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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 88/148

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

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	E. T. El Kogali
	A. G. A. Faria, Temporary
	Zhang Z.
	C. S. Warner
	D. C. Templeman, Temporary
	A. Rieffel, Temporary
J. de Groote	J. Prader
	E. C. Demaestri, Temporary
M. Finaish	A. M. Othman
G. Grosche	B. Goos
	D. V. Nhien, Temporary
	L. M. Piantini, Temporary
	D. McCormack
	J. Gold, Temporary
	K. Kpetigo, Temporary
	I. A. Al-Assaf
	J. V. Fernández, Temporary
	C. Noriega, Temporary
	M. Fogelholm
	D. Marcel
	G. P. J. Hogeweg
	I. Sliper, Temporary
	M. A. Hammoudi, Temporary
	A. Vasudevan, Temporary
	N. Adachi, Temporary
	N. Kyriazidis
	S. Rebecchini, Temporary

C. Brachet, Deputy Secretary
S. B. Woolls, Assistant

Also Present

B. Samojlik, Minister of Finance; J. Zajchowski, Deputy Chairman, Planning Commission; W. Czulno, Ministry of Finance; K. Krowacki, Financial Counsellor, Embassy of the Polish People's Republic. IBRD: K. Y. Amoako, Africa Regional Office; P. Nouvel, Europe, Middle East and North Africa Regional Office. African Department: A. D. Ouattara, Counsellor and Director; E. L. Bornemann, Deputy Director; E. A. Calamitsis, Deputy Director; G. E. Gondwe, Deputy Director; N. Abu-zobaa, D. T. S. Ballali, C. Enweze, M. G. Kuhn, B. R. H. S. Rajcoomar, D. J. Scheuer. European Department: P. B. de Fontenay, Deputy Director; M. Guitián, Deputy Director; A. R. Boote, L. G. Manison, R. J. Ossowski, J. Prust, D. M. Ripley, H. O. Schmitt, T. A. Wolfe. Exchange and Trade Relations Department: L. A. Whittome, Counsellor and Director; J. T. Boorman, Deputy Director; B. Christensen, S. Kanesa-Thasan, C. Puckahtikom. Fiscal Affairs Department: V. P. Gandhi, R. Holzmann. IMF Institute: W. Majcherzak, M. Ulusow, Participants. Legal Department: J. Head, J. K. Oh, J. V. Surr. Treasurer's Department: J. E. Blalock, P. J. Bradley, P. S. Ross. Bureau of Statistics: J. A. J. Bove. Advisors to Executive Directors: M. B. Chatah, P. Pétervalvy, M. Pétursson, G. Pineau. Assistants to Executive Directors: R. Comotto, S. K. Fayyad, B. R. Fuleihan, S. Guribye, C. L. Haynes, J. Heywood, M. A. Kyhlberg, J. K. Orleans-Lindsay, G. Serre, C. C. A. van den Berg, R. Wenzel, Yang J.

1. POLISH PEOPLE'S REPUBLIC - 1988 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1988 Article IV consultation with Poland (SM/88/175, 8/11/88; and Sup. 1, Cor. 1, 9/14/88). They also had before them a background paper on recent economic developments in Poland (SM/88/184, 8/18/88).

Mr. Bazyli Samojlik, Minister of Finance and Governor of the Fund for the Polish People's Republic, Mr. Jozef Zajchowski, Deputy Chairman of the Planning Commission, Mr. Wladyslaw Czulno of the Ministry of Finance, and Mr. K. Krowacki of the Embassy of Poland were also present.

Mr. Samojlik made the following statement:

I would like to thank the staff for its report. The report presents an accurate analysis of Poland's current economic position and displays a good understanding of the workings of the Polish economy. During the past year several missions have visited Poland as part of the Article IV consultation and to provide technical assistance in the fields of banking reform, tax reform, computerization, and statistical issues. I am grateful for these missions, which have contributed to a better mutual understanding between the staff and the Polish authorities.

My Government agrees with much of the report's assessment. Not all of the staff's proposals, however, are acceptable to my authorities. In particular, the speed of adjustment of the convertible current account assumed in the first two scenarios in Appendix IV of the staff report--namely current account balance in 1989--is not, in our view, feasible, essentially because of the domestic social constraints we face.

My authorities agree with the staff that a precondition for successful economic reform is the attainment of domestic economic equilibrium. To this end, we have been pursuing policies to limit excess demand and increase the domestic supply of goods and services. On the demand side, the rate of growth of broad money in 1988 is planned to be 10 percentage points lower than the rate of growth of net material product (NMP). In addition, I am implementing a rigorous budget policy. For the first time in ten years, the state budget was in surplus--amounting to Zl 100 billion--during the first eight months of 1988. The growth of budgetary expenditures in current prices is 6 percentage points lower than the growth of NMP. Despite some unforeseen expenditures, the budget deficit during 1988 should not exceed the planned amount of Zl 270 billion.

The rise in administered prices implemented in early 1988 was designed to make an important contribution--through reducing subsidies--to cutting budget expenditure. It was also intended to improve the balance on the domestic market and to improve the structure of relative prices. Our failure to make the intended progress in these areas is essentially due to the resistance of important social groups to a fall in their standard of living. Public awareness of rising prices was more acute than awareness of rising wages, a phenomenon not unique to Poland. As a result, wages grew much faster than initially planned and rose faster than prices, which only moderately exceeded planned levels. In consequence, there was little improvement in the structure of relative prices, which only moderately exceeded planned levels. In consequence, there was little improvement in the structure of relative prices, except for an increase in the relative price of energy and an end to the relative decline in food prices.

The events of the past year underline the necessity for even the best designed economic program to take into account social realities. First, there is a limit to society's tolerance of inflation. The current rate of inflation in Poland--approaching 60 percent--exceeds that limit. Hence, an imperative for economic policy is a substantial reduction in the rate of inflation. Second, there is a limit to the extent to which social partners are prepared to accept a cut in the real wage. Again this is a constraint to which any economic program--if it is to be successful--must adapt.

My authorities have taken various supply-side measures to increase domestic production. The autonomy of managers of socialized enterprises has increased, with good performance encouraged by bonuses and bank credit available for profitable enterprises. Conversely loss-making enterprises have had budget subsidies and bank credit withdrawn, with chronic loss-makers being either restructured or liquidated. Formal and legal restrictions on the activities of private entrepreneurs and companies have been reduced. As a result, in Poland there are now 560,000 private economic units, 2,900 incorporated private companies, 713 enterprises wholly owned by foreign capital, and 40 larger enterprises jointly owned with foreign companies. More than 500 research and development units have been established to accelerate the implementation of technical progress and the adaptation of new organizational forms in the economy.

In addition, steps have been taken to improve the distribution of convertible currency imports. Imports financed centrally are being gradually reduced, while the proportion of imports financed by enterprises--through foreign currency retention accounts--has been increased. The allocation of foreign currency between enterprises has been improved, with a simplification of the retention system under way and a sharp increase in the transfer of foreign currency between enterprises via auctions. Foreign currency has also been made available in auctions to domestic trading organizations and nonexporting production enterprises on equal terms for public and private sectors of the economy.

My authorities remain committed to additional measures to improve domestic supply. A draft Law on Economic Undertakings is under consideration by Parliament, which should further encourage new activity of enterprises, without differentiating between the socialized and nonsocialized sectors. A new law on joint ventures is also under consideration and reform of the banking system--on which we have received advice both from the World Bank and the Fund--is well advanced.

It should be emphasized that the vast bulk of imports consists of raw materials, semiprocessed products, and spare parts. It is only in exceptional circumstances--in response to acute shortages--that significant imports of consumption goods occur. The Polish economy remains critically dependent on the availability of hard currency imports. Sustained export growth requires a continued growth of imported inputs. Equally, the success of the policies taken to improve domestic supply requires the availability of imports both to provide needed technological expertise and the stimulus of external competition for a highly monopolistic economy. The elimination of inefficient enterprises may create gaps in domestic production which will have to be met by imports. Any program which aims at a sustained improvement in Poland's economic performance must, therefore, provide for a growing level of hard currency imports.

Poland has been grappling with economic crisis since 1981. Despite the fact that current levels of industrial output and exports considerably exceed precrisis levels, the standard of living per capita has not yet reached the 1980 level. From 1982-87 Poland ran a persistent convertible currency trade surplus despite the level of imports remaining below the 1980 level. Over this period about $11.6 billion was paid in debt service to foreign creditors with only $3.1 billion received in new credits.

Since 1987, hard currency exports have been growing rapidly--by over 15 percent in dollar terms--largely in response to the more active exchange rate policy we initiated in mid-1986. Augmented foreign exchange retention rights and larger tax reliefs for exporters--at considerable cost to the budget--were also important factors. In 1988, I have moved to curb the budgetary costs of tax reliefs and to place more emphasis on the exchange rate to stimulate exports. However, there is a limit to the extent that exports to the West can be boosted without an adverse effect on exports to Council of Mutual Economic Assistance (CMEA) countries, which in turn could imperil supplies of needed raw materials.

We remain determined to move our convertible balance of payments into a sustainable position. We intend to adhere to our medium-term plan of reaching current account balance in 1991 and moving into surplus thereafter. We are not interested in a once-and-for-all effort to achieve current account balance, which cannot be maintained. Equally, we cannot rely on balance being achieved through a further rise in receipts of transfers, which are inherently volatile. I must stress that a sustainable improvement in our balance of payments position requires a structural transformation of the Polish economy. Pursuing this goal, we envisage a major role to be played by the World Bank. Hence, our determination to pursue the program of reforms I have outlined.

We attach great importance to the normalization of relations with all our creditors. In our view, this would be advantageous both for Poland and our creditors. We consider debt rescheduling a poor substitute for new credits.

In July 1988, we signed an agreement with commercial banks which governs our payment obligations until 1993. This agreement provides for a stabilization of our financial relations with this group of creditors and adjusts debt servicing to Poland's payment potential. In December 1987, we signed a multilateral agreement with the Paris Club. We would like to eliminate barriers on the implementation of this agreement as soon as possible. To this end, we will introduce considerable flexibility, despite Poland's serious payment difficulties. Our aim is, together with our official creditors, to establish repayment terms consistent with Poland's ability to pay.

Despite the difficulties that have emerged over the past year, my authorities remain committed to economic reform, which is necessary to improve economic efficiency and provide for sustainable domestic and external equilibrium. We recognize the need--as emphasized by the staff--for reforms to be supported by growth-oriented macroeconomic policies. We share the goals enumerated by the staff of reducing the rate of inflation, removing excess demand, and improving the convertible current account. We also share to a considerable degree the staff's analysis of the policies required to reach these goals.

Where we differ from the staff is not over the ultimate objectives but over the pace at which they can be achieved. The difficulties of the past year--which I have made no attempt to disguise--underline the need to proceed carefully, making due allowance for social realities in Poland. As I have argued earlier, in Poland there is a clear limit to the acceptable level of inflation, to the amount real wages can be reduced, and to the compressibility of imports. For an economic program to be sustainable due recognition must be given to these points.

My authorities have a difficult balancing act to perform. We are talking to our creditors on external adjustment. Equally, we are talking to the social partners in Poland on domestic adjustment. I am convinced that we can agree on policies that will satisfy all parties--and provide for an economic program that is economically justifiable while recognizing the social constraints in Poland. This requires of course an understanding of all social forces of the need for both domestic and external adjustment. Equally, I trust that our creditors and the Fund will place due weight on the social constraints I have outlined.

