jordan conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. The Fund notes that Jordan's exchange system is free from restrictions other than for relatively liberal limits on certain invisible payments maintained in accordance with Article XIV.

Decision No. 8907-(88/96), adopted
June 20, 1988

2. UNITED ARAB EMIRATES - 1988 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1988 Article IV consultation with the United Arab Emirates (SM/88/108, 5/16/88). They also had before them a background paper on recent economic developments in the United Arab Emirates (SM/88/122, 6/6/88).

Mr. Finaish made the following statement:

As in many other oil exporting countries, economic policy in the United Arab Emirates (U.A.E.) has focused in recent years on the need to adjust to the substantial decline in oil export revenues. Though they recovered somewhat in 1987 from their highly depressed 1986 level, these revenues have remained some 54 percent below their level in 1981. The adjustment task that faced the authorities was, therefore, quite considerable, particularly in light of the predominance of the oil sector in both the fiscal and external accounts. It was against the background of these developments, as well as the negative repercussions of the security situation in the region, that the authorities sought to strike an appropriate balance between the need, on the one hand, to maintain a relatively strong external asset position and, on the other, to mitigate the contractionary impact on the economic activity of the expenditure restraint in the wake of the reduction in oil revenues.

The macroeconomic adjustment has been carried out mainly through restraint in government spending--a policy stance that has also reflected adjustment to more normal circumstances following the period of rapid economic growth and development of the country's social and economic infrastructure in the decade up to the early 1980s. Faced with a sharp decline in oil receipts, which was the main factor behind a 61 percent reduction in consolidated government revenues over the period 1981-86, the authorities reduced expenditures substantially. Particularly affected were development outlays, which, reflecting not only the spending policies adopted as a result of the decline in oil revenues, but also the completion of major infrastructural projects, were reduced by nearly 40 percent over the period 1982-86. Also affected were disbursements of grants and loans to other developing countries, which nevertheless still remained substantial. On the other hand, current outlays were maintained at a relatively constant level over the same period mainly to moderate the adverse impact on the economy of the recession in the oil sector. However, despite the large reduction in total government spending, the sharper contraction of revenues shifted the overall fiscal position from a surplus of 4 percent of GDP in 1981 to an annual deficit of 3-5 percent in 1982-85. The fiscal deficit rose sharply in 1986 owing mainly to the precipitous drop in oil prices during the year, before declining somewhat in 1987 on account of a partial recovery in these prices. The authorities consider that further improvement in the overall fiscal position can be attained by a further rationalization of expenditures, particularly by eliminating services duplicated by federal and local authorities. With respect to revenues, the authorities favor the use of fees and charges on government services not only to enhance the revenue performance, but also to promote efficiency. The matter of raising user fees is under consideration in the context of an ongoing effort that is aimed at coordinating them in the Gulf Cooperation Council (GCC) region at levels that better reflect the economic cost of the services.

Reflecting the policy of fiscal restraint, monetary growth has been quite moderate. As to other developments in the monetary field, the authorities continued in 1987 to build on the considerable progress that they have achieved--through replacing banks' managements where necessary, promoting bank mergers, and implementing measures to improve banks' liquidity, loan provisions, and capital bases--in improving the financial soundness of the banking system. By the end of 1987, provisions for bad and doubtful loans had risen to about 29 percent of all loans and advances outstanding, or the equivalent of nearly all nonperforming loans. Consequently, as banks are not expected to have to make large provisions in 1988, their profits--which rose by approximately 62 percent in 1987 over their level in 1986--would benefit accordingly. In addition, the substantial increase in 1987 in banks' holdings of central bank certificates of deposits has brought their dirham positions into better balance. Another indication of improvement in the soundness of the banking system is that by the end of 1987, the ratio of banks' capital and reserves to their total assets stood at nearly twice the required level. In this respect, it is particularly noteworthy that all banks are currently above the requirement put forward by the Committee on International Regulatory Standards of the Bank for International Settlements, which the Central Bank is applying on an experimental basis as part of the ongoing cooperation among GCC bank supervisors.

With the oil and gas sector accounting in recent years for over 80 percent of export receipts, developments in the United Arab Emirate's external sector have largely been shaped by developments in the international oil market. The adverse impact of the latter on the trade account has been mitigated by a reduction in imports associated with the economic slowdown and the depreciation of the dirham since 1985 in line with the U.S. dollar. After remaining nearly unchanged in volume terms in 1987, imports are expected to decline somewhat in 1988 on account of, inter alia, a lower budget deficit and a large accumulation of inventories, before rising at a moderate pace over the period 1989-90. The United Arab Emirate's trade system has continued to be liberal, with import duties at the lower end of the relatively low GCC range. The outlook for the United Arab Emirate's economy is closely linked to the medium-term prospects of the oil market, which at the present time are at best uncertain. Nevertheless, it appears that the United Arab Emirate's official reserves are sufficiently large to afford the authorities considerable room for maneuver. In any event, the authorities fully intend to continue to be responsive to developments in the oil market while maintaining an environment conducive to the resumption and sustainability of normal growth.

Mr. Al-Assaf made the following statement:

The United Arab Emirates has continued to adjust to the drop in its export earnings resulting from the drastic decline in international oil prices. The authorities have responded by cutting expenditures and by increasing non-oil revenues, and despite the prevailing adverse economic circumstances, they have also been able to maintain a surplus in the overall external position.

The authorities continue to face a real dilemma as they delicately balance the need to cushion the drop in economic activity with the need to maintain fiscal expenditures at a sustainable level. At this juncture, the present level of expenditures is appropriate in light of the authorities' portfolio of foreign assets and the fact that the budget deficits are overstated owing to the exclusion of investment income. Moreover, the authorities and the staff are correct that the structure of federal finances will need to be improved. However, since this issue extends beyond public finance, a gradual approach will be necessary.

The measures that have been taken to strengthen the banking system and those directed at achieving uniform banking standards within the Gulf Cooperation Council (GCC) region are welcome. Furthermore, the successful sale of large amounts of certificates of deposits is commendable, and will not only improve the Central Bank's net income position, but will also enhance its ability to absorb excess liquidity in the system.

The authorities' maintenance of an open exchange and trade system is commendable, as is their exchange rate policy, which has improved the trade balance and has helped to stabilize the banking system and private capital outflows.

Looking ahead, the authorities' main challenge is to restore sustained growth. The private sector will clearly have to take the lead in this respect, but growth will also be facilitated by increased coordination within the GCC, which will provide the private sector with larger markets and more investment opportunities. In this context, I share the authorities' hope that the ongoing talks between the European Communities and the GCC will be concluded successfully, thereby ensuring the greater access of petrochemical products to European markets.

The authorities deserve to be commended for their prudent management of an economy that is facing adverse external developments. As a result of these developments, the economy has become more efficient with a better allocation of resources and a healthier financial sector, which will clearly facilitate the achievement of sustainable economic growth.

Mrs. Walker made the following statement:

The economic situation in the United Arab Emirates remains broadly unchanged in 1987 from 1986. In particular, the continued decline in oil revenues translated into a low level of economic activity in both the oil and non-oil sectors. However, there was some improvement in oil revenues, which helped to reduce the consolidated fiscal deficit. For the most part, it appears that the policy prescriptions that the Board and staff suggested during the previous Article IV consultation remain broadly appropriate.

While it appears that the authorities are confident that it will be possible to finance the federal deficits from Abu Dhabi's and Dubai's foreign assets, I caution the authorities about relying too heavily on this approach, even if it appears that financing is available. It is prudent, as the staff suggests, to take a conservative approach to public finance in difficult times to prevent the possibility of a worsening in the deficit in the future if oil projections do not turn out as expected, or other events cause the situation to worsen. In this respect, the authorities should look for opportunities to reduce spending in less essential areas of the budget. In addition, there apparently remains scope for improvement in the structure of the budget process so that revenues could be provided to the Federal Government on a more timely basis and so that the timing of the approval of the budget could be improved.

I welcome the continuing efforts by the Central Bank to improve banks' financial soundness, which contributed to the increase in their profitability in 1987. The steps that have been taken toward unifying the banking systems in the Gulf Cooperation Council (GCC) also appear to be helping to improve the banking system in the United Arab Emirates. I agree, however, that the Central Bank must continue to watch closely developments in the banking sector to ensure that difficulties do not recur.

As the staff's medium-term scenarios indicate, the external payments position appears to be broadly satisfactory. However, there is always room for improvement, which, in this case, should be through the diversification of the export sector. The discussions in the GCC on greater economic coordination aimed at diversifying member economies appear to be particularly timely and useful. I note Mr. Al-Assaf's point on the role of the private sector in this process.

I also note that the authorities wish to remain on a 12-month consultation cycle, which I will obviously respect. However, the United Arab Emirates and Jordan--both of which we are considering in the Board this morning--are requesting 12-month cycles; we do not seem to be finding many countries that want to switch to the bicyclic procedure. I would think the authorities would receive adequate staff analysis from the bicyclic consultation, and I am wondering whether the reason they do not want to be placed on this cycle has to do with the lack of Board involvement in the annual cycle. I would be interested in Mr. Finaish's comment on why the authorities do not see the bicyclic procedure as being appropriate or beneficial.

Mr. El Kogali said that given the overriding importance of the oil sector in the Jordanian economy, it was gratifying to note that the authorities had continued with an orderly adjustment to the drastic decline in oil prices. However, the adjustment had thus far been based essentially on the reduction of government spending. Further adjustments, particularly of a structural nature, would be needed in a number of areas if there were no substantial improvements in the oil market soon.

The oil sector accounted for one third of GDP, Mr. El Kogali continued. Therefore, the thrust of structural adjustment should be to diversify the productive base. Perhaps the staff could elaborate further on how that could be achieved. The efforts under way to enlarge regional economic integration could partially contribute to diversification. The authorities should give maximum priority to the work of the high level committee that was addressing the technical aspects of economic integration among member countries of the Gulf Cooperation Council (GCC).

The structure of the fiscal budget would have to be adjusted, since oil revenues had been accounting for more than four fifths of government revenues, Mr. El Kogali noted. As the amount of non-oil revenues had been rather insignificant, the brunt of the adjustment--which had become more pronounced in 1987--had been in government expenditure, particularly in development outlays. That expenditure restraint was not sustainable: expenditure cuts were leading to a significant shrinkage in non-oil GDP, which fell by 2 percent and 4 percent in 1985 and 1986, respectively. The authorities' concern was entirely understandable, and he agreed with their present fiscal policy stance that aimed to maintain the expenditure level while financing the resulting deficit from investment income and by drawing down foreign assets in the expectation that the international oil market would recover in the near future. In that connection, however, the staff was correct that to strengthen the federation of the United Arab Emirates, the Federal Government needed broader revenue raising powers in the long run.

Beyond the question of the Federal Government's revenue raising powers, two things stood out clearly in the staff report, Mr. El Kogali considered: the heavy reliance on petroleum revenue; and the fragmented data on other taxes and their bases. There was scope for increasing non-oil revenue through a more efficient collection of the corporate income tax, the possible introduction of a personal income tax, and the introduction of fees and charges for government services. Although the potential revenue increases might not be very large, such taxes and fees might be important to educate the people on the efficient use of resources. Nevertheless, before one could make consistent recommendations with respect to potential tax revenues and the streamlining of the tax system, it would be necessary to get a more complete picture. Therefore, the authorities should request that a technical assistance mission visit the country. He would appreciate some comments from the staff on the feasibility of providing such assistance.

The authorities should be commended for their major accomplishments in the monetary sector and for their decisive restructuring of the banking system, involving the strengthening of management, the building up of the liquidity of banks, and provisioning and capitalization requirements to ensure that a banking crisis did not recur, Mr. El Kogali concluded. The authorities had established the necessary framework for the formation and implementation of the strong monetary policy needed for a program of economic diversification.

Mr. Enoch said that the staff report recognized the strong medium-term external position of the United Arab Emirates, given the country's proven oil reserves and its strong asset position, and given the significant success that had been achieved already in adjusting to lower oil prices. It also usefully identified a number of specific measures that should be taken to improve further the workings of the economy.

The cuts in federal expenditure were an appropriate response to the reduced oil revenues, Mr. Enoch continued, while the planned increase in certain fees and charges and the elimination of the duplication of services between the Emirate and Federal budgets should make a further contribution to the adjustment. Nevertheless, a sizable fiscal deficit remained, exacerbated by the erratic flow of payments from the Emirates. While, as the staff report noted, such deficits could be financed for quite some time by running down foreign assets, it would be prudent for the authorities not to have to deplete those assets too rapidly. In addition, he endorsed the staff's comment that flows from the Emirates to the Federal Government should be made more predictable, although he well recognized the sensitivities that were involved. The uncertainties surrounding the present arrangements had led to payment shortfalls that had served to undermine international confidence in the country.

The government issue of certificates of deposit--allowing the commercial banks to match dirham assets and liabilities more effectively--could become a useful instrument of monetary policy, Mr. Enoch considered. Perhaps the staff could comment on the reports that the Government might be considering the issue of treasury bonds to finance the 1988 federal deficit. The authorities had made significant improvements in supervising the banking sector, particularly in the areas of capital adequacy and provisioning. However, as the staff noted, continued vigilance in the monitoring of that sector was necessary. In that connection, it would be helpful if the authorities could clarify the legal position on contractual interest. He also wished to know whether there had been any progress on the deposit insurance scheme that the authorities had discussed with the staff mission in 1986.

The policy of pegging the dirham to the dollar had been appropriate given the economic downturn, Mr. Enoch observed. He was interested in staff comments on whether any progress had been made in discussions on a common Gulf Cooperation Council exchange rate.

The authorities should continue with prudent economic management, Mr. Enoch concluded. The external asset position remained strong, although it would obviously have been adversely affected by the stock market crash in October 1987. The authorities should make greater efforts to supply the Fund with statistics; as the staff report noted, the position in that respect remained unsatisfactory. It was slightly surprising to see the authorities' apparent strong preference for the 12-month Article IV cycle, as one would have thought that the relatively strong medium-term position of the country made it an appropriate candidate for the bicyclic procedure. He wondered whether the bicyclic procedure should perhaps be presented in a slightly different or more positive manner.

The Chairman noted Mr. Enoch's comments on the Fund's need for appropriate statistics.

Mr. Rouai commended the authorities for the measures that they had taken to overcome the economic and financial difficulties created by the drop in oil prices. In 1987, the consolidated fiscal deficit had been reduced, domestic liquidity had increased moderately, and the inflation rate had been contained at a rate of 5-6 percent. Since he was in broad agreement with the thrust of the staff appraisal, his comments would cover only some policy issues.

It was clear from the staff report, Mr. Rouai noted, that the authorities intended to continue to focus their efforts on fiscal and monetary policy in order to strengthen the economy and to reinforce the non-oil sector, in particular.

For greater efficiency in the federal budget process the authorities should harmonize the procedures relating both to expenditures and revenues, which would substantially improve fiscal management and help to avoid delays, Mr. Rouai added.

The authorities' efforts to improve the soundness of the banking system were welcome, Mr. Rouai commented. Indeed, the introduction of standards and other regulations on provisions applicable to all banks had dramatically improved the management of the banking sector. It was gratifying to note that the authorities were committed to continuing the close supervision of banking activities to avoid the re-emergence of the previous difficulties.

While the oil industry dominated the real sector, the authorities had developed a large-scale manufacturing industry, Mr. Rouai pointed out; but, for that sector to expand, industrial countries, especially those of the European Communities, should avoid adopting any protectionist measures. In that respect, he hoped that the discussions between the

European Communities and the Gulf Cooperation Council would be concluded as soon as possible to allow the United Arab Emirates and other Gulf countries to diversify their export earnings.

In the external sector, the policies pursued or planned seemed to be adequate, Mr. Rouai concluded. It was gratifying to note that there were no changes in the Central Bank's reserve management policy, which was aimed at stressing liquidity and security as well as yield. The exchange and trade system continued to remain free of restrictions, while the stability of the dirham continued to be the authorities' objective. He supported the authorities' request to have a 12-month cycle for the Article IV consultation.

The staff representative from the Middle Eastern Department said that one of the difficulties that the United Arab Emirates faced with respect to the issue of diversification was its narrow resource endowment. The World Bank estimated that 90 percent of the labor force consisted of expatriate workers; hence, in the effort to diversify the economy, the authorities had to consider whether to opt for rapid output growth, or whether to try to achieve other objectives, such as a high level of domestically retained value added. Of course, externalities were involved in the question; for instance, higher growth might promote further development of managerial skills and entrepreneurship.

The authorities' approach to diversification had been a market-oriented one, the staff representative continued: they had generally not used price subsidies, price controls, import quotas, or tariff restraints, but had instead operated a very open and liberal economy. Furthermore, they had directed much spending to building infrastructure, industrial zones, and similar facilities, and had undertaken to strengthen the financial system. However, the authorities had been providing electricity and water subsidies, which was perhaps an issue, although a consideration in that respect was the appropriate cost of the gas inputs needed for electricity and water production. In the latter connection, the authorities had been considering raising the charges for public utilities in the context of discussions about utility charges among members of the Gulf Cooperation Council (GCC). The agricultural sector had received some small subsidies owing to the authorities' desire to support the rural population and prevent a heavy migration to the cities.