We are currently working on a new economic plan covering 1989 and 1990, which aims at growth-oriented adjustment. I would like this work to be in full collaboration with the Fund. To this end, I would like to invite the staff to visit Poland in October 1988 to start negotiations on a possible stand-by arrangement with the Fund. The full participation of the Fund would provide not only much valued technical advice but also an important additional impulse for economic reform. I hope the Board will support this request.

Mr. Prader made the following statement:

I agree, on most aspects, with the staff's interesting analysis, including its recognition of progress made in restoring economic growth and improving the current account position. However, the situation has changed significantly since the discussions with the Polish authorities, which form the basis for the staff report, took place. Also, the more recent supplementary information given by the staff is far from complete, and is silent about the repercussions of recent social developments. I understand the need for caution and diplomatic etiquette in this forum, but the staff should never go so far as to refrain from assessing new social and economic events and developments. To carry politeness that far would place the)ard in danger of missing possible turning points and would block its analytical horizon. I wonder whether it is possible to discuss the present situation of Poland in a sensible manner without taking into account the recent labor strikes and their implications for Poland's economic policy, social consensus, and economic prospects.

The second wave of strikes, which took place in August 1988, has changed the parameters of economic policy in important respects: the domestic economy may have been affected adversely by the losses in production, the large wage increases, and the further demotivation of the work force. External trade is also bound to worsen as a result of reduced coal exports and increased imports, with the objective of improving the supply of goods. As a result, attainment of current account equilibrium in 1988, which recently seemed to be within reach, has become rather improbable.

In the wake of the recent labor unrest, the authorities are considering significant changes in economic policy. By late November 1988, a new plan for the consolidation of the economy in 1989/90 is to be submitted, which aims at reducing the chronic market disequilibria, with the correction coming not primarily from price increases, but rather from an increase in imports and stimulation of consumer goods production, as well as from a fundamental reform of investment.

Given these new developments, the present discussion should address the question of whether, and to what extent, the general assessment of Poland's economic prospects and economic policies must be revised.

The staff is right in emphasizing that, during the past year, the Polish authorities have taken important steps toward reforming the economic system and in particular strengthening its market orientation. We welcome these reforms.

At the same time, the staff assessment of the reform ideas and the prospects for success seems to be overly optimistic. We take this view not only in the light of past negative experiences, but also for the following reasons. First, the program for the second stage of economic reform was--as is often the case in Poland--quite reasonable in its economic design. It was also comprehensive and far reaching. Very early, however, great difficulties emerged with respect to the implementation and timing of the measures. Consequently, the results have fallen far short of expectations. In the final analysis, the reform has resulted only in drastic price increases, which have not met their objectives of restoring market equilibrium, eliminating excess demand, reducing subsidies, correcting distortions in the structure of relative prices, and liberalizing prices. Second, the Government has admitted mistakes in its economic policies. Some officials have even called the reform a fiasco. Third, every reform program, no matter how well designed, is bound to fail unless it manages to mobilize and secure the interest and support of the population. In Poland, the prospects for success of any reform depend critically on the people's perception that the Government is actually determined and able to solve the economic problems of the country. In other words, economic success is predicated on political and social consensus about political and economic reforms.

The Polish authorities so far have made the implementation of substantial reforms contingent upon the restoration of market equilibrium, which was to be reached through demand restraint. By arguing that the attainment of the objectives of lower inflation rates, removal of excess demand, and rapid elimination of the current account deficit call for the consistent implementation of restrictive demand policies, the staff seems to agree with the authorities. However, it might be useful to consider another approach. It might be more effective to begin, without delay, the introduction of fundamental systemic reforms, which otherwise are again in danger of being postponed to the distant future. Only after completing these reforms, should the socially sensitive, demand-dampening measures be adopted.

Market imbalances can be corrected not only through restrictive demand policies, but also through the implementation of reforms aimed at structural changes in production and investment. Measures to improve the supply side would be preferable to demand restraint, not least because, in Poland, the use of demand restraint is constrained by the conflict between what is economically needed and what is politically feasible. Reforming the Polish economy will require the use of both approaches, because fundamental structural reforms to improve the supply of goods and services will have to be accompanied by restrictive monetary, fiscal, and incomes policies to dampen the growth of domestic demand.

External trade has improved remarkably over recent years. Particularly noteworthy is the increase in manufactured exports to western industrial countries, which has been accomplished primarily through an active exchange rate policy. The current account deficit in convertible currencies has been decreased, not least by a strong increase in private transfers, and foreign exchange reserves have risen. On the other hand, the external position is still unsustainable: Poland receives no new credits, is continuously accumulating arrears, rescheduling, and carrying high and rising levels of debt.

The staff is right to argue that quick elimination of the current account deficit in convertible currencies and the building up of a surplus is a target that is both necessary and feasible. A current account surplus is an essential precondition for normalizing relations with external creditors. It would ease rescheduling negotiations and permit the restoration of voluntary lending. Still another precondition for the resumption of these flows would be to earmark a higher portion of foreign exchange revenues for the servicing of debt.

Obviously, there are still differences of opinion between the staff and the Polish authorities on the speed of the external adjustment. The staff argues convincingly that a faster external adjustment than is envisaged by the Polish authorities is feasible without excessive internal costs, and that reasonable growth rates of production and domestic demand can be maintained. However, this is an objective that can only be realized if comprehensive reforms are aimed directly at raising economic efficiency, lowering the import dependency of the Polish economy, and improving competitiveness. The staff's medium-term scenarios are extremely valuable in showing the close correlation between internal and external objectives.

In addition, the staff emphasizes the crucial role of market-oriented exchange rates, higher interest rates, and sustainable price adjustments, which should be accompanied by a phasing out of price controls. However, these instruments can only be effective in an economy that reacts to price signals. In other words, their effectiveness presupposes the reform of economic planning and a greater autonomy of companies. So long as companies are subject only to soft budget constraints and central administrative resource allocation is the rule, indirect methods of guiding the economy will remain simply irrelevant and will fail to work.

Therefore, what is needed most is a strengthening of competition and of the financial discipline of companies, a reduction of subsidies, a contraction of the scope of the redistributional role of the state, a standardization and unification of the tax system, and a restrictive regime in the area of credit policy. If the authorities are willing to undertake the completion of this necessary reform process and to accept the inevitable short-term costs, and if they can maintain the credibility of this commitment, then positive real interest rates, a realistic and unified exchange rate, and price liberalization will produce the expected positive results.

The introduction of market-oriented economic mechanisms is an essential requirement for the success of all the policies recommended by the staff. Important elements of this process are the gradual liberalization and reform of external trade and the price system. The authorities are now pursuing an active exchange rate policy, but the additional elimination of administrative controls over prices, imports, and exports, and the creation of an efficient transmission mechanism between external and domestic prices would markedly enhance the efficiency of the exchange rate as a policy instrument. At the same time, the system of complex and changing export incentives through subsidies, tax reductions, regulations for retained foreign exchange, and auction schemes could be replaced by exchange rate adjustments.

However, if the necessary adjustment of relative prices, the exchange rate, and interest rates are to result in something more than mere increases in the general price level, restrictive fiscal and incomes policies are needed. For these policies to succeed, improved supply, and a better motivation of the population, based on a social consensus, are necessary preconditions.

Only if the general and specific measures are actually and credibly implemented and the structure and efficiency of investment are actually improved will it be possible to attain external and internal equilibrium, medium-term growth, and a lower rate of inflation. In addition, this program will require financial support from external creditors, including reschedulings and new credits to finance a possible stabilization program.

There are hopeful signs that various segments of Polish society are willing to take part in a dialogue on the fundamental issues of the reform. The present general political climate in the region seems to favor such a dialogue. Poland is not alone among the socialist countries in looking for dramatically new approaches to solving its long-neglected problems. China, the Soviet Union, and Hungary are also implementing major reforms.

The staff should follow developments in Poland closely and give all possible continuous assistance to the forces in Poland that favor reform. Once the Polish authorities have formulated their comprehensive program, and the internal coordination process makes its prompt implementation feasible, the Fund should commit substantial resources of its own to facilitate the renewal of voluntary lending from other official and private lenders.

Mr. Templeman said that economic developments in Poland since the previous Article IV consultation (EBM/87/139, 9/16/87) had been somewhat mixed. On the positive side, there had been a relatively good balance of payments performance and a continuation of initial efforts aimed toward structural reforms, notably in the preparation of reforms of the tax and financial systems. However, those positive developments were being undermined by the dangerous acceleration of wage and price inflation, reflecting too lax financial policies and insufficiently effective incomes policies.

The experience of the past year in Poland clearly demonstrated the close interrelationship between the conduct of macroeconomic policy and successful structural reform, Mr. Templeman commented. It should be noted at the outset that a number of structural reforms were under way, including the planned introduction of a value-added tax and a personal income tax, the prospect of a more standardized tax on enterprise profits, further reductions in the direct allocation of productive inputs, some trade liberalization, a restructuring of public enterprises, the opening up of some economic activities to private and foreign participation, and modest price adjustments and decontrol efforts. Unfortunately, those structural reform efforts had not been complemented by the necessary financial and incomes policies. For example, the rapid rise in the overall price level was making it increasingly difficult to pursue policies aimed at changing relative prices to reallocate resources more efficiently and, thereby, achieve the goal of sustainable economic growth.

Under the present circumstances in Poland, adequate control over nominal income and overall domestic demand required an effective incomes policy, Mr. Templeman considered. That, in turn, depended on a cooperative working relationship among the Government, enterprises, and labor. There did not seem to be such a consensus at present, although recent developments could lead to improved prospects. Meanwhile, there had been an overshooting of nominal and real wages, increased nonwage income, accelerated price inflation, and pressure on the budget. The continued prevalence of price and import controls had tended to bottle up those pressures, and the prospects for adequately adjusting administered prices and effecting some general price decontrol had worsened. The best hope for bringing the rate of inflation under control consisted of tightening monetary policy, resisting pressures to allow the fiscal deficit to grow, and achieving a cooperative relationship among the social partners.

In the monetary area, a substantial increase in interest rates seemed crucial to reduce excess credit demand, foster household financial savings, contain consumer demand, reduce budget subsidies to the banks, and facilitate the eventual elimination of direct credit controls, Mr. Templeman continued. The reluctance of the authorities to move in that area was somewhat puzzling, and he was quite skeptical about the success that could be achieved by simply waiting for the rate of inflation to decline, as a means of reducing the degree to which interest rates were negative in real terms.

Although the size of the fiscal deficit and the corresponding demand for credit had been modest, it was still important that current inflationary pressures should not be accommodated through increased subsidies to households or bail-outs of inefficient public enterprises, Mr. Templeman cautioned.

Poland had made commendable progress in the growth of manufactured exports, and the increase in income from private transfers had been a source of strength, Mr. Templeman observed. The large real effective depreciation of the zloty had demonstrated a more promising export potential than had originally seemed likely. The prospect of reconciling economic growth with a reduction in the current account deficit also seemed better, although he recognized the uncertainties inherent in medium-term scenarios. However, there were competing priorities to consider. The authorities' present concern was that inflationary pressures and the tolerance of the society for such high rates of inflation could lead to a diversion of resources to meet domestic demands, rather than exports, and thereby delay the achievement of current account balance. In addition, the authorities were proceeding with a more rapid elimination of the current account deficit in the nonconvertible currency area than in the convertible currency area. His authorities were concerned that the present pattern of resource allocation could send a wrong signal to Poland's trading partners and creditors in the convertible currency area, and they urged the authorities to review that position. Also, success in meeting interest payments on convertible currency debt, settlement of outstanding debt rescheduling issues on reasonable terms, and evidence of an ability to employ foreign capital more efficiently would help to improve Poland's relations with its foreign creditors.

There had been a number of positive developments in Poland over the past year, Mr. Templeman noted. However, unfortunately there were numerous troublesome areas, which had made the achievement of stabilization and structural reform goals more difficult and which had created uncertainties about prospects in the period ahead. Therefore, close monitoring of developments would be needed to determine whether current problems were being resolved and whether questions about some aspects of economic performance and economic policy were being answered. He hoped to see some specific actions taken, both to correct macroeconomic problems and to advance planned structural reforms. It was very important that Poland establish a track record of dependable performance against the broad range of economic objectives that were embodied in its adjustment and reform program. In light of both the complexities of the desired transition to a more open and market-oriented economy and of current economic difficulties, it was important for Poland to demonstrate clearly the credibility of its reform effort--and for the Fund to protect its own credibility. He strongly supported the ongoing technical assistance in four different fields being provided by the Fund.

Mr. Zhang made the following statement:

> The Polish economy suffered a setback in 1987; growth in net material product declined to 1.7 percent as a result of the fall in agricultural production, which was mainly due to unfavorable weather conditions. This, in turn, exacerbated the social and economic constraints already existing in the economy. The authorities pursued firm adjustment measures to alleviate excess demand pressures and promote domestic production, and they tried to bring about domestic economic equilibrium as a means of creating a better environment for economic reform. Remarkable results were achieved. Current account deficits were narrowed to 0.6 percent of GDP, while the trade balance continued to be in surplus. Domestic credit was reduced substantially to 14 percent, compared with 27 percent in 1986. According to Mr. Samojlik's statement, for the first time in ten years, the state budget was in surplus in 1988. In addition, domestic production was buoyant in the first half of the year.

Moreover, despite the difficulties that emerged over the past year, the authorities have continued to implement the second stage of the economic reforms.

The recent performance of the Polish economy has shown improvement, although there are still areas of concern. Before touching upon specific areas, it should be emphasized that the Board's assessment should take full account of the special nature of the Polish economy during the transitional period. Imbalances cannot be expected to disappear overnight when an economy, which has been highly centralized for decades, moves toward a more market-oriented system, especially when such a system is completely new to the country. Adjustments have to be made at a gradual and practical pace to avoid social and political unrest.

Turning to specific areas, care needs to be taken to promptly identify adjustment-induced price increases and inflationary trends. Price increases are generally unavoidable when the pricing system of a country is moving from a highly administered system to one that is market oriented. Tremendous adjustments usually have to be made to rationalize the distorted structure of relative prices during the transition period. An adjustment-induced price increase is normal in the sense that it brings prices in line with a level that truly reflects market conditions. This important aspect of price development needs our attention and warrants positive consideration.

A serious problem arises when price increases are pushed by excess liquidity in the economy. Two major factors contributing to the faster increase in money supply relative to nominal incomes are the tendency for wage bills to increase and for an increase in foreign assets, mainly as a result of the higher local currency value of foreign currency deposits within the domestic banking system.

Concerning wage increases, there is also an adjustment-induced element associated with price reform. It is impossible to achieve price adjustment without rationalizing the wage structure, which--like the price structure--has been seriously distorted by a highly centralized wage system. However, attention needs to be paid to the increase in nonwage social benefits. It is not a good idea, in the long run, to accommodate public pressure by increasing these types of benefits available to workers while the wage structure is being adjusted, because an inflationary spiral may be created that could eventually undermine the price and wage reform process. What is needed is a plan under which structural measures are aimed at making the enterprises financially responsible--to exercise fiscal restraint in the face of possible losses and to provide incentives when they show a profit. I am pleased that the authorities have already taken steps in this direction.

With respect to excess liquidity generated by increased deposits of foreign assets denominated in local currency, measures to neutralize these increases may be useful; otherwise, inflationary economic pressures could well be aggravated.

On external adjustment, it is heartening to see that measures to adopt better export incentives and a more flexible approach to foreign exchange management have improved the current account position. Maintaining the current momentum of export expansion is vitally important. On the import side, the concerns of the authorities must be fully considered. Raw materials, machinery, and transport equipment--items that are crucial to sustained export and production growth--account for a large share of total Polish imports. Given the economic and social constraints generated by the sharp reduction in agricultural production and the depressed domestic investment of recent years, a further decrease in imports may not be desirable.

Fortunately, even in the face of great difficulty, the Polish authorities are committed to economic reform and are currently working on a new economic plan covering 1989 and 1990, directed toward growth-oriented adjustment. I fully support the Polish authorities' intention to use Fund resources by entering into a stand-by arrangement. At this critical juncture, such resources will certainly provide important assistance to Poland in the reform and development of its economy. I support the proposed decision.

Mr. Grosche made the following statement:

The staff report conveys a mix of good and bad news concerning recent economic developments in Poland. The staff's analysis was excellent, and I fully support its policy recommendations. Therefore, I will limit my comments to policy areas in which action is particularly needed.

First, on the external sector of the economy, the dramatic improvement in the trade surplus with respect to convertible currencies during the first half of 1988 should be taken as an encouraging sign that the Polish economy is regaining some lost ground and that Polish manufactured goods can be sold abroad. The depreciation of the zloty and the trade liberalization measures are paying off nicely.

I agree with the staff that this success should convince the authorities that a rapid elimination of the current account deficit is not only necessary, but also feasible. Meeting interest obligations with earned resources would help to normalize relationships with foreign creditors, an objective which should be given highest priority. Such normalization would be crucial in securing prolonged reschedulings of maturities and in generating the fresh capital necessary for accelerating the restructuring of the economy. For this reason, it is difficult to understand why the Polish authorities are so slow in translating the Paris Club rescheduling agreement for Poland, which was finalized in December 1987, into bilateral agreements. As far as I know, not a single agreement has been signed. Experience with Paris Club reschedulings over the past few years does not assist potential creditors in coming up with fresh money.

Somewhat in contrast to the financial side, on the real side of the external economy, the authorities have embarked on an appropriate program. Exchange rate policies have been successful and could be made even more efficient. The same applies to the foreign exchange retention schemes. In supporting the staff's suggestions, I can go along with the proposed decision.

Unfortunately, the success in the external sector is being threatened by large deficiencies in the domestic economy. More imports than are absolutely necessary are being sucked in, owing to excess demand. Clearly, the major challenge the authorities are facing is the containment of inflation. Monetary policies have appropriately been tightened, but, like the staff, I consider further increases in nominal interest rates to be essential for a more rational allocation of scarce resources. I realize that the budget has been kept well under control, and Mr. Samojlik deserves most of the credit for this achievement. Although he will have a hard time in the coming weeks and months to keep the deficit at planned levels, this would be a very important objective. Further steps in reducing subsidies would certainly help in controlling expenditures.

The most pressing problem that emerged recently is the steep rise in real wages. As the staff indicated, effective incomes control is essential, and it probably can be achieved only through a social consensus. I hope that the recent developments in Poland have opened the way for a collaborative approach, in which necessary price adjustments, the closing down of inefficient enterprises and the splitting up of others, and a broader wage differentiation will not result in an acceleration of the rate of inflation, but in a substantial average reduction. This effort seems to be a crucial test of the Polish authorities' ability to follow through with further reform steps that could be supported by the Fund.

The authorities deserve to be commended for having embarked on far-reaching reforms. They have taken bold steps, and further measures are under consideration. There are deficiencies, however, and problems in implementation. I appreciate Mr. Samojlik's clear and concise opening statement, which did not hide the problems the authorities are facing. I warmly support Poland's request for a new staff mission to work together with the authorities in formulating further steps. I hope close collaboration will lead to a program that could be supported by Fund resources. However, such a program has to be carefully worked out. Neither the Polish authorities nor the Fund can afford a failure. Although, in making bold steps, both parties have to run certain risks, these risks should be limited as much as possible. Considering Poland's track record with foreign creditors, it is necessary to re-establish as much credibility as possible, particularly with respect to the authorities' ability to back up their words with appropriate deeds. To this end, it is of paramount importance not only to persevere with tight financial policies--and I have a lot of confidence in the current leadership of the Treasury and the Central Bank--but also, more importantly, to reach a social consensus with respect to wages and prices.

Mr. Marcel said that the recent performance of the Polish economy had been mixed. Sustained economic activity had made it possible to restore the precrisis level of per capita consumption. However, the recovery, which was most welcome following the severe depression experienced in the early 1980s, had been accompanied by growing excess demand and mounting inflationary pressures. On the external side, recent export developments had been encouraging, but, at the same time, the authorities remained reluctant to step up the pace of external adjustment. As to structural policies, several significant initiatives had been initiated recently, but the authorities were still unable to develop a comprehensive and integrated strategy in that area.

The recent surge in the rate of inflation was worrisome, Mr. Marcel commented. The objective of promoting a price structure more in line with underlying economic scarcities by lowering subsidies on a broad range of goods was well warranted. However, that approach should have been shouldered by a tight control over wage developments, if an inflationary spiral was to be avoided, although he recognized that that was not an easy task under the present circumstances.

In the present situation of mounting wage pressure, the authorities should take all necessary measures to stabilize the financial setting, Mr. Marcel recommended, including a strengthening of the fiscal stance. In particular, a strict containment of subsidy payments to state-owned industries would induce them to better resist wage claims. Likewise, the increase in social benefits should be brought under control, given the persistence of excess demand.

Tighter monetary control should also play a crucial role, Mr. Marcel stated. In that area, the authorities were not very well equipped. The existence of substantial foreign currency deposits inside and outside the banking system represented a serious impediment to the close monitoring of monetary developments. It was actually difficult for the authorities to act on that significant source of liquidity to alleviate demand pressure. The staff should comment on steps that could be contemplated to enhance monetary control.

The insufficient use of exchange rates, as a way of controlling liquidity conditions, represented another major obstacle to a more efficient monetary policy, Mr. Marcel considered. The systematic recourse to credit ceilings in allocating financial resources to the corporate sector was not the best approach to promoting financial discipline. However, a more flexible interest rate policy would go a long way toward stabilizing the consumption and saving behavior of the household sector.

With respect to the external sector, his authorities endorsed most of the staff's analysis and recommendations, Mr. Marcel continued. The supplementary information that had been provided on September 13, 1988 had made it clear that the strong recovery of exports was a lasting development. The authorities should make sure that the favorable conditions necessary to consolidate the significant first results were maintained, in particular in the exchange rate area. In that respect, greater reliance on a flexible policy should help reduce the use of direct export-enhancing activity.

In the light of the noticeable progress that had already been made in restoring the external viability of the economy, the authorities should assign the highest priority to the normalization of the country's relationship with its creditors, Mr. Marcel remarked. In that respect, his authorities concurred with the staff in urging the authorities to finalize, without further delay, the bilateral agreements relating to the Paris Club rescheduling arrangement concluded at the end of 1987. His authorities considered that the sustained improvement of the external situation should induce the country promptly to discharge its external obligations. A protracted failure to do so could only complicate future relationships with official creditors.

The intentions expressed by the authorities with respect to structural reforms and the few initiatives that had already been taken in that area were most welcome, Mr. Marcel commented. Nevertheless, the scope and complexity of the reforms to be undertaken called for a determined and well-coordinated implementation. That was all the more true, given the present context of rather unstable macroeconomic conditions.