The question of raising revenues was a difficult political one, the staff representative remarked. At the Emirate level, the authorities considered their revenues to be adequate and relatively strong, but at the Federal level revenues needed to be strengthened. At the Federal level, the authorities were considering raising fees and charges, but they recognized that it would not greatly increase revenues, although the measures would reduce waste in the provision of government services. The question of raising federal revenues involved the constitutional distribution of powers between the Emirates and the Federal Government, and thus a request by the authorities for the staff to conduct a technical study would have to take into consideration whether the Federal authorities would be in a position to follow up a proposed change to the revenue structure.

The staff had no information on whether the authorities planned to issue treasury bonds to finance the fiscal deficit in 1988, the staff representative noted, and neither was there additional information on the deliberations of GCC members on exchange rates. However, with respect to deposit insurance, the staff had prepared a study in 1987 for the ongoing discussions of GCC members on that matter.

The authorities had not misperceived the nature of the bicyclic consultation procedure, the staff representative from the Middle Eastern Department concluded. For a number of years, the United Arab Emirates had strongly wished to be treated as other GCC members were. It might be correct that the authorities preferred the annual procedure because of the Board's involvement in that cycle: the authorities found Directors' statements to be very helpful. Moreover, annual visits by the staff, and the reports that were discussed subsequently by the Board, gave the Federal authorities leverage vis-à-vis the Emirate Governments and so helped to enhance the coordination of policy views and statistics between the two levels of government.

Mr. Finaish said that although it was correct that the Federal finances and fiscal structure were relatively weak, the issue went beyond public finances and was one of considerable sensitivity. The Federation had only been created in the 1970s and was composed of seven Emirates, two of which--Abu Dhabi and Dubai--were dominant, because of their endowment of oil and gas resources. The Federal Government had been dependent on revenue transfers from these two Emirates and, since 1985, from Sharja.

The financial relationships between the Federal and Emirate Governments were still evolving, Mr. Finaish added. By 1977, the police, the telecommunications sector, and the armed forces had come under Federal jurisdiction. By 1980, the Abu Dhabi Government had also transferred other functions to the Federal Government. In 1981, the Federal Government became responsible for administering the United Arab Emirates' foreign aid program, although some grants continued to be paid by the Emirates directly. Given the large degree of autonomy within the Federation and the fact that the financial relationships between the Federal and Emirate Governments had not yet fully evolved, one could see why the Federal Government finances remained structurally weak so far. One could also see why some duplication of services and facilities was built in.

The argument that domestic taxes should be raised because of declining oil revenues and widening fiscal deficits had been made for other oil countries, and most recently for Saudi Arabia, Mr. Finaish observed. However, as he saw the situation, there were important reasons why the authorities had delayed taking action on that front. The politically feasible time for raising revenues--when the economy was strong--did not coincide with the time when the revenues were most needed, a cyclical dilemma that had especially confronted the authorities over the previous few years of economic slowdown. It was always difficult to talk about imposing new taxes when, at the same time, one wanted to encourage the private sector. Another cause for the authorities' reluctance to raise revenues was the free factor mobility in the GCC region, and the obvious question of competitiveness. If one GCC country raised its taxes without the others doing the same, that would affect its competitiveness. A further problem was that the people did not recognize the need to increase revenues, which was reinforced by a popular notion that the oil resources belonged to the people as a whole and that the oil revenues of the Government, or the "custodian" of those resources, were tantamount to taxes. This argument, however, ignored the role that taxation played in the redistribution of income.

The discussions between the GCC and the European Community on trade matters were important, Mr. Finaish considered, because the GCC wanted to gain better access for its petrochemicals in that market. About 14 percent or $15 billion of European Community goods--equivalent to about 35 percent of GCC imports--were exported to the Gulf countries.

The Board should accede to the authorities' request for holding the next Article IV consultation with the United Arab Emirates on the standard 12-month cycle, Mr. Finaish remarked. He noted that Directors thought the United Arab Emirates was a good candidate for the bicyclic consultation procedure, but considered that the staff representative had well described the situation in explaining how the authorities valued access to the Board's views of the country's circumstances. In the summing up, he did not believe that there would be a need to mention the issue of the annual versus bicyclic consultations; instead, the staff could communicate with the authorities on a more informal basis about that matter.

The Chairman made the following summing up:

Directors were in general agreement with the views expressed in the staff appraisal. They noted that the sharp fall in oil receipts since 1981 had caused a large reduction in government revenues, lowered the balance of payments current account surplus and reduced non-oil output. Directors felt that the policies followed by the authorities had generally coped with these challenges. Part of the drop in government revenues had been offset by reductions in government development spending, as large infrastructural projects were completed and no major new ones were started. Current spending had been kept relatively constant to support the non-oil sector and achieve important social objectives. A prudent domestic policy stance nonetheless remained appropriate in the current oil market context. Although some Emirates had substantial foreign assets from which to finance the consolidated fiscal deficit, Directors encouraged the authorities to keep fiscal policy under review so that these foreign investments were not reduced excessively before government oil revenues recovered. In addition, they expressed concern about the size of the federal deficit, urging that improvements be made in budget procedures to facilitate a timely transfer of revenues from the Emirates to the Federal Government. In the long run, structural changes, including a broadening of the tax base, were called for to enhance Federal revenues.

Directors noted the moderate growth of monetary and credit aggregates in recent years and welcomed the diversification of the instruments of monetary control. They encouraged the authorities to continue the supervisory and other steps that had succeeded in improving commercial banks' financial condition.

It was noted that the drop in oil export receipts had been partly compensated for by adjustments in other items so that the current account of the balance of payments had remained comfortable and was projected by the staff to continue to be so in 1988-90. In this context, Directors viewed the current exchange rate arrangement as broadly appropriate and commended the liberal exchange and trade policies being pursued by the authorities.

Looking ahead, Directors thought that greater reliance would have to be placed on the development of the private sector in the context of the Gulf Cooperation Council to foster economic and export diversification and sustained growth. The importance of foreign market access was noted in this connection.

Directors noted that the coverage and currentness of statistics in a number of areas had to be improved.

The next Article IV consultation with the United Arab Emirates will be held on the standard 12-month cycle.

Mrs. Walker said that considering that both Jordan and the United Arab Emirates wished to remain on the standard 12-month consultation cycle, she hoped that the next time that the staff reviewed the bicyclic procedure, it would address the issue of why it had so little appeal to the authorities. There was sometimes a tendency to lose sight of individual countries when an overall policy was examined.

The Chairman said that the staff of the relevant departments would respond to Mrs. Walker's report, and would also be made aware of the need to better inform authorities about the bicyclic consultation procedure.

## 3. PHILIPPINES - 1988 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1988 Article IV consultation with the Philippines (SM/88/113, 5/25/88; and Cor. 1, 6/15/88). They also had before them a background paper on recent economic developments in the Philippines (SM/88/121, 6/6/88; and Sup. 1, 6/6/88).

Mr. Rye made the following statement:

This is the fourth time in 15 months that the Board has reviewed developments in the Philippines. The previous three were in relation to the use of Fund resources, and in each case, the Board recognized and expressed its full support for the efforts of the Philippine authorities. My authorities appreciate this support, which has been helpful in ensuring that other necessary external financing has been obtained. They would also like to acknowledge the efforts of the staff in preparing well-balanced and comprehensive reports that have facilitated a better understanding of economic developments in the Philippines.

Important macroeconomic and structural adjustment measures have pulled the Philippines out of the severe recession of the mid-1980s, with its accompanying substantial external payments arrears and extreme rates of inflation. Fiscal and monetary policy reforms and structural adjustments in agriculture and the public sector, supplemented by incomes policy initiatives, and the change in political leadership have collectively re-established a competitive market environment in which government involvement in the economy has been much reduced and the external trade and payments system substantially liberalized.

There are increasing signs that the private sector is responding favorably and vigorously to the dismantling of government monopolies and to the reduced cost of imported inputs for domestic production resulting from import liberalization. Moreover, the stabilization of domestic prices through decisive monetary and exchange rate policies, and efforts to increase real incomes of a wider base of consumers through tax reform and government expenditures in the rural areas have provided a favorable climate for private sector activity.

Growth in 1987 can generally be characterized as being consumption led as the initial phase of the authorities' strategy was intended to prop up incomes through government expenditures in depressed areas. Toward the end of 1987, however, the general momentum of the economy generated renewed private sector investment activity that accelerated through the first half of 1988 as the various reform measures and the absence of major political disturbance enhanced profitability and production.

Moreover, in 1987, as indicated in the staff papers, major new balance of payments problems were avoided, the external debt situation improved, and close cooperation with the international financial community was maintained. In addition, the strengthening of the economic base allowed the authorities to withstand periodic destabilizing incidents without affecting confidence in the economy.