A priority for the authorities should, therefore, consist of stressing the structural reforms, which could help buttress financial policies, Mr. Marcel considered. In any case, a common objective should be greater reliance on a favorable price system. In the monetary area, that implied a systematic use of interest rate movements for deposit and credit activities.

As to the fiscal field, the major two reforms envisaged by the authorities were crucial, but the staff was right in stressing the importance of lesser central government involvement to promote greater financial discipline in the productive sector, Mr. Marcel concluded. The good results associated with the recent flexible exchange rate policy should induce the authorities to move toward a gradual liberalization of imports. Such a move, associated with a less administered system of exchange allocations, was the best way to intensify competitive pressure within the Polish economy.

Mr. Enoch made the following statement:

> The staff papers represent a frank but fair assessment of the problems currently facing the Polish economy. I can be relatively brief, because I agree with the staff's recommendations, and I support the proposed decision.
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> Over the past few years, the Polish authorities have begun to grapple at last with the deep-rooted and pervasive effects of an economic system that has denied the fundamental role of price incentives in resource allocation. Not surprisingly, the task has proved daunting, and progress has been uneven.
>
> The staff report showed very clearly that the fundamental prerequisite of successful structural reform is a sound macroeconomic environment. Unfortunately, a failure to coordinate demand-management and structural policy adjustments in the first half of 1988 appears to have blown the authorities' ambitious reform seriously off course.
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> The most important challenge now is to regain control of the inflationary process, without compromising the objective of further relative price changes. This will require vigorous action in the three areas of monetary, fiscal, and incomes policy.
>
> As to monetary policy, the official data suggest that over recent years, the growth of broad money has been on a rising trend, accommodating successive increases in nominal income. I suspect that the data provided by the staff may overstate the rate of growth of money in 1987, since the rapid buildup of foreign currency deposits may have been matched by a decline in money held outside the banking system. Nevertheless, it is clear that a tightening of monetary conditions has been made necessary by recent price and wage developments.

Given the impending and very welcome decentralization of the banking system, the temporary retention of credit ceilings seems prudent. However, I strongly agree with the staff that a further increase in nominal interest rates is warranted, notwithstanding the important rationalization of the interest rate structure that was recently implemented. A sharp increase in lending rates would not only reduce monetary growth; it would also facilitate a reduction in the subsidy to the banking sector and reduce the incentive for speculative stock-building.

With respect to fiscal policy, the unwelcome deterioration in the budgetary position over the past year highlights the need for a further reduction in subsidies and a rationalization of the complex system of tax reliefs. Given the staff comments on the extent of excess demand in the economy, the 15 percent real increase in consumer price subsidies in 1987 was doubly inappropriate.

On the revenue side, plans to introduce a value-added tax and a personal income tax are extremely timely. Equally important, however, the authorities should make further efforts to cut through the complex system of tax relief enjoyed by the enterprise sector. Not only does this system reduce the effective rate of tax, it also greatly complicates tax administration and affects allocative efficiency.

Given the strong inflationary pressures currently emerging, action on monetary and fiscal policy needs to be accompanied by more direct measures to control nominal incomes. As part of this process, a reduction in the real growth of social money benefits would go with the grain of the authorities' policies to increase the participation rate to ease labor shortages. In addition, the tax on excessive wage increases needs to be strengthened further by the elimination of ad hoc relief. This tax has thus far proved highly ineffective in holding down wage growth, as the authorities seem to recognize. I join Mr. Grosche in hoping that recent developments have opened up the possibility of devising new ways to achieve an effective incomes policy.

One very welcome development over the past few years has been the rapid growth of exports, buttressed by the authorities' flexible exchange rate policy and the provision of considerable incentives to export. Given the need for fiscal retrenchment, I agree with the staff that consideration should be given to removing the tax relief for exporters altogether with a compensating depreciation in the exchange rate.

The authorities should reconsider the feasibility of reducing the convertible currency account deficit. If the productive and allocative efficiency of investment is improved,

> the necessary compression of import growth should not have significant effects on output. Moreover, an improved current account position, together with the authorities' reserve cushion, should assist the process of normalizing external financing relations over the medium term. In contrast, a continued unwillingness on the part of the authorities to make the necessary adjustments and the continued delay over bilateral discussions with official creditors will not expedite the recovery of substantial voluntary capital inflows or enhance the authorities' chances of obtaining medium-term debt relief.
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> Action is now required on several fronts to reverse the economic crisis that has befallen Poland. The authorities have shown a willingness to bring forward ambitious structural reforms. However, to ensure that these can be successfully implemented, the authorities need to move swiftly to restore an appropriate macroeconomic framework. I note the authorities' invitation to the staff to visit Poland in October 1988. I believe that close collaboration between the Fund and the Polish authorities is entirely appropriate, and I hope that the Polish authorities will be prepared to take the various measures that the staff and Directors have recommended, so that such a staff visit could be productive.

Mr. Fernández said that he supported the proposed decision and welcomed the authorities' intention to start negotiations on a possible stand-by arrangement with the Fund. The performance of the Polish economy since 1983 was impressive. Output had expanded at an average rate of over 4 percent, and industrial production--in particular--had expanded at an annual rate of 5 percent. In addition, gross fixed investment had experienced strong increases over the past six years, and the current account balance had shown strength with a very satisfactory export performance. Official forecasts for 1988 pointed to another year of strong growth and increasing trade with western countries.

His authorities were in broad agreement with the staff appraisal, Mr. Fernández continued. At the same time, however, they agreed with the points that had been made by Mr. Samojlik in his opening statement concerning the pace at which current account equilibrium should be achieved and the need to take into consideration the specifics of the Polish economic structure, as well as social realities in Poland.

He agreed with other speakers that sound macroeconomic policies were a necessary condition for the economic liberalization to be successful, Mr. Fernández considered. High rates of inflation, increases in wages that exceeded increases in productivity, and continuing growth in the real value of money benefits might be perceived to be in contradiction with external competitiveness and the exchange rate policy. Exchange rate devaluations were necessary and the authorities should always be ready to maintain a realistic exchange rate. However, unification of the multiple exchange rate system was imperiled by both high inflation rates and increases in real wages. At the same time, it would not be sufficient to rely always on permanent and increasing depreciations of the exchange rate to maintain external competitiveness. In that respect, like other Directors, he had supported a combination of strict control of demand and a new push toward price liberalization. The success of both the structural reforms that had already been undertaken and the new liberalization measures depended very much on the credibility of macroeconomic policies. Therefore, a first priority should be to reduce the present high rate of inflation.

Social consensus might be of greater help in reaching economic targets, Mr. Fernández remarked. He wondered to what extent workers' organizations should be invited to share the Government's goals and points of view on the economic constraints and requirements to sustain growth in the medium term. It would be important to reach a social agreement to give new impetus to the liberalization process and to improve external competitiveness by means of cost moderation.

As to import and export trends, he was aware of the different points of view of the staff and the authorities concerning the current account balance target for the next two to three years, Mr. Fernández continued. He tended to agree with the authorities. It would not be consistent to advise the authorities to constrain imports when they were faithfully embarking on a process of trade liberalization. Mr. Samojlik had stated that most convertible currency imports consisted of nonconsumption goods. Imports of inputs and capital goods from hard currency countries were essential to sustain a strong pace of export growth and to modernize the productive system. That modernization would be the basis for sustainable economic growth in the future. Moreover, recent experience had shown that exports had responded well to strong increases in imports with the welcome trade account surplus maintained over past years. The staff had been favorably surprised by the strong performance of exports, and that performance was related in part to the continued growth of imported inputs, as Mr. Samojlik had indicated. He congratulated the Polish authorities for the courageous economic reforms they were taking.

Mr. Hogeweg made the following statement:

Centralized economies moving toward a market-oriented economy are fascinating. The responsiveness of an economy to market forces depends on its structure. It is a very real problem that, on the one hand, certain preconditions must be created, while, on the other hand, a certain critical mass of adjustment measures is needed to see results. These considerations seem especially relevant in situations of excess domestic demand, such as in Poland.

I agree with the staff that a sustained implementation of tight aggregate demand policies is crucial. It will help to reduce the rate of inflation, which, according to

Mr. Samojlik's opening statement, is one of the domestic social constraints, and to eliminate the convertible current account deficit. In addition, it is the only way to allow easing of administrative controls. Fiscal policy, monetary policy, and incomes policy all need to be used to this end.

From the staff report, I received the impression--which was made very explicit by Mr. Samojlik's statement--that the differences between the staff and the authorities do not relate to the direction or the extent of needed adjustment, but to the pace of adjustment in the face of social tolerance. This, of course, is a very real problem in Poland at this juncture. The problem is, however, by no means unique to Poland. This Board has discussed quite a few cases in which the authorities called for caution and referred to social realities, while the staff called for early decisive action.

Of course, the authorities are in the best position to judge their own particular situation. Nevertheless, this involves not a one-way, but a two-way risk. Too ambitious an approach may, as Mr. Samojlik indicated, either be bound to fail, owing to social resistance, or only be short-lived, because it does not rest on the required structural change. There is a significant danger in slow adjustment too: the population continues to experience painful adjustment, but does not see motivating results. Results are absent, either because the measures were not strong enough or because some essential element of the critical mass of adjustment measures is missing. This situation could create an environment in which adjustment fatigue thrives and social tolerance is unnecessarily tested. Social realities may be a given in the short run, but they most certainly can be influenced--and in both positive and negative ways. Mr. Samojlik was right in noting that the Polish authorities have a difficult balancing act to perform.

I welcome the intention of the authorities to start negotiations on possible Fund involvement in the Polish adjustment effort. It would be a welcome development if a program could be worked out, which would warrant the use of Fund resources. In this connection, I found the arguments of the staff on the need for positive real interest rates and an increase in nominal interest rates to address that goal quite convincing. Likewise, on the feasibility of rapidly eliminating the convertible current account deficit while maintaining sufficient domestic absorption, I was impressed by the staff's argument concerning the possibilities for improved investment efficiency. However, the staff may wish to comment on Mr. Samojlik's point that liquidation of loss-making enterprises increases import demand.

On exchange rate policy, at the time of the previous Article IV consultation with Poland (EBM/87/139, 9/16/87), I welcomed the introduction of retention schemes and foreign exchange auctions as a step in the right direction, but I endorsed the staff view that, in the longer run, the export incentive should be brought about by a unification of the exchange rate. This message may be repeated. In this connection, I note that approval of some multiple currency practices has been proposed, but only until the end of 1988. I would like to know why this proposal was made in this way. I did not receive the impression that Poland is planning to move quickly toward elimination of multiple currency practices.

I endorse the remarks made by Mr. Grosche and Mr. Marcel on the agreements following the Paris Club meeting. I note Mr. Samojlik's statement on Poland's flexibility. Like Mr. Samojlik, I hope the difficulties can be overcome, but the solution should lie within established Paris Club procedures and practices.

Mr. Sliper noted that there was a large measure of agreement between the authorities and the staff on many aspects of the current economic situation in Poland. First, there was agreement that Poland was at a crucial stage in the adjustment program. Directors had acknowledged that much had been done, especially in terms of outlining objectives and direction, but much remained to be done to ensure that Poland would achieve a sustainable growth path. Second, there was a large measure of acceptance that, at least from an economic viewpoint, there was no turning back in the adjustment process. The option of reverting to centralized controls and detailed planning did not seem to be either feasible or sensible. In that context, he was pleased to note Mr. Samojlik's statement of the Government's determination to continue with the present course.

The area of disagreement concerned the pace of reform, Mr. Sliper observed. There was a difference between the authorities and the staff, and various shades of opinion had been expressed among Directors. Therefore, he would concentrate his remarks on that matter.

In some of the speeches the Managing Director had given over the past year, he had emphasized that there were no universal Fund prescriptions for adjustment, Mr. Sliper recalled. The Managing Director said that he had looked to see whether the Fund had any such prescriptions, but he had not found any, and that if he had found such prescriptions, he would have stamped them out. Most Directors would agree with that thought, especially as applied to an adjustment program in an economy with a long history of centralized controls. Nevertheless, there were some elements that were vital to successful adjustment.

First, there was the most fundamental importance of getting two key prices--interest rates and exchange rates--right by ensuring that they reflected underlying supply and demand conditions, Mr. Sliper noted. The authorities clearly had made some progress on the exchange rate and the more realistic level was certainly paying off in terms of exporting to countries with convertible currencies. The need to simplify tax, export, and administrative controls, and the incentives surrounding exporting, should still remain a high priority over the coming year. However, the situation with respect to interest rates was much more unsatisfactory and the highly negative rates were leading to excess demand and poor resource allocation decisions. A sharp increase in interest rates more in line with inflation and inflationary expectations would be absolutely critical in the coming months.

A second element of successful adjustment was the importance of having a phased program in which the Government presented a reasonably worked-out timetable of specific measures, Mr. Sliper went on. The program then had credibility and allowed economic actors to plan their decisions with more certainty. The announcement of a phased program was even more important in a situation in which previous adjustment programs had not met with success. Inevitably, in such situations, some skepticism arose, and the commitment to, and follow-through, of a phased program could do much to negate that skepticism.

A third element of good adjustment was providing the corporate sector with an effective framework in which to manage enterprises, Mr. Sliper continued. In the case under discussion, he had received the impression that while the authorities had lifted many of the controls on the corporate sector, they had substituted other ad hoc measures, which had weakened the decentralization thrust. In other words, it appeared that, with respect to the autonomy of corporate enterprises, there had been some giving with one hand, but taking with the other. If the enterprises in Poland were to perform successfully, it would be vital for the managers to be given more responsibility for determining prices, wages, and the quantity of labor required.

In the case under discussion, a fourth element that would seem to be essential at the present stage was some form of incomes policy, Mr. Sliper considered. He had some reservations about incomes policies as an effective economic instrument, but the present juncture of economic trends in Poland, especially the burgeoning rate of inflation, justified an incomes policy. Such a strategy would also be consistent with the establishment of a phased program of reform measures.

Turning to the fiscal sector, it seemed that the authorities were contemplating a huge reform program, and he urged them to quickly establish priorities, Mr. Sliper stated. He suggested caution about the introduction of a value-added tax, particularly given its inflationary stimulus. Instead, the authorities should concentrate on removing many of the special tax breaks and incentives and, thus, try to get the tax structure operating more neutrally.

In his opening statement, Mr. Samojlik had called upon the Fund to work with the Polish authorities in establishing a new economic plan for

1989-90 with the expectation of a possible stand-by arrangement, Mr. Sliper recalled. He welcomed the fact that the Polish authorities were keen to have Fund involvement in the adjustment process. Nevertheless, he joined other Directors in expressing some reservations about the Fund committing itself too quickly to a stand-by arrangement. As Mr. Grosche had noted, it would be bad for Poland and bad for the Fund if a stand-by arrangement were agreed, but then went off track. The Fund had to be assured of the ability of the authorities to commit themselves to a phased program before embarking on such a course.

Mr. Vasudevan made the following statement:

Mr. Samojlik's opening statement touched on the important issue relating to the speed of adjustment. While the staff prefers to have macroeconomic policies and institutional reforms quickly in place, Mr. Samojlik argues that there is a need to proceed carefully, making due allowances for social realities concerning an acceptable level of inflation, limits to real wage reduction, and limits to import compression. These are important considerations, which should have a prominent place in the design of any program for growth-oriented adjustment. In addition, we note that the authorities are willing to have a stand-by arrangement with the Fund. A stand-by arrangement would be a welcome signal to official creditors, as it would provide a basis for debt restructuring negotiations. It is for this reason and in light of the need to maintain the present momentum of adjustment, that we would support any request for a future stand-by arrangement.

We commend the authorities for the progress achieved in 1988 in most policy areas, in particular in institutional reforms. The measures that are being envisaged in this area would help promote competitiveness. These measures provide an excellent foundation for the proposed growth-oriented adjustment program for 1989-90. However, the need to reduce the rate of inflation is most urgent, and it is therefore necessary, as the staff has indicated, to control income growth. Mr. Samojlik's opening statement clearly recognized this point, as reflected in the understatement: "Public awareness of rising prices was more acute than awareness of rising wages, a phenomenon not unique to Poland."

In its report, the staff argued that interest rates are not positive in real terms. While it is helpful to have nominal interest rates in relation to the inflation rate, it should be recognized that, in the transition period, credit ceilings, on which the authorities attach importance, would contribute to the reduction in the growth of liquidity. The authorities have moved the interest rates on deposits and credits significantly upward in 1988. Besides, bank credit for loss-making enterprises has been withdrawn. These are important measures in the right direction that should go a long way to ensure that credit is availed of by productive and profit-making enterprises.

Fiscal developments in 1988 are evolving in an expected manner. The intention of the authorities to make further adaptations in pricing policy and to standardize taxation of enterprises is welcome. With respect to the external sector, there is a clear difference of opinion between the authorities and the staff on achieving external viability with growth. A number of policies have been already taken to improve the trade balance with convertible currency areas. The authorities should persevere with the active exchange rate policy, pursued since mid-1986. Import liberalization has been accepted as an important policy goal. Further liberalization of imports, the large replacement of aging capital stock with more up-to-date machinery and equipment, and the need to have critical industrial inputs in sufficient quantities would necessitate an increase in convertible currency imports. This would have a salutary effect on output growth and would encourage exports. How quickly the adjustment should occur, however, would depend on the strength of the relationship between imports and output growth, especially in the export sector. In any case, sustainable external viability together with growth would imply not merely structural adjustment on the part of the authorities, but also substantial financing support from the international community, including the multilateral financial institutions.

Mr. Kyriazidis made the following statement:

In 1987, Poland continued in its endeavor to cautiously adjust the imbalances affecting its economy. Important results have been achieved in the external sector where current account deficits, both on the nonconvertible and convertible side, were the smallest they had been for many years, while significant steps have been taken in the area of economic reform. This outcome in two key areas is encouraging and underlines the authorities' firm commitment to the attainment of internal and external economic equilibrium. At the same time, however, the acceleration of inflation, the slowdown in the growth of GDP, and the substantial deterioration of the state budget indicate the magnitude of the difficulties still facing the Polish economy.

The main issue in the case of Poland's adjustment lies in structural reforms. They are the key to Poland's sustained and balanced development process. The authorities largely share this view, and they agree on the objectives that should be pursued by macroeconomic policies to support the process of structural transformation of the Polish economy, namely, to remove excess demand, reduce the rate of inflation, and improve the convertible current account.

Since we broadly agree with the analysis and conclusions of the staff, I can be brief and focus my remarks on a few main issues.

The restructuring of the price system remains at the core of the structural reforms. The prevailing price level is at the basis of the excess demand for the output of the socialized sector. In the process of liberalizing the price structure, higher inflationary pressure is likely to surface. This reinforces the need to keep the rate of monetary expansion under rigorous control, below the nominal rate of growth of income. Incomes policies should also share the burden of lowering inflation. In this regard, the rate of domestic credit expansion in the first half of 1988 is encouraging, since it was substantially in line with the growth initially planned. However, the higher than expected increases in wages, overall incomes, and prices during the same period are of some concern.

Still on price adjustment, further steps toward the restoration of real positive interest rates are also called for. By increasing the level of the rate of interest and correcting some distortions affecting its structure, monetary growth would be curtailed, undesirable impacts on savings and investment would be limited, and the phenomenon of speculative stockbuilding would be restrained. It should also be noted that the lending rate is lower than the rate offered on deposits. The state pays subsidies to banks to make up for the difference, which of course, has had some undesirable impact on the state budget.

In view of the need to reduce excess demand pressure stemming, in part, from a distorted price structure, great attention should be paid to demand-management policies. In this respect, the substantial deterioration of the state budget in 1987 is, of course, cause for concern. Room for improvement can be found, for example, in the area of subsidies to enterprises and banks. We are glad to learn from the latest update that for 1988 the state budget, as a percentage of GDP, will show an improvement in line with what was planned, or an even greater one, owing to a faster than expected growth of GDP.

Turning to the external sector, Poland's financial position remains fragile, with a fairly high debt service ratio, and we share the authorities' concern in this respect. In order to improve the overall external position, the authorities have adopted a more active exchange rate policy since mid-1986. This policy helped significantly to boost hard currency exports, and therefore to invigorate the process of improving the current account in convertible currencies, a process which had come to a halt in 1986. According to the most recent information available, during the first part of 1988 exports in hard currencies continued to grow rapidly, thus further reducing the relevant current account deficit. This is a better outcome than the authorities had foreseen at the time of the consultation discussions, and seems to confirm the economy's ability to speed up the adjustment of the current account in convertible currencies.

An even more rapid expansion of hard currency exports could be desirable, in principle, because it would spur a faster approach to current account balance with the convertible area, thus speeding up the process of normalizing relations with external creditors. In his opening statement, the Minister of Finance confirmed the great importance his Government attaches to the normalization of relations with all their creditors. However, in deciding the pace of adjustment, the Polish authorities should take into consideration the sustainability of a faster growth of exports. The impact on domestic absorption and the social consequences of the adjustment should not be overlooked.

On the external sector, we encourage the Government to continue to pursue an active exchange rate policy to maintain and improve the good trade performance of 1987. In addition, we welcome the numerous initiatives taken by the authorities aimed at progressively broadening the use of market-determined exchange rates. However, there still remains a significant gap, between the official and parallel exchange rate markets. We encourage the Government to persist in its efforts to reduce this gap, to unify the different exchange rate regimes as soon as possible. Finally, as an additional shift toward improving the exchange system, we agree with the staff's suggestion that the so-called submarginal method of exchange rate determination should be abandoned.

We agree with the proposed decision, and we are in favor of examining the possibility of negotiating a stand-by agreement with Poland in the near future.

Mr. Othman made the following statement:

Following the economic difficulties of the late 1970s and early 1980s, Poland has been embarking on a wide range of economic adjustment policies. A good measure of success has been achieved in improving the economic situation over the past few years, including in particular, the expansion of output, the substantial productivity gains in the industrial sector, and the growth in exports of manufactures. These gains, however, are currently overshadowed by domestic demand pressures that have caused a rapid increase in prices and continued pressure on the external position.

Under these circumstances, I concur with the staff that the main tasks facing the authorities in the coming period are the removal of excessive demand pressures, the reduction of the high rate of inflation, and the elimination of the external current account deficit.

I agree with the staff that the achievement of these objectives requires the implementation of tight monetary and fiscal policies, reinforced over the short term by more direct restraint on the growth of nominal income. Financial restraint will be crucial not only to mitigate the impact on prices of exchange and interest rate adjustments, but also to facilitate the relative price corrections that constitute an important aspect of the structural reform. In addition, measures are needed to enhance the financial discipline of enterprises. A more efficient management of enterprises is likely to improve the allocation of labor, which in turn may reduce the tightness of the labor market, and thus remove the pressures for higher wages.