After growing by 5.7 percent in the whole of 1987, real GNP is estimated to have further grown at an annual rate of 7.6 percent in the first quarter of 1988. While national income statistics are not yet final, the data from various investment monitoring agencies and surveys of manufacturing firms indicate that capital investment--both domestic and foreign sourced--was a substantial component of this growth and that manufacturing industry will be a major area of output growth for 1988.

On the other hand, the inflation rate--which was 7.6 percent over the course of 1987--rose to 9.7 percent over the year to April and declined slightly to 9.2 percent for May. The run-up in prices during this period may be traceable to the increase in domestic liquidity in the last quarter of 1987, partly associated with the political disturbance in late August. The most recent data on reserve money indicate that the excess liquidity has been checked; the authorities are still confident that the expected inflation rate of 8 percent, at most, for 1988, is achievable, as well as the real growth target of at least 6 percent.

With respect to the external accounts, the overall balance of payments for the March 1988 quarter registered a surplus of $116 million compared with a $20 million deficit for the same period in 1987. The improvement came from both the current and capital accounts despite a slightly wider trade gap, as imports of raw materials and investment goods increased significantly.

The level of reserves has remained steady at around $1.8 billion (or about two months of projected imports of goods and services) and exchange rates stable at about P 21.00 to $1.00. Speculative activities have been checked and the Central Bank has resumed foreign exchange purchases to protect the reserve level. Total central bank purchases of foreign exchange between March and May of this year amounted to $241 million, although not all of it was used for intervention purposes.

Data on performance criteria for March under the stand-by arrangement indicate the authorities' compliance with the program's requirements. Preliminary indications suggest that June performance criteria will likewise indicate that the ceilings will be met.

On the policy front, the President signed into law on June 10 the Comprehensive Agrarian Reform Program (CARP) passed by Congress. The main features of this land reform law are: a retention limit of 5 hectares to the landowner plus 3 hectares for each heir who is at least 15 years old and will till the land; a 25 percent cash down payment to landowners with lands in excess of 50 hectares, which will be immediately distributed during CARP's first phase; a 30 percent down payment for those owning 24 to 49 hectares of land, to be distributed in the fourth year; and 35 percent for those owning 5 to 23 hectares in the sixth year. The balance will be paid in government bonds; and an additional 5 percent incentive to be given to those who opt for voluntary transfer.

The CARP law will have no impact on the 1988 budget. The initial expenditures for the program are expected to be financed from the P 6.5 billion proceeds from the of sale of disposed government assets already budgeted for this purpose.

As the Board is well aware from previous discussions of the Philippines, the implementation of the macroeconomic and adjustment program has not been without hitches. Overshooting of ceilings and speculative attacks on the country's reserves have, in fact, been among the reasons for the frequent Board discussions of the Philippines over the past 15 months. The disruptions threatened to dislocate seriously the program, but, in all cases, because of the inherent strength of the adjustment efforts and the determination of the Philippine authorities, serious problems were averted and a return to stability was quickly effected.

The demonstrated resolve of my authorities to keep within the principles of the adjustment framework that they themselves have formulated has resulted in the resurfacing of the inherent strength of the economy with its rich natural resources and highly skilled manpower, and its location in a growth region of the world. As my authorities put it, their efforts have resulted in the discovery and plugging of the leakages in the economy that had resulted in inefficient utilization of these resources. In turn, the private sector has responded favorably to these efforts and has begun to make a more appropriate contribution to growth and development. The overall result has been a sharp rise in the efficiency and productivity of the economy. It may no longer be appropriate, therefore, to project forward the macroeconomic relationships of the past decade or so in assessing the outlook for the economy.

Such improvements in efficiency can explain why, for example, despite the large shortfall in public investment expenditure in 1987--which was considered crucial for growth--the growth target was broadly achieved and the prospects for 1988 remain sound.

My authorities are aware that despite the achievements, adjustment efforts need to be maintained. The authorities are also aware that to generate external financial support for these efforts, it is essential that the efforts be viewed as being within the framework of a comprehensive adjustment with growth. Thus they remain committed to prudent monetary policy and flexible exchange rate policy, mindful that the expected price increases and programmed wage adjustment will require greater vigilance in liquidity control and trade competitiveness.

In the fiscal area, the increases in personnel expenditures in 1987 can be viewed as investments in national security (in the case of the salary increases for soldiers) and in human capital (for the salary increases for teachers). The budget allocation for the early retirement incentive plan--to improve the quality of government service--is a one-off item of expenditure. Looking ahead, the authorities have indicated that the faster pace of current over capital government expenditures is not expected to extend to the 1989 budget, and, that, for the 1988-92 period, growth in capital outlays is programmed to exceed that of current expenditures.

Because of the comprehensive tax reform, the authorities are currently poised to benefit substantially from improvements in tax administration, which is an area where greater efforts are being exerted.

It is essential that the policy measures adopted be viewed as being within the framework of a comprehensive adjustment with growth. My authorities, and I hope that the Board, as well as the international community share this perspective and will continue, as in the past, to provide their financial support to the Philippine adjustment effort.

Mr. Yamazaki made the following statement:

As Mr. Rye clearly noted in his opening statement, the marked progress in adjustment efforts made under the stand-by arrangement and the favorable economic response to such efforts are pleasing. After the Philippine economy's performance deteriorated in the mid-1980s, the authorities began a sturdy growth-oriented adjustment program. The performance under the program has been broadly satisfactory: after the initial fiscal stimulus, the public sector deficit has declined; while monetary policy has been tightened, following the resurgence of inflation, and a number of far-reaching structural measures have been implemented to remove the distortions in the economy and to streamline the economic system.

These strenuous efforts have started paying remarkable dividends. The Philippine economy has been growing robustly, the employment situation has improved significantly, and price developments have been broadly in line with the program, although there is increasing inflationary pressure. While developments on the external front have not been as favorable as on the domestic side, the authorities' overall achievements are commendable when noneconomic factors such as the political situation are taken into consideration.

However, to sustain economic growth and to attain external viability, the authorities have to continue to assail a number of structural and financial problems--on which this chair has repeatedly elaborated during previous reviews, but will not do at present. Nevertheless, I will underscore a few points that are essential for the country's further development.

With respect to fiscal policy, I do sympathize with the increase in personnel expenditure in 1987, as it will provide a basis for stability in the Philippines. However, public investment is essential for sustaining financial support from the international community, and in this respect, Mr. Rye's statement that capital outlays are programmed to exceed current expenditures over the medium term is welcome.

Furthermore, the authorities should remain cautious in their control of liquidity since the rekindling of inflation is a major cause for concern.

The change in exchange rate policy in early 1988 is welcome: flexible exchange rates will no doubt contribute to an improvement in the current account. However, the medium-term scenario underscores the need for the authorities to take more decisive adjustment efforts to attain external viability.

The authorities should remain committed to structural reform, although significant progress has already been made. In this context, it was gratifying to learn from Mr. Rye's opening statement that the long-awaited land reform has begun, which I hope will pave the way for further growth. In this connection, Mr. Rye or the staff's comments on the scenario for financing the land reform would be welcome.

I reiterate my authorities' support for the Philippines and encourage the authorities to take further steps to sustain the country's credibility in the international community.

Mrs. Ploix made the following statement:

The major structural reforms that have been put in place over the previous two years, combined with the maintenance of an adequately tight macroeconomic setting, have resulted in a remarkable economic performance. The Philippine example of adjustment with growth deserves particular mention.

Despite the substantial progress that has been achieved, the staff is right to caution the authorities against any relaxation of the current adjustment stance. The main threat in the short term stems from a deterioration in the fiscal position: any further weakening in this area would increase the risk of overheating and put serious constraints on monetary policy, while it would also be detrimental to the strengthening of the country's financial relations with foreign creditors, whose support appears to be critical for continued sustainable growth over the medium term.

The fiscal backsliding that is anticipated for 1988 is a cause for concern on two accounts. First, in terms of GDP, the forecast deficit is unsustainable and could undermine the whole stabilization process. Second, as the staff notes, the lack of control over current expenditure is not only responsible for the loosening of financial discipline, but is also constraining the implementation of the public sector investment program. Even if civil servants' wages have to be adjusted, it is imperative to stabilize them at their current level in real terms. Moreover, considering that this pay policy can be viewed as an investment in "human capital"--as Mr. Rye puts it in his opening statement--it should result in higher labor productivity. The authorities should therefore consider a more significant streamlining of the public sector payroll.

The enhanced efficiency of the tax system should not induce the authorities to be complacent about the present fiscal deterioration. The responsiveness of public revenues seems to have been increased by the tax reform; however, this should not diminish the pressure for acting on the expenditure side of the budget.

A final element that can also reinforce concerns about the fiscal prospects for the Philippines relates to the cost of the recent land reform law. Like Mr. Yamazaki, I would appreciate some clarification about the estimated overall cost of the reform and its potential impact on the fiscal position over the medium term.

The recent fiscal developments can only complicate the monetary authorities' task. The tightening of monetary conditions at the beginning of 1988--by pushing up interest rates--proved to be instrumental in curbing speculative capital outflows and in facilitating the replenishment of official reserves. The staff sees some limits in this approach to the extent that it could be inconsistent with greater exchange rate flexibility and more sustained capital formation. On the latter point, it may be argued that adequately high real interest rates are necessary to raise the low domestic savings rate. In addition, a sustained level of economic activity can be considered to be as critical for investment behavior as the level of interest rates.

The stabilization of the exchange rate in real terms vis-à-vis the main trading partners of the Philippines does not pose an immediate threat to the country's competitive position. The persistence of inflationary expectations remains a reason for having a rather prudent exchange rate policy. Therefore, as long as the dilemma between the domestic and external objectives is not more acute, it seems to be preferable to gear monetary policy to domestic financial stabilization.

The medium-term projections included in the staff report are rather preliminary, but clearly show the implications of sustained growth for the export sector and for external capital flows. Even if optimistic assumptions are retained for the expansion of exports, the Philippines will still run a significant current account deficit over the medium term. To contain this deficit at a manageable level, it will be crucial for the country to maintain a competitive position based on sound financial policies.

In any event, substantial contributions from the international financial community will have to be mobilized. Given the recent adjustment record of the Philippines, the authorities should feel rather confident in this respect as long as they adhere to prudent financial policies. However, a significant part of these additional financings will remain conditional on the pursuit of close cooperation with the Fund. I wish to hear more comments from Mr. Rye or the staff on the type of arrangement that could succeed the present stand-by arrangement.

Mr. Templeman made the following statement:

The authorities are to be commended for the very impressive progress that has been made in a number of macroeconomic and structural areas as a result, in no small part, of their serious and broad-based efforts of recent years. In particular, economic growth seems to be well under way, without having a seriously adverse impact on the inflation rate and the balance of payments thus far. It appears that the Philippines is in compliance with the end-March performance criteria under the current stand-by arrangement and that important structural reforms are still proceeding. In addition, the authorities continue to exhibit a cooperative approach to relations with their creditors.

I will not go into details on structural reform efforts, since past progress and areas of future need are well laid out in the staff report. However, this should not be interpreted as undervaluing in any way the importance of structural reforms.

Despite past progress, there are some potential short-term dangers and some longer-term challenges that need to be addressed forcefully. In the first instance, there is a danger of a resurgence in inflation--triggered largely by excessive public wage increases--which could undo the past success in reducing the inflation rate from its peak of 50 percent in 1984. While the threat does not appear to be large and immediate, it would be a great pity if a serious inflationary problem was allowed to re-emerge. The longer-term challenges encompass, principally, the achievement of a stronger balance of payments position, the contemporaneous reduction of the fiscal deficit to help make that possible, and the completion of a number of structural reforms to provide greater assurance of sustainable and efficient economic growth.

The real economic growth rate in 1987 was an impressive 5.7 percent. Job creation has been accelerating and the unemployment rate has begun to come down. Particularly impressive was the rise in real fixed investment in durable equipment of more than 16 percent, after four years of negative real growth. Consumption also rose strongly, with private consumption increasing by 5 1/2 percent and public consumption rising by 7 1/4 percent. However, consumption growth at these rates--particularly for public consumption--and the rise of employment in the government sector may prove to be a mixed blessing. I note, for example, that employment in the national government sector rose by 20 percent during the period 1983-87, while real wage compensation in that sector rose on average by nearly 8 1/2 percent over the three years 1985-87.

The staff report estimates that the increase in real wage compensation in the National Government in 1988 may reach 28 percent. This is a very high rate in light of past increases and is a serious cause for concern should the authorities be unable to contain further wage increases in the government sector, or should substantial wage increases spread to the private sector, which has not benefited from such high increases in recent years. The Philippines cannot afford to allow its domestic cost and price performance to erode its competitive position vis-à-vis its trading partners--particularly those in the Pacific region--and still expect to achieve growth with financial stability and a sustainable external position. While the rate of inflation is still rather moderate, the 9-10 percent annual rate that has prevailed over recent months is not altogether reassuring. In that connection, actions taken in May of this year to reduce petroleum prices and to place a ceiling on or to reduce electricity rates do not strike me as the best approach to containing inflationary pressures.

The rise in personnel costs in the budget in 1987 has contributed to a less desirable mix of public expenditures than was anticipated--the wage bill rose and public investment continued to fall short of plans. The latter development is particularly disappointing in light of the serious and chronic problem of a large backlog of high priority public investment projects. Although the ratio of the consolidated public sector deficit to GNP fell substantially in 1987 to about 3.2 percent from 5.4 percent in 1986, one-time factors seem to have accounted for much of the improvement, and the expected deficit for 1988 will be on a par with the high deficit ratios of 1985 and 1986. More important, I am disappointed that the staff has not presented some medium-term fiscal projections along the lines of those prepared for the balance of payments. As the staff correctly points out, a reduction in the fiscal deficit and public dissavings would greatly facilitate the achievement of an acceptable balance of payments outcome. Furthermore, I notice in the staff report that there is a medium-term land reform financing gap and that the authorities do not yet have a medium-term plan for fiscal deficit reduction. The authorities should focus on these matters with a sense of priority.

The increase in the current account balance in the years 1986-87 of $1.5 billion was probably the inevitable result of the recovery of economic activity. Increases in the volume of imports in those two years of 20 percent and 31 percent, respectively, may be a counterpart to the declines of 23 percent and 16 percent in the previous two years. However, if the authorities are to maintain real economic growth at about 6 percent a year, they will have to pay careful attention to containing domestic absorption, to preserving the competitive position of the Philippines, and to continuing structural reforms. The decline in the real effective exchange rate by 18 percent and 9 percent, respectively, during the past two years, and the good export performance, suggest that Philippine exports may be reasonably competitive. However, the authorities' medium-term balance of payments projection assumes that the growth of nontraditional exports will be about double that of the country's export markets. The staff suggests that any export shortfall might be offset by a lowering of the propensity to import. I wonder how this might be accomplished. Given recent price and wage developments, close attention will certainly need to be paid to the pursuit of a flexible exchange rate policy.

In that connection, I share the staff's caution about avoiding an excessive dependence on tight monetary policy, although I recognize the potentially adverse impact on confidence coming from a rapid exchange rate depreciation.

I also note the rather large external financing gaps that are shown in the medium-term projection, even after assuming continued official debt rescheduling. A much more active role for debt-equity swaps could help significantly to close the financing gap and would provide other economic benefits. More generally, creditors have been impressed with the Philippine authorities' previous progress in economic adjustment and structural reform and are generally well disposed to provide continued financial support. In fact, my own authorities are considering possible ways of mobilizing external financial support for the Philippines in the context of a strong and comprehensive adjustment and reform effort.

With respect to the role of the Fund in the Philippines after the termination of the current stand-by arrangement, I would be very interested to hear the authorities' views. I believe that at least as cautious an approach to the management of macroeconomic policy as has been exhibited over recent years will need to be pursued in coming years and that much remains to be done in some areas of structural reform to reinforce macroeconomic adjustment and, thus, to help assure the achievement of sustainable growth. In the category of further structural reform efforts, the following measures need to be considered: continued reform of the financial and nonfinancial public corporations, including their prioritization; elimination of bottlenecks to permit more rapid implementation of the World Bank-supported public investment program; further reforms in trade policy; land reform; a more open approach to foreign direct investment; and perhaps some additional reforms of financial markets. Both the Fund and the Bank have expertise in several of these areas and could make an important contribution to further progress while reassuring other creditors. Of course, the Philippines has been a prolonged user of Fund resources so the Board must carefully weigh the form which any further Fund support of the adjustment and reform effort should take. Therefore, perhaps the most appropriate course would be to provide another stand-by arrangement of modest size, which might not even be fully drawn on.

Mr. Piantini made the following statement:

Since the previous Article IV consultation in October 1986, the Philippines has achieved a remarkable performance. In 1987, the rate of economic growth almost tripled to 5.7 percent, and is expected to be maintained in 1988. However, investment as a percentage of GNP remains at a very low level compared with the first part of the 1980s. The estimated inflation rate for 1987 was 3.8 percent; thus, it was lower than the predicted rate, but it is projected to almost double in 1988 owing basically to the effects of drought and typhoons. In 1987, the public sector deficit decreased by two fifths in relation to GNP; nevertheless, the balance of payments deficit widened owing to the instability created by the attempted coup in August and by the boost to growth coming from increased private consumption and domestic investment. Furthermore, the unemployment rate declined.

The authorities are successfully implementing their macroeconomic policies. All of the performance criteria under the stand-by arrangement were observed in March 1987, as Mr. Rye pointed out in his opening statement, and almost all of the comprehensive structural reforms foreseen in the program have been adopted.