Poland's external debt situation will continue to be difficult. A further improvement in the current account is clearly needed. Apart from stabilizing the level of external debt, such an improvement will create an environment that is more conducive not only to debt rescheduling, which Poland depends on, but also to improving Poland's relations with its creditors.

In this context, the difference between the authorities and the staff regarding the speed of adjustment on the convertible current account is noteworthy. While we recognize the benefit of the speedy path suggested by the staff, we feel more inclined, in light of the events referred to in Mr. Samojlik's opening statement, to sympathize with the Polish authorities' pace of adjustment. However, it is very important that, to ensure the flow of necessary finances, Poland move boldly to implement structural and macroeconomic policies in a comprehensive and integrated fashion.

Timely and speedy progress in the finalization of the negotiations with bilateral creditors is also an important factor in supporting Poland within the international community. In this respect, we join the staff in urging the Polish authorities to make their best effort to conclude these negotiations promptly.

In conclusion, the Polish authorities' continued commitment to the reform of the economy is most welcome. The policy package described in the staff report provides a good basis for a comprehensive economic reform, which if fully implemented can help restore confidence both internally and externally. The role of the Fund in this endeavor is also very important. The willingness of the Polish authorities to cooperate with the Fund to promote adjustment is welcome, and deserves the financial support of the Fund. I endorse the proposed decision.

Mr. Fogelholm made the following statement:

The Polish authorities are confronted with a major task of economic adjustment, a problem to which there is no easy or quick solution. Efforts by the authorities in recent years have, unfortunately, not yet generated a return to the economic conditions and living standards experienced by the population prior to the economic setbacks that occurred early in this decade. A broad range of policy measures will clearly be necessary to achieve sustained growth and to continue the restructuring of the economic system in a more market-oriented direction.

The Polish authorities should place the highest priority on curbing the current high wage inflation, which seems to be a precondition for the successful execution of all other policies and economic reforms, and on the increasing use of market prices. This appears to be fully acknowledged by the authorities, who will, therefore, have to consider austere incomes policies to break the inflationary spiral, in spite of the huge political problems attached to such a policy. This will not be an easy task, and I join Mr. Grosche and Mr. Enoch in hoping that such policies can be worked out.

Despite ambitious efforts on the part of the Polish authorities to enhance competition through the introduction of market instruments while simultaneously decentralizing decision making in the economy, progress to date has been somewhat disappointing. It would also seem that the advances made during one period have been undermined by changing economic and social conditions during subsequent periods. This raises the question of the pace at which reforms should be introduced. It may be unrealistic to expect rapid changes, considering the still highly monopolistic productive sector, and the heavily regulated economy. The staff, however, emphasizes the need for a more rapid adjustment, in particular, of the external balance. The staff and the authorities should, therefore, try to work out an appropriate and realistic pace of reform that can be sustained both in economic and in social terms. One cannot, however, rule out the possibility that administrative devices will still have to be relied on for some time to come in the allocation of resources. Hence, the authorities should try to establish clear priorities with respect to the most crucial policy issues, while other necessary changes may have to be implemented at a slower pace.

I fully agree with the staff that elimination of the current account deficit is essential, and that this goal should receive general acceptance in Poland. However, the current account deficit cannot be turned into a surplus unless growth in domestic demand is constrained and kept at a lower level than growth of domestic production. Thus, economic policies should aim at diverting resources from domestic use to export-promoting activities. If the authorities do not succeed in this endeavor, it is hard to see how sustained improvements can be brought about, remembering the simultaneous need for an inflow of foreign capital for investment and a restructuring of industry.

The authorities should give high priority to reforming the public enterprise sector. State enterprises still maintain a monopoly in most areas, despite an encouraging increase in the number of private companies in recent years. The authorities should be commended for having reduced subsidies, and, indeed, for raising interest rates. Nevertheless, the large credit demand of enterprises still appears to be largely stimulated by negative interest rates, price regulations, and general corporate inefficiency.

An industrial sector more exposed both to domestic and foreign competition would clearly enhance the reform efforts. Therefore, the authorities should further loosen the close relationship between industry and the public sector, and thus allow productivity and price competition to determine profitability in the various sectors and enterprises. In the process, liquidation of some inefficient enterprises cannot be ruled out, nor can the emergence of some unemployment, which, in turn, may decrease the pressure on wages.

From all aspects, the current debt situation and Poland's relations with foreign creditors are not acceptable. This is evident from the staff report, and was acknowledged by Mr. Samojlik; it therefore needs no further elaboration. However, foreign reserves have been increasing to a sizable level following improvements in the trade balance and a rise in net receipts from private transfers during the course of the past year. The authorities should be encouraged to use some of these resources to make repayments to foreign creditors as part of a comprehensive policy to normalize relations. In this context, it is regrettable that little progress has been made over the past year to conclude negotiations on rescheduling with official creditors.

The intention of the Polish authorities to continue reforming the economic structure is welcome. I support the proposal to grant all possible technical assistance to Poland, and I support close and continued collaboration between the Fund and the Polish authorities, with a view to preparing a Fund-supported program.

Mr. Adachi made the following statement:

Like Mr. Prader, we would appreciate further comments from Mr. Samojlik on the effect of recent social developments.

We basically agree with the staff's assessment of the Polish economy and policy requirements, and endorse the thrust of the staff appraisal. Moreover, the authorities' aims are the same as those recommended by the staff. Therefore, we would like to focus primarily on the issue upon which the authorities and the staff do not agree, namely, the pace of internal and external adjustment.

Because it is a heavily indebted country, to pursue a growth-oriented adjustment, Poland has to maintain credible policy management that provides creditors with confidence concerning the economic environment. Therefore, while we recognize the present crucial political situation, we believe that the authorities have to implement a far-reaching and comprehensive adjustment program to contain the imbalances stemming from deep-rooted distortions in the Polish economy.

On the domestic side, the efforts made by the authorities are welcome. However, the authorities should take further steps to control income growth as well as to adjust prices to redress the vicious wage-price spiral. In this respect, we would welcome comments from Mr. Samojlik or the staff on the possible effects of recent social and labor movements on the wage increase. Having said this, we emphasize the need to maintain and strengthen tight monetary and fiscal policies.

As to the external sector, we support the staff's view on the rapid elimination of the current account deficit in convertible currencies, and we welcome the significant improvement of the current account deficit in the first half of 1988. In this connection, we are not convinced of the effectiveness of the model presented by the staff, which separates the underlying economic growth rate from the import dependent growth rate, because the stable relationship between overall economic growth and import dependent economic growth might be difficult to identify in the medium term, especially in a period of structural reform. Nonetheless, the authorities should expedite their timetable for external adjustment, because earlier adjustment will provide further confidence to creditors and potential creditors. Moreover, like Mr. Grosche and Mr. Marcel, we urge the authorities to redouble their efforts to conclude bilateral negotiations with official creditors.

While we commend the authorities for their commitment to the economic reform, we encourage them to expedite their growth-oriented adjustment. In this context, Poland's invitation to the staff to start negotiations on a stand-by arrangement is very welcome.

Ms. Gold made the following statement:

We commend the authorities for the progress they have made in introducing structural reforms and liberalizing the economy since the 1987 Article IV consultation (EBM/87/139, 9/16/87). Moreover, the Polish economy has shown surprising resilience in the past several years, despite the setback suffered in 1987; domestic output expanded at 4 percent on average since 1982, and export growth has substantially accelerated since 1985. However, it is clear that considerably more remains to be done, and the authorities are facing substantial challenges.

As we are in agreement with the staff report and support the proposed decision, my remarks will be brief.

A major challenge, as was clearly indicated by Mr. Samojlik in his opening statement, is getting the rate of inflation under control. The accelerating inflation rate is not only economically destabilizing, but also an increasingly important justification for the public's unwillingness to fully support the reform efforts. The implementation of appropriate financial policies, and particularly the establishment of positive real interest rates, with the support of an incomes policy, is imperative to reduce the rate of inflation. The use of price controls and regulations without appropriate macroeconomic measures will only temporarily mask inflationary momentum and will lead to increased inefficiencies and obstacles to reform. The substantial deterioration of the state budget position in 1987 was of some concern. However, corrective action has been undertaken, and the state fiscal budget target for 1988 is expected to be met.

The authorities are of the opinion that an ongoing inflation spiral can be avoided. However, like the staff, I have serious concerns about the danger of an inflationary spiral emerging, particularly in light of the continuous labor unrest. We appreciate the difficulties facing the authorities at this juncture, but caution them that increasing wages could undo much of what has been achieved to date. Moreover, the trend in recent years of increasing the importance of state-provided social benefits relative to wages increases rigidities and hampers the authorities' efforts to link gains in real income to productivity.

We commend the authorities for the progress made in institutional reforms in the past year. Decentralization of the banking system and the streamlining of the central economic administration are proceeding as planned, and several initiatives to increase competition and promote structural changes are being taken. The continuation of these reforms is essential to increase the competitiveness and productivity of the Polish economy. It is through these channels that the overall standard of living can be raised on a sustainable basis.

With respect to external policies, since mid-1986, the real effective exchange rate of the zloty has depreciated by about 50 percent. The substantial growth in exports since that time can be attributed largely to this devaluation, as well as to the supporting policies that have increased incentives to export. However, imports have increased almost as quickly as exports have, so that the overall trade surplus has remained the same in nominal terms for the third year in a row and has declined in real terms. In light of Poland's large and growing external debt, we urge the authorities to take the necessary action to increase the trade surplus. Given the recent strong export performance, it is evident that the authorities have not been sufficiently ambitious with respect to their external targets. We agree with the staff that a stronger external balance is within reach.

Exchange rate policy should be managed so that, at a minimum, there is no real effective appreciation of the zloty from its current level. However, like Mr. Enoch, I agree with the staff that it would be more effective to replace the tax relief provisions for exporters with an across-the-board devaluation.

My authorities are disappointed about the long delays in the signing by Poland of its bilateral rescheduling agreements with official creditors and its poor debt-servicing record to these creditors. I agree with Mr. Grosche, Mr. Marcel, and other Directors that such delays can only have negative implications for Poland's creditworthiness. Furthermore, it could raise doubts about Poland's willingness and/or ability to fully implement a Fund-supported program and subsequently service its debt to the Fund. Given the current high level of foreign reserves, Poland's actions seem to be increasingly indefensible.

We urge the authorities to embark on a consistent and comprehensive reform program. Measures taken in one sector without appropriate supporting policies in the other sectors have little chance of success; often, in such cases, progress in one area will be hampered by continued inefficiencies and bottlenecks in other areas. Moreover, as noted by Mr. Hogeweg, such an adjustment path, if effective at all, given its slow pace, fails to maintain the support and cooperation of the public, because it entails high visible costs and little obvious reward.

The staff representative from the European Department said, in response to Mr. Prader's observations about the limited scope of the supplement to the staff report (SM/88/175, Sup. 1, Cor. 1, 9/14/88), that the supplement was limited in terms of both its scope and the period covered, because the information that had been provided by the authorities had covered only the period up to July 1988, which preceded the recent events in Poland. A fuller coverage would have been helpful but, owing to the nature of the labor unrest and the lack of reliable information concerning the economic impact of that unrest and its longer-term impact on the sociopolitical situation, the staff had considered it inadvisable to make comments that would necessarily have been based on speculation. However, Mr. Samojlik might wish to comment on that subject.