The reform of the tax system has improved its elasticity and has increased revenue collection by 2 percent of GNP since 1985. Nonetheless, the measures taken in May 1987, such as the ceilings on tariffs and prices, the reduction in the interest rate charged by the National Housing Authority, and the discontinuation of counterpart deposits by public entities for rescheduled foreign debt may restrain the progress already under way. The authorities should gradually reduce the fiscal imbalance while keeping the implementation of the reforms on track.

A cautious policy on wages and salaries in the public sector, and a shift in expenditures in favor of appropriate investment, should reinforce the growth that is occurring and avoid excessive pressures on prices and the external sector. The authorities are carrying out reforms in public corporations and have approved the privatization of over 100 of them.

The projected growth of monetary aggregates is consistent with both the target for the inflation rate and for real economic growth in 1988. Owing to the opening up of the economy, the authorities are correct that a tightening of monetary policy is the most suitable means of dealing with the exchange rate and inflationary pressures while the economy accommodates the structural reforms. From this point of view, a further reduction in the public sector borrowing requirement is essential to avoid an increase in interest rates and to make room for private sector investment.

Exports, led by manufactures, have continued to recover since the beginning of 1986 despite the large cut in U.S. sugar quotas. The maintenance of a competitive exchange rate, which has depreciated by 25 percent in real terms since 1985 vis-à-vis major trading partners, has been the key element in achieving the export performance. Exchange rate adjustment coupled with the important trade liberalization policies that are planned should strengthen the external sector by improving efficiency in the allocation of resources.

For the period 1988-93, the authorities' projection for the trade balance seems to be realistic. The staff notes that the envisaged annual average growth of exports equivalent to 0.8 percentage points of GNP appears to be optimistic; however, between 1985 and 1987, exports increased at an annual average rate equivalent to 1.2 percentage points of GNP. Furthermore, the comprehensive reforms that have been implemented will enhance the country's growth potential. Nonetheless, the continuing good export performance will depend crucially on the removal by developed countries of protectionist measures that affect Philippine exports, as described on page 86 of SM/88/121 (6/6/88).

The Philippines is one of those countries in which a high external debt burden could destroy the effectiveness of strong internal adjustment efforts. The debt service ratio in 1993, after rescheduling, will be the same as it was in 1988, and during the next five years average interest payments will be equivalent to 5.6 percent of GNP, which is equivalent to twice the estimated current account deficit for the period 1989-93. Owing to the high level of external resources required by the Philippines in the future, the country will need strong concessional support from the international community.

Mr. de Groote made the following statement:

The current discussion is the fourth time in 15 months that we have reviewed economic developments in the Philippines. On each occasion, including today, the country's situation has been seen as further improved and the adjustment process as moving steadily forward despite occasional adverse political events. Of course, it must also be understood that this adjustment began only recently and from a very low starting point; there remains a long road ahead before the Philippines can regain its former rank of 30 years ago as the second richest country in Asia.

After a long colonial history that has been compared with 400 years in a convent followed by 50 years in Hollywood, a new national identity is beginning to emerge that is capable of serving as a pillar for strong economic growth. The major reform measures described in Mr. Rye's opening statement clearly justify optimism about the country's prospects for growth. The reform measures may be described generally as instilling in

Philippine working and business communities, a sense of national responsibility and purpose, while preparing the country for a gradual lessening of the Government's deep involvement in the economy.

The first results are already apparent: current growth is robust, and growth estimates for 1988 have even been revised upward. Although high, this rate of growth will have to be sustained for several year's to outstrip the 2.4 percent annual growth in population and to regain the former standard of living; and although I agree that there is a risk of some increase in the inflation rate, it would not be wise to sacrifice growth altogether on the alter of zero inflation.

In their conduct of monetary policy, the authorities should accordingly try to avoid overtight monetary conditions, which are apt to combine with the existing fiscal deficit to produce excessively high real interest rates and strangle the profitability of private enterprises. As the staff suggests, the monetary impact of debt-equity swaps should be accepted up to certain limits, as long as these schemes help to reduce the external debt burden and promote investment at the same time.

If control of the inflation rate through tighter monetary policy warrants less attention, the growing fiscal deficit requires more scrutiny; but, it must be of the right kind. In this connection, the staff points to the high salary increase granted to the civil service sector. It may seem strange that the staff does not find more merit to the authorities' arguments justifying this increase, which strikingly resemble those used by the staff's own association in its negotiations with the Fund's management. In any event, the lowest wage in the civil service is still some 25 percent below the official poverty level, even after the increase. Instead of holding down civil service salaries, the authorities might be well advised--as suggested by Mrs. Ploix--to seek more room for streamlining public administration, or failing that, to try to increase public sector productivity by freezing the number of civil servants while motivating those already employed with salaries that, at least, permit them to support their families. I agree with Mr. Rye that the salary increase for the army is an investment in national security, since it appears that even after a 60 percent increase the average colonel will still earn only $300 a month.

In the context of the public sector, I am confident about the effectiveness of the World Bank loan--approved five days ago--in financing a program for reforming nonfinancial government corporations through rationalization, privatization, or liquidation. Reducing the number of government corporations from 286 to 37, and eliminating most of the subsidies that have supported them, should help considerably to bring down the fiscal deficit, along with a further broadening of the tax base and the increased tax revenues coming from high growth. In sum, the Bank's adjustment loan is based on the assumption that a reduction in the fiscal deficit depends on the long-term success of the public sector reform. As was pointed out by Mr. Abdallah during the recent discussion on structural aspects of fiscal adjustment (EBM/88/81 and EBM/88/82, 5/20/88), it appears that a precondition for such an achievement is an efficient administration with appropriate salaries.

The projected land reform--which is expected to cost more than $2 billion--will have to be financed. In view of the country's large impending investment needs, there is much talk at present about a "Marshall Plan" for the Philippines; one also reads in the press that, in 1987, only about $1 billion of the $3.5 billion committed by donors was actually used, and in 1986, only $770 million out of $3.2 billion was used. The staff or Mr. Rye should comment on these figures and also tell us what plans exist for designing a new Fund-supported program, to follow the one that is expiring, that can maintain the momentum of growth. Mr. Templeman's suggestions about the broad outlines of a program under a new stand-by arrangement deserve serious attention. A priori, I do not see, however, why the Fund's assistance has to be limited, if the authorities do not intend to draw on a new stand-by arrangement; the authorities' expectations in this respect are important given the country's prolonged use of Fund resources.

The staff mentions that recent and projected inflows of foreign investment capital are so modest that the regulations governing foreign investment should perhaps be reviewed. There might be a tendency in the Philippines to overemphasize the inward orientation of attitudes and policies: it is the Government's responsibility to convince the people that the country needs foreign investors to sustain growth and can therefore no longer afford to have an investment code that foreign investors find to be inferior to Viet Nam's, not to mention that of a robust competitor like Thailand.

Mr. Grosche made the following statement:

The further progress that has been achieved toward the main objectives of the adjustment program of the Philippines is welcome, and the authorities deserve to be commended for their continued commitment to adjustment. The Philippines has made significant progress in a number of areas under the current stand-by arrangement, but, it is obvious that much remains to be done in 1988 and beyond.

If the relatively rapid growth of domestic demand were to continue over the period ahead, it would certainly have a detrimental impact on the external accounts and would, at the same time, contribute to a further acceleration of the inflation rate. While the recent tightening of monetary policy is therefore welcome, it must clearly be limited and should be accompanied by more decisive actions to reduce budget deficits.

The shift that occurred in the structure of fiscal expenditure is a cause for concern, although I have a lot of sympathy with Mr. de Groote's attitude of paying reasonable salaries for a highly qualified, but small government staff. Moreover, it is difficult to fully understand the rationale for the recent measures to reduce petroleum and electricity prices; those measures cannot easily be reconciled with the objective of consolidating the fiscal budget.

The increase in the inflation rate differential vis-à-vis the main trading partners and competitors of the Philippines points to the need to keep exchange rate developments under close review and to be prepared to further depreciate the currency in real terms.

Remarkable progress has been made in the area of structural reforms. It seems, however, that the privatization of a large number of state enterprises could be expedited somewhat if the lengthy and often unnecessary bureaucratic procedures could be avoided. Complicated bureaucratic procedures also seem to hamper foreign direct investment, which, in other Asian countries appears to make a more significant contribution to economic development than in the Philippines. It is also a cause for some concern that foreign aid cannot be utilized to the extent possible, because the Government has not yet concluded the reformulation and reshaping of its medium-term development plan.

The land reform that was signed into law recently is welcome, and although I could have imagined a bolder approach in terms of a quicker pace of implementation and a smaller budgetary impact, I hope that it will work and that it will bolster activities in the private sector. While the land reform will--as Mr. Rye has informed us--have no impact on the 1988 budget, it is my impression that the authorities wish that the international community will provide generous financing for land purchases over the years to come. In this respect, my authorities share the view held by the World Bank and the Asian Development Bank, namely, that financing should first be sought from Philippine sources.

The medium-term growth target of 6 percent annual average growth of real GNP requires, inter alia, sizable additional financing, which raises the question of whether it is advisable to depend to such an extent on foreign financing, or whether the country should instead try to generate more domestic savings.

I endorse the staff appraisal.

Mr. Hogeweg said that the staff was right to commend the authorities for what had been achieved thus far. At the same time, the staff was very clear about the challenges that lay ahead--the large financing gaps in the authorities' medium-term scenario illustrated that point. He largely agreed largely with the staff appraisal.

The staff noted that rapid growth of domestic consumption posed a serious risk of accelerating the inflation rate and of worsening the balance of payments, Mr. Hogeweg continued. It viewed the recent tightening of monetary policy as a necessary step, but cautioned the authorities against relying too heavily on monetary policy in view of the need to maintain an environment that was conducive for investment. While he agreed with the foregoing analysis, he did have some reservations about the staff's recommendation for greater exchange rate flexibility in view of the widening inflation differentials vis-à-vis the country's trading partners and competitors, and he asked it to be more specific about what was meant by "flexibility"--namely, did it imply a further depreciation of the currency?

Only after the staff had referred to the exchange rate did it express its concern about the considerable fiscal policy slippages that had occurred, Mr. Hogeweg observed. In the fiscal area, developments certainly did seem to be going in the wrong direction, with the sharp increases in personnel expenditures--although he had noted Mr. Rye's point about investment in security and human capital--the scaling down of investment outlays, and the recent adoption of measures that tended to weaken public sector finances and financial discipline. The authorities' emphasis should be on prudent fiscal policy, because it was the only means of avoiding an excessive reliance on monetary policy.

A further depreciation to avoid higher interest rates in the face of inflationary pressures was clearly not the way to adjust when fiscal policy was moving off track, Mr. Hogeweg commented. He had been somewhat puzzled to read that weaknesses in the implementation of monetary policy reinforced, to some extent, the staff's concerns about using it as the primary tool of stabilization. Weak monetary policy implementation most certainly should not lead to further exchange rate depreciation as a way out. The same argument, that weaknesses in policy implementation should allow for a currency depreciation could, but should not, be made with respect to fiscal policy.

In both the monetary and fiscal policy areas, the authorities should build up the institutional setting so that it would be conducive to the implementation of policy as the need arose, Mr. Hogeweg considered. The authorities had taken important steps to enable the Central Bank to perform both open market operations, and ones that were independent of the treasury. The issue of the debt service burden was a heritage of the Central Bank's quasi-fiscal function. He agreed with the staff that serious consideration should be given to transferring the debt service burden to the treasury, but wondered whether it might not weaken the implementation of fiscal policy.

With respect to Table 11 in the staff report showing the authorities' medium-term balance of payments projections, Mr. Hogeweg inquired why certain capital inflows from official and multilateral sources that still had to be arranged were not included in the financing gap, while reschedulings with the Paris Club and with commercial banks--which had been concluded already--were part of that gap. The line that read "external financing to be arranged" was more meaningful than the financing gap defined in terms of Paris Club and commercial bank reschedulings.

The authorities had made commendable achievements under the current program, Mr. Hogeweg concluded, particularly in the area of structural reform, although he had not dwelt on them. Significant adjustment and a return to higher growth rates had taken place simultaneously. He hoped that the authorities would continue to be able to profit from the Fund's involvement in their efforts.

Mrs. Hepp made the following statement:

> The performance of the Philippine economy during 1987 was commendable: the economic recovery was strong, and substantial progress was made in most of the economic policy areas. While the growth and inflation rate objectives were closely in line with the program, the external position deteriorated owing partly to the weakening of confidence arising from political events. These developments were complemented by the implementation of fundamental structural measures to improve the economy's efficiency and to sustain a high rate of growth. In this respect, the introduction of tax system and public sector policy reform, the trade policy reform, and the reforms in the agricultural sector are highly commendable developments.
>
> It is gratifying to note that beside the support of the Fund, through the current stand-by arrangement, and the World Bank, the Philippine economic program has received the international financial community's strong support in the form of a favorable rescheduling arrangement. There is no doubt that this agreement reflects the international financial community's recognition of the authorities' serious effort to address the country's economic difficulties through a very comprehensive and consistent growth-oriented strategy.
>
> Since I am in broad agreement with the staff appraisal, I will concentrate my comments on three specific aspects of

policy. The first issue is the greater emphasis that has been placed on monetary policy during recent months, instead of exchange rate policy, to strengthen the international reserves position. I have noted the authorities' reasons for this choice; however, some caution is called for. In monitoring monetary policy, special attention should be placed on interest rates and monetary aggregates to ensure that appropriate conditions for the development of economic activity exist. At the same time, the authorities should be prepared to use a flexible exchange rate policy to maintain an adequate level of competitiveness and thus to sustain the needed export growth and to improve the balance of payments position. In this connection, close attention should also be paid to the differential between the domestic inflation rate and that of trading partners. This is particularly valid considering the inflationary pressures that could result from the rapid growth expected in domestic demand, which is partly associated with the increase in current budgetary expenditures.

With respect to public sector policies, I note that as presented in the initial program, the public sector deficit is expected to increase in 1988. However, by comparing the revised projections for 1988 with the program presented in January 1988, it is apparent that in relation to GNP, further increases in the fiscal deficit are concentrated in current and personnel expenditures, compensating for the envisaged reduction as a percent of GNP of capital expenditures. This expenditure trend is a cause for concern, particularly if we consider the role that public investment should play as a complement to private investment in the growth prospects of the economy. Therefore, the comment by Mr. Rye in his opening statement that the faster pace of current over capital expenditures is not expected to extend into future budgets is welcome. I also share the staff's concerns about the magnitude of the wage adjustment in the public sector, which--as a permanent expenditure--will limit the authorities' room for maneuver if future fiscal adjustments are needed. Moreover, the wage increase is aggravating the pressures on the internal and external balances.

The third issue is related to the structural reforms, particularly the recent approval of the land reform. Mr. Rye's indication, in his opening statement, that the law will have no impact on the 1988 budget is welcome. However, the staff report indicates that preliminary projections for the period 1987-92 show a funding gap for financing compensation and post land reform activities of P 16 billion. I would appreciate some further information from the staff or Mr. Rye on this issue, in particular, about the possible costs of the land reform in future budgets.

The preliminary medium-term projections show that a substantial amount of funding needs to be arranged to cover the significant external financial gap in the coming years. The authorities have indicated their intention to fill the gap by arranging new lending from banks and official institutions, as well as through debt exchanges resulting in debt reductions. As the staff notes, the important financial support that will be required from the international community will force the authorities to persevere in implementing sound economic policies to achieve external viability and sustained growth. I am sure that the consistency and comprehensiveness of the strategy of adjustment and growth already adopted will merit the international community's continued support.

Mr. Cassell noted the good progress that the Philippine economy had made and commended the authorities for their impressive efforts, particularly in the area of structural adjustment. However, some very serious problems remained that had to be tackled effectively.

Many of the problems could be summarized by saying that the pattern of demand that had emerged in 1987--which had produced very good growth of output and had accompanied an acceptable evolution in the balance of payments--was not one that could be sustained for very long without the economy running into rather difficult problems, Mr. Cassell continued. The authorities had to address that problem, and had to adjust fiscal policy in particular. While the public sector borrowing requirement was reduced in 1987, the fiscal position remained weak. Whereas the original intention had been to reduce the fiscal deficit significantly after the initial "pump priming" in 1986, a substantial increase in the budget deficit was forecast for 1988. The shortfalls in public investment--as compared with the original policy intentions--and the overrun on personnel expenditure, were very disappointing.

The dangers of excessive liquidity had rightly been noted and the recent tightening of monetary policy was therefore welcome, Mr. Cassell remarked. The authorities were probably correct in down-playing somewhat the effect of high real interest rates as a major disincentive to potential investors; but nonetheless, the effects of high real interest rates were a cause for concern, as was the issue of whether the weak fiscal position would not carry some risk of placing too much of the burden of demand management on monetary policy.

Recent export performance suggested that the exchange rate was at about the right level, Mr. Cassell considered. However, it was vital that the exchange rate be kept fully competitive to ensure a sufficiently rapid growth of the tradable goods sector needed for continued external viability. The latter need suggested, as the staff seemed to say, that a more flexible exchange rate policy should be adopted than possibly was considered at present. A more flexible policy was particularly important in view of the medium-term projections: the major increase in the current account deficit in the period 1988-91 and the large exceptional financing requirements throughout those years were causes for concern. The medium-term projections also appeared to suggest that the current very high growth rate objectives could be overambitious.