On the point Mr. Prader had raised on the possibility of developing an approach to Poland's difficulties that would focus directly on systemic reform, the staff did not want to give the impression that it was suggesting that there was a choice between either supply-side measures of systemic reform or demand-management measures, the staff representative explained. The intended thrust of the staff analysis was to indicate that a very intimate relationship existed between the two aspects of economic policy. It was not feasible to have one element without the other.

Previous experience, both in Poland and in other countries, had shown that problems arose when economic policy issues were addressed from only the supply or the demand side, the staff representative observed. For instance, when prices were decontrolled for supply-side reasons, but demand was not adequately constrained, a surge in the rate of inflation occurred; the demand for investment by enterprises could not be controlled effectively when the financial resources available to them were excessive; and pressures on the balance of payments could not be sufficiently alleviated without gaining some control over imports through demand management. The staff considered that, unless a country was moving toward a situation in which aggregate demand was under control, problems would occur in one or more of the areas mentioned, and those problems would inevitably lead to an ad hoc reimposition of controls and an undermining of the reform process.

A number of speakers had referred to the role of foreign currency deposits, and Mr. Marcel, in particular, had asked whether the staff had any suggestions on how that problem could be managed, the staff representative noted. Holding foreign currency was a historical tradition in Poland. A number of currencies had circulated in living memory within the geographic area that was now Poland, and perhaps partly for that reason, there was skepticism about the value of the national currency and a propensity to hold other currencies. The holding of foreign currencies had become a fairly deeply ingrained habit, and it would be futile to suggest that it could easily be overcome in the short term. However, some initial steps could be taken to address the problem. Most important, increases in the interest rate to reverse the situation of recent years, in which the local currency--the zloty--yielded a substantially negative rate of return and foreign currencies yielded a substantially positive rate of return. This was one of several reasons firm and decisive interest rate action should be taken.

Another measure that could be taken would be to reduce the rate of return on holdings of foreign currency deposits, by reducing the rate of depreciation of the zloty in the black market, the staff representative went on. Again, the whole complex of demand-management policies affected the currency situation. However, to the extent that demand management could reduce demand in the black market and reduce the black market discount on the zloty, it would be possible to reverse the historical relationship between the yields on domestic and foreign currencies.

As to the observation made in Mr. Samojlik's opening statement that the impact of closing down loss-making enterprises could put greater pressure on imports and the balance of payments, that observation could very well be true in the short run, if all other factors were held constant and some elements of production were reduced, the staff representative said. However, the counterbalancing side of that observation would take into account the fact that those loss-making enterprises might be substantial and inefficient absorbers of imports. The possibility of creating greater factor mobility should also be taken into account. The resources that were currently tied up in loss-making enterprises could be diverted to more efficient uses.

A question had been raised about the specification of the growth equation used in the staff's medium-term scenario, the staff representative continued. The staff did not want to overemphasize its conclusions, but, as it indicated in the staff report, although that equation was not precise, it captured the basic relationships involved, namely, that some growth was attributable to autonomous factors and some to imports. The specifications that had been adopted were not inconsistent with the limited amount of econometric evidence available.

Mr. Samojlik thanked the Executive Directors for their helpful comments. Many interesting and complicated points had been raised during the discussion, and, as in previous Article IV consultations, his authorities would consider those points carefully.

The events of the past month with respect to labor unrest would have some influence on Poland's prospects for the year 1988 as a whole, Mr. Samojlik continued. The strikes had been limited in time and in scope, so they would have only a marginal effect on the overall levels of production and exports. However, another problem, indirectly related to the strikes, was the level of incomes and wages. The recent increases in incomes and wages were not directly related to the strikes, but had resulted from the price and wage reform that had been introduced in February 1988. The adjustment that had been intended to make uniform and direct compensation for the increasing cost of living had been too high. To correct the wage system, it had been necessary to adjust the overall relationship between wages and prices, and some mistakes that had been made in combining wage and price policies resulted in overly large wage increases.

Although the situation with respect to wage and price policy was not out of control and the authorities were currently making corrections, it presented a difficult problem, owing to the possible impact of the gap between incomes and prices on the level of goods and services, Mr. Samojlik went on. For 1988, GNP was expected to be about 4 percent higher than it had been in 1987. Exports were expected to increase by about 15 percent in dollar terms, and the supply of goods and services was expected to increase by no more than 3-3.2 percent. However, at the same time, wages were projected to increase by about 64-66 percent. Therefore, the level of real wages would be at least 2 percentage points too high in relation to the supply of goods and services. That would create pressure on the markets and excessive demand compared with the supply of goods and services.

Another important problem, which many Directors had pointed out, was the substantially negative level of interest rates, Mr. Samojlik observed. Interest rates were, in fact, even lower than they appeared to be, owing to the common availability of interest rate relief in Poland, beyond the already negative interest rate. Although the authorities were certainly willing to increase interest rates, it was difficult to do so, owing to the substantial budget costs involved. It would be extremely difficult to increase those rates at the expense of borrowers. Therefore, interest rate relief would have to be avoided. The authorities were trying to solve the interest rate problem, at least partially, in 1988, but it would become a bit easier to solve in 1989, owing to the low level of inflation projected for that year. The authorities would not need to increase real interest rates in 1989 through price increases, because real interest rates in 1989 were expected to become positive, provided existing interest rate relief was withdrawn.

Policymaking with respect to prices was difficult in Poland, Mr. Samojlik remarked. The authorities wanted to move toward a more market-oriented economy, but it was difficult to establish a starting point for that transition, given the present structure of prices. There were many areas in which the levels of subsidies were two to four times higher than the level of prices. Therefore, without some correction of the price system, it would be very difficult to move toward a system of market mechanisms. Such a correction was needed in any case, given the current relationship between costs, prices, and subsidies.

With respect to the food market, and factors of production for agriculture and energy products, subsidies were quite high, sometimes two to three times higher than prices, Mr. Samojlik observed. In 1988, the authorities would try to correct that problem, at least partially, not through autonomous market forces, but by increasing prices to a level that could provide a basis for establishing equilibrium between the levels of supply and demand and reduced subsidies. In addition, the level of inflation was expected to be lower in 1989 than it was in 1988.

The price increases to be introduced in January 1989 would not be greater than 10-12 percent, Mr. Samojlik remarked. Therefore, the authorities hoped to halve the rate of inflation in 1989. The carry-over effect from the level of inflation in 1988, of about 20 percent, combined with the price increase of 10 percent, would raise the overall cost of living by about 30 percent. However, the carry-over effect would also influence the level of wages. The current level of inflation in Poland was about 3 percent, month to month, and it was decreasing, primarily owing to the February 1988 price increase for raw materials and energy. The pressure to raise prices in Poland was not caused by a problem with respect to the level of inflation, but rather, by the gap between incomes and prices. Currently, prices in Poland were not a problem, owing to the system of administrative controls. However, imbalances would arise as controls were withdrawn and prices were increased to adjust to the conditions of supply and demand. At that time, it would become extremely difficult to control the rate of inflation.

The current level of debt was not a problem, but the authorities would have to address the consequences of the tight monetary and credit policy introduced in 1988, Mr. Samojlik stated. The implementation of that policy would mean that radical changes would have to be made in the real economy with respect to the structure and methods of production. Given the number of enterprises operating at significantly high costs, many difficult social and political problems would arise as the effects of the tight monetary policy became evident.

The most obvious problem with respect to the Polish economy was the difficult transition from a regulated economy to a market-oriented system, Mr. Samojlik considered. The economy was not competitive; it was largely composed of monopolies and oligopolies. Therefore, the usual economic instruments did not work according to classical rules. It was necessary to monitor economic developments from a practical standpoint and then try to limit the effects of certain measures or make corrections accordingly.

The authorities were trying to create a competitive economic structure as a necessary precondition for the proper implementation of economic measures, Mr. Samojlik went on. Without that restructuring of the economy, the tighter monetary policy and price liberalization would not have the desired results. Therefore, the most difficult problem facing the authorities was the creation of competitiveness with respect to both the domestic economy and the external sector. Through competition, enterprises would be forced to examine the economic environment and to adjust production costs and prices accordingly. However, the orderly transition to such a system took time. Although specific economic measures could be introduced at almost any time, changes in the basic structure of the economy involved problems related to past investments and capital flows. Therefore, changes in the basic structure could occur only very slowly.

As to Poland's relations with the Paris Club, the authorities had signed an agreement with the Paris Club creditors in December 1987, Mr. Samojlik concluded. Despite the relative difficulties Poland faced with respect to its balance of payments position, the authorities were trying to be as flexible as possible. They were trying to find a way to solve the balance of payments problem and to implement the Paris Club agreement without changing it. The authorities had proposed a schedule of payments to the Paris Club that would be commensurate with Poland's ability to repay its loans. The Polish authorities were confident that, with the cooperation and assistance of creditor countries, it would be able to finally implement that agreement.

The Acting Chairman made the following summing up:

Directors commended the Polish authorities on their efforts to increase the economy's market orientation and thereby facilitate the reduction of domestic and external imbalances and establish the conditions for sustained economic growth. They noted, however, that many difficulties had been encountered in implementing these reforms, the results of which so far had been very mixed. Directors hoped that recent events would offer an opportunity for building the needed consensus around the development of mutually supportive macroeconomic and structural adjustment policies. Directors, at the same time, however, recognized the difficult technical challenges facing the Government as it moved from a highly regulated economy toward a more market-oriented system.

Most Directors stressed the need for appropriate macroeconomic policies. The current rate of inflation--at over 50 percent--worried many Directors, and underlined the need for tighter fiscal and monetary policies. Without such policies, there was a danger that further attempts to introduce needed relative price changes would be swamped by inflation. Such policies were also essential if price pressures were to be reduced without undesirable recourse to administrative price controls and the introduction of new distortions in the allocative system.

Pervasive excess demand necessitated holding both monetary expansion and nominal income growth below the growth of expenditures. In this context, the steps taken in early 1988 to raise and simplify the structure of interest rates were welcomed. Much more needed to be done, however, and Directors urged the establishment of a structure and a nominal level of interest rates that would help discourage currency substitution, improve credit allocation, and reduce overall credit growth. Reducing subsidized rates should be a high priority.

Directors observed that the fiscal deficit had increased in 1987, which had contributed to accelerating inflation. Directors urged a reduction in the fiscal deficit by reducing expenditures, with particular emphasis on subsidies, which would permit a reduction in the current high level of enterprise taxation. The desirability of standardized enterprise taxation and of progressively eliminating the complex system of tax reliefs and subsidies was also underscored.

Directors were concerned that the authorities' plan to contain real wages in 1988 was not being achieved, resulting in an intensification of excess demand and inflationary pressures. While wage determination was clearly a sensitive issue, an effective incomes policy backed by the necessary social consensus remained essential in the adjustment effort. Several Directors remarked that the recent trend for social benefits to rise faster than wages further heightened the need for wage restraint. Directors urged the authorities to intensify their program of price reforms and progressively to reduce administrative price controls. However, they commented, any realignment of relative prices would have to be supported by firm demand-management policies if it was to have an enduring impact on resource allocation.