The debt-equity conversion scheme could make a useful contribution to improving the country's debt position, Mr. Cassell stated, but the staff should outline the authorities' efforts to ensure that the conversions would represent additional investment. He understood that some members of the Philippine Senate were urging the Government to adopt a ceiling on debt service payments of 10 percent of export receipts and were recommending that payments on selected loans be suspended. Unilateral action of that sort would be a very high risk strategy; hence, the responsible attitude taken by the authorities in resisting such proposals was very welcome.

The debt service ratio of 35 percent for 1987 mentioned in the staff report, seemed to be three points higher than the one given in the staff paper on the request for the extension of the stand-by arrangement in February 1988, Mr. Cassell noted. He asked the staff to explain the reason for the quite substantial upward revision in the figure. Moreover, he would like the staff or Mr. Rye to describe the authorities' intentions toward official creditors. To the best of his knowledge, they had not asked the Paris Club for further rescheduling even though the stand-by arrangement had been extended.

The Chairman said that the question about the authorities' future relationship with the Fund was indeed an important one. Moreover, as Mr. Cassell had remarked, it was interesting to compare the current situation in the Philippines with that of countries that had not been able to resist the temptation to put ceilings on their debt service payments.

Mr. Ayales said that the Philippine economy's performance in 1987 was impressive. Domestic and external confidence in the economy had certainly improved compared with a year ago. The staff recognized the commendable performance in several areas: growth had recovered remarkably well, having been robust in 1987 and being expected to remain strong in 1988; major new balance of payments problems had been avoided; the external debt situation had improved; tax reform had been implemented successfully; the replacement of central bank bills by primary issues of treasury securities had been an important first step in improving monetary policy implementation; the reform of the sugar and coconut sectors had been completed; the reform of government financial institutions was at an advanced stage; and considerable strides had been made in the area of trade policy reform. Those achievements reflected the Government's strong commitment to macroeconomic stabilization and to structural reform, as was pointed out by Mr. Rye in his opening statement. A particularly telling and commendable commitment was the Government's determination to resist the introduction of tariffs above the rate of 50 percent and to avoid changes in the value-added tax legislation.

However, although the overall economic picture had improved and prospective developments were favorable, Mr. Ayales continued, there were some areas that needed special attention to ensure that sustained medium-term growth was achieved.

He appreciated the staff's balanced assessment of monetary policy, but supported the authorities' view that more emphasis should be put on liquidity control and interest rates than on having a "too flexible" exchange rate policy, Mr. Ayales remarked. In that respect, and under present circumstances, exchange rate movements should be related to inflation rate differentials instead of to real effective exchange rate considerations aimed at balance of payments targets. The authorities had pointed out that the country's external competitive position was satisfactory; a positive real interest rate differential served balance of payments purposes; relatively high interest rates had not proven to be a deterrent to investment decisions; the inflation rate was a matter of concern, calling for a restrictive monetary policy; and currency depreciation increased inflationary pressures. Yet, the Government remained committed to a flexible exchange rate approach should macroeconomic imbalances re-emerge. In brief, under present circumstances, the authorities believed that an active exchange rate policy would have more costs than benefits.

He was well aware of the staff's point about the weaknesses in monetary policy implementation and suggested that the authorities move as soon as possible in the direction of granting the Central Bank more independence from the Department of Finance, Mr. Ayales commented. He fully supported the staff's recommendation that the accumulated debt service burden should be transferred to the Treasury. The cost of deficit financing must be transparent, widely known, and be attached to the government's budget.

The staff was correct that the main cause for concern was fiscal policy, Mr. Ayales agreed, but he did understand the reasons why the authorities had decided to increase public wages. He had noted why problems had emerged in the implementation of the public investment program and that the World Bank had accepted the Government's explanation of the matter. Public wage increases would hopefully not spill over into the private sector; the authorities should make every effort to limit wage increases to a once and for all phenomenon, and thus avoid raising inflationary expectations. Moreover, he was aware of the weak statistical base for the labor market, but wished that the staff would provide more information on that matter.

The authorities should continue with their good performance on structural reforms, Mr. Ayales added, by moving ahead with the reform of nonfinancial public enterprises, with the land reform, and by making further progress in the field of trade policy and foreign investment regulation. The staff's views on those areas were appropriate. Moreover, external financing to support the newly passed land reform law would be most helpful.

Recent export performance had been encouraging, Mr. Ayales noted. The Philippines required imported goods for the modernization of its economy, and to make foreign exchange available for those imports, export performance would have to be sustained, while sociopolitical stability was needed to increase tourism receipts and foreign investment. In any event, continuing external financial support seemed necessary during the next few years for the economy's growth potential to materialize; that need was clearly shown in the authorities' preliminary medium-term balance of payments scenario. Financial support from public and private creditors should run in parallel with the authorities' adjustment efforts, if those efforts were to succeed in placing the Philippines on a solid path of sustainable growth. In that respect, he would certainly welcome the continued support of the Fund for the country.

Mr. Pétursson made the following statement:

> I concur with the staff's basic assessment of the economic situation.
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> In broad terms, economic policies must be aimed at restraining the impending inflationary pressures. One militating factor behind these pressures is the substantial nominal wage rises of 13-28 percent in some important sectors, which one would expect to have noticeable price effects. If these wage increases are viewed against the 7 percent inflation target, there will be a very substantial increase in real income. The wage increases do not seem to be very realistic if they spill over into other sectors; even a smaller real wage increase would put a great strain on competitiveness and on the exchange rate.
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> Consequently, I agree with the staff that it is extremely difficult to preserve adequate competitiveness in export industries without some exchange rate adjustment. Furthermore, for the authorities to maintain a stable exchange rate, it seems crucial that monetary, fiscal, and structural policies be coordinated more effectively.
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> The increased fiscal deficit of close to 6 percent of GNP and the lack of fiscal support for the main economic objectives for 1988 are regrettable. The deterioration in the general fiscal performance is a cause for concern, and corrective measures through expenditure reductions seem to be needed urgently. The authorities should, nevertheless, be given credit for reducing public sector reliance on foreign borrowing.
>
> The staff is correct that every effort should be made to step up efficient infrastructural investment, while simultaneously containing growth of public consumption. I note that low public sector investment has been a matter of concern to the World Bank and the Fund.

The deteriorating financial performance of public corporations is also a cause for concern: proper pricing of public services has been restrained, interest rates on housing loans have been reduced, and enterprise deposits for rescheduled foreign debts may be abolished. All of these measures can only weaken the overall fiscal position, which is hardly the correct policy stance in a situation of overall economic expansion.

The authorities should be commended for reforming financial institutions and for their determination to continue to liberalize trade, despite the pressure on the current account. Moreover, the tax reforms implemented at the beginning of 1988 will very likely prove to be most useful for long-run fiscal management.

Some progress in land reform has been made over the years; the importance that the authorities attach to this reform challenge is welcome. It is, indeed, an economic reality that both productivity and profitability in the agricultural sector are low. As a matter of economic necessity, these must be raised to increase agricultural sector income and thereby facilitate industrialization and decrease the country's dependence on foreign capital and assistance. The staff should comment on the medium-term fiscal effects of the Land Reform Act.

It seems clear, as stated in the staff report, that the Philippine economy will be heavily dependent on foreign capital and assistance during the years ahead. It would have been interesting to see a medium-term scenario provided by the staff based on both current economic policies and on alternative ones. However, it is encouraging to note that in 1987 major balance of payments problems were avoided, the external debt situation improved, and cooperation with the international financial community was maintained.

The Executive Directors agreed to continue their discussion in the afternoon.

## DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/88/95 (6/17/88) and EBM/88/96 (6/20/88).

### 4. JOINT COMMITTEE ON REMUNERATION OF EXECUTIVE DIRECTORS - GOVERNORS' VOTE

The Executive Board approves the report of the Secretary (EBAP/88/102, Sup. 2, 6/16/88) on the canvass of votes of the Governors on Resolution No. 43-2, with respect to remuneration of Executive Directors and their Alternates, approved by the Executive Board (EBM/88/68, 4/29/88) for submission to the Board of Governors. The Governors' vote on the Resolution is recorded as follows:

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| Total affirmative votes | | 676,286 |
| Total negative votes | | 182,558 |
| Total votes cast | | 858,844 |
| Abstentions recorded | 20,619 | |
| Total replies | | 879,463 |
| Votes of members that did not reply | | 58,162 |
| Total votes of members | | 937,625 |

Decision No. 8908-(88/96), adopted June 17, 1988

### 5. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director and by an Advisor to Executive Director as set forth in EBAP/88/148 (6/16/88) is approved.

APPROVED: January 25, 1989

JOSEPH W. LANG, JR.
Acting Secretary