Directors noted that, since the last consultation, agreements for rescheduling debt had been reached with both official and commercial bank creditors. Several Directors, however, regretted the lack of progress in Poland's bilateral negotiations with official creditors. This was likely to undermine international support for Poland and complicate the prospects for securing further debt relief and other financial support. In 1987, the convertible current account deficit had fallen to 0.6 percent of GDP, the lowest level this decade. Poland's rapid export growth over the past 18 months was particularly encouraging. Directors urged the Polish authorities to build on these developments. The external position needed to be strengthened to allow a progressive reduction in reliance on debt relief and a normalization of external financial relations. With these aims in mind, most Directors considered that the convertible current account should be moved rapidly into surplus through a combination of demand restraint and measures to enhance the supply of tradable goods. The merchandise trade surplus should be increased rapidly, and a buildup in domestic demand pressures in 1988 not be allowed to threaten the external position.

Directors welcomed Poland's recent active exchange rate policy, which was seen as an important cause of faster export growth. They urged that this policy be continued and that the level of the exchange rate be kept under review in light of the overall balance of payments position and the need to liberalize imports. The effectiveness of the exchange rate policy would be enhanced by a general easing of price controls. The need for tax reliefs and other subsidies for exports would also be reduced by a lower real exchange value for the zloty. Directors welcomed the steps taken by the authorities to broaden the use of market-related exchange rates as well as the various measures taken to reform the exchange and trade system. These included the simplification of the foreign exchange retention system for exporters, although Directors hoped that over time the need for these retention arrangements would be eliminated. They encouraged the authorities to take further steps to liberalize the exchange and trade system.

Many Directors stressed the role of the Fund in assisting the authorities in establishing a comprehensive set of mutually reinforcing policies and a specific timetable for their implementation. The basic requirement of such policies was that they strengthen the external position, reduce inflationary pressures, and lay a foundation for sustained growth. Directors noted that there had been numerous staff contacts with the Polish authorities over the past year, including the provision of substantial technical assistance. While the hope was expressed by a number of Directors that a program of adjustment and reform eventually could be supported by the use of Fund resources, Directors stressed the need for a demonstration by the authorities of their ability to maintain a steady course in the implementation of their economic reforms and to ensure the credibility of policy undertakings under any Fund-supported program.

It is expected that the next Article IV consultation will take place on a standard 12-month cycle.

The Deputy Director of the Exchange and Trade Relations Department said that, with respect to the proposed decision concerning Poland's exchange practices, the staff recommendation for Board approval or non-approval of certain multiple currency practices was based on a judgment concerning the temporary nature of the restrictions underlying those practices and the compatibility of current policies with the eventual elimination of those restrictions. The staff had made its recommendation for approval until the end of 1988 of certain multiple currency practices based on the current policies of Poland. As Directors knew, the authorities were currently defining their policies for 1989-90, and it was expected that the staff would hold discussions with the authorities concerning those policies once they were formulated. Therefore, the staff had considered that it might be appropriate to provide approval for certain multiple currency practices until the effects of future policies could be better assessed for the coming period.

The Executive Board took the following decision:

1. The Fund takes this decision relating to Poland's exchange measures subject to Article VIII, Sections 2(a) and 3, and in concluding the 1988 Article XIV consultation with Poland, in the light of the 1988 Article IV consultation with Poland conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. The restrictions on the making of payments and transfers for current international transactions, and the multiple currency

practices which are described in detail in SM/88/184, are maintained by Poland in accordance with Article XIV, except for the multiple currency practices connected with the foreign exchange auctions and the convertible foreign exchange coupon scheme which are subject to approval under Article VIII, Sections 2(a) and 3. The Fund encourages the authorities to accelerate the process of simplifying and eliminating the very complex multiple currency practices. Moreover, the Fund urges the authorities to take early steps to eliminate the exchange restrictions evidenced by payments arrears and bilateral payments arrangements, and the multiple currency practices maintained and adapted under Article XIV, including those evidenced by broken cross rates. In the meantime, the Fund grants approval of the existing multiple currency practices connected with the foreign exchange auctions and the convertible foreign exchange coupon scheme until December 31, 1988.

Decision No. 8982-(88/148), adopted
September 14, 1988

2. SOMALIA - OVERDUE FINANCIAL OBLIGATIONS - REVIEW FOLLOWING DECLARATION OF INELIGIBILITY

The Executive Directors considered a staff paper on the review of Somalia's overdue financial obligations to the Fund following the declaration of its ineligibility to use the general resources of the Fund (EBS/88/191, 9/9/88), together with a staff paper on the Government's economic and financial policies (EBS/88/190, 9/8/88).

The staff representative from the African Department made the following statement:

In the seven weeks following the adoption by the Government of the economic and financial policies described in the staff paper, the authorities have acted to implement many of those policies.

On the exchange system, the export surrender requirement was reduced to 60 percent, and a free foreign exchange system has been established. Most foreign exchange for imports is now transacted at the free market rate. In line with the Government's announced policies, the official exchange rate has been adjusted weekly to reflect relative price developments in relation to the currency basket countries, and changes in international exchange rates. On September 10, 1988 the rate was adjusted to So. Sh. 227 to the dollar. Since early August 1988, the exchange rate on the free market has depreciated, due in large part to the continuing scarcity of foreign exchange, to about So. Sh. 380-400 to the dollar. The consumer price index has shown month-to-month increases of 5.1 percent in July and 13.4 percent in August.

The acceleration of the rate of inflation in August 1988 was due largely to higher food prices, which showed a year-on-year increase of 130.3 percent.

The authorities have implemented the new tax measures described in Table 6 of the staff report. Also, the local currency price of petroleum products has been adjusted to reflect the depreciation of the official exchange rate, and utility tariffs have been revised to effect a full pass-through of the exchange rate and the tax adjustments. The authorities have indicated that they will continue to pursue their announced policy to make changes in petroleum and other prices in line with exchange rate developments.

Preliminary indications are that the end-August 1988 target for net credit to the Government has been met. Information on total domestic credit as of that date is not yet available.

The staff has not received any new information concerning the cancellation of the contract to purchase a new aircraft. However, the authorities have asked the World Bank to undertake an analysis of alternative means of upgrading the fleet capacity of Somali Airlines.

A World Bank sponsored donors' meeting, in which the Fund staff participated, was held in London on September 9, 1988. At that meeting, donors decided to resume disbursements under their commodity import programs. Disbursements would amount to some $40 million during the second half of 1988, broadly in line with the assumptions made in the staff report. Some donors also indicated that they would review the amount and form of their assistance with a view to filling the cash financing gap.

Mr. Finaish made the following statement:

Let me say at the outset that the Somali authorities attach considerable importance to this review. It is their hope that this discussion will help further the process toward normalizing Somalia's financial relations with the Fund. Obviously, Somalia is not out of the woods yet, and there is a great deal more to be done by all parties concerned. However, the steps taken by the Somali authorities over the past few weeks provide a good foundation for further progress and for intensifying the collaborative effort that will be required in the period ahead.

The staff paper on the Government's economic and financial policies (EBS/88/190) contains a detailed description of the measures that were formulated in collaboration with the Fund staff during their recent missions to Somalia. Therefore, I do not need to go over all those measures again. But, it is important to underscore the broad nature of the policies already adopted and the fact that the authorities have shown a good deal of courage by taking difficult policy decisions, despite the unsettled political and security situation. It is true that some of the policy intentions for 1989 are yet to be incorporated in a full-fledged policy program for next year, which will be part of a medium-term framework. As reported by the staff, discussions between the authorities and the staff on a policy framework paper and on an economic program for 1989 will resume shortly after the Fund's 1988 Annual Meetings. In the meantime, the authorities are implementing the measures agreed with the staff for the period up to end-December 1988.

Let me just highlight some of the measures implemented recently by the authorities.

First, in the exchange rate area, in addition to the 45 percent devaluation of the Somali shilling, which was effected in June 1988, the Somali shilling was pegged to a basket of currencies of Somalia's trading partners. Since that time, weekly adjustments in the official rate have taken place on the basis of inflation differentials. As a result, the official exchange rate now stands at So. Sh. 227 to the dollar, compared with the rate of So. Sh. 180 to the dollar following the June 1988 devaluation. The weekly adjustment of the rate will continue in accordance with the agreed formula. In addition, all imports except those financed by commodity assistance will be transacted at the free market rate.

Second, in the fiscal area, the revenue package outlined on page 12 of EBS/88/190 has already been implemented. The authorities are also proceeding with their policy of expenditure restraint with the aim of reducing recurrent spending in 1988 by 23 percent in real terms compared with 1987. The overall fiscal objective is to limit the deficit on a cash basis to 4 percent of GDP in the second half of 1988, and, thereby, to reduce the overall fiscal imbalance significantly from its 1987 level.

Third, in support of fiscal restraint, the authorities have tightened monetary policy considerably with the aim of containing the rate of liquidity expansion and reducing the rate of inflation to about 40 percent by December 1988. As of August 1, 1988, the interest rate on savings deposits was raised from 12 percent to a minimum of 40 percent, while the lending rate for nongovernment credits was raised from the range of 15-22 percent to a 50 percent minimum. At the same time, the discount rate was increased from 12 percent to 45 percent. Limits on domestic credit were also imposed, with sublimits on government and parastatal credit to ensure sufficient credit allocation to the private sector.

Fourth, in the structural area, important steps were taken, including the lifting of all price controls as of June 1988. In addition, public enterprises were allowed to adjust their prices to fully reflect exchange rate adjustments and other costs. In the meantime, the authorities are working on a comprehensive action plan to reform the public enterprise sector. In this, as well as in a number of other areas of structural reform, the authorities are working closely with the World Bank. In addition, the authorities are seeking technical assistance from a number of sources in order to help improve policy formulation and implementation as well as the monitoring of performance.

The measures I have just outlined as well as those described in the staff paper represent a substantial effort by the authorities. Obviously, this effort needs to be sustained beyond 1988, and indeed beyond 1989. The magnitude of the imbalances clearly necessitates a long-term commitment by the authorities; and the authorities have already indicated their readiness to work with the Fund in charting the adjustment road that lies ahead. By the same token, the success of the authorities' effort will require a commensurate commitment on the part of the donor and creditor community to assist Somalia in this endeavor. As the staff papers clearly indicate, Somalia's debt-servicing burden to multilateral organizations alone exceeds its expected total export earnings for 1988. The overdue obligations to the Fund are equivalent to about two thirds of export receipts. Under these circumstances, it is clear that a full settlement of the arrears to the Fund will have to be part of a coordinated financing package that will enable Somalia to become, and remain, current with the Fund, and at the same time ensure that the adjustment effort is supported by adequate assistance.

As Directors are aware, a meeting of Somalia's donors took place in London a few days ago. Although we have not yet received detailed information on the outcome of the meeting, we understand that it has been constructive. It is important, however, that any progress achieved in that meeting be followed up by the parties concerned. Fund management and staff will also have an important role to play in gathering the needed financial support.

With respect to the proposed decision, the wording of paragraph 3 may be counterproductive, as it could be interpreted as a signal to creditors and donors that it is too early for them to engage in any serious effort to assist Somalia. It would be more productive to recognize the important steps that have been taken and to urge the authorities to sustain and strengthen their adjustment efforts, as well as to note the forthcoming discussion on a medium-term framework of adjustment, which will constitute a basis for an intensified collaborative approach to the problem of Somalia's arrears to the Fund. This could be done if the first sentence of paragraph 3 ended with the word "direction," and the rest of the paragraph was replaced by a sentence that reads: "The Fund urges the authorities to sustain and strengthen their adjustment efforts, and notes that discussions will begin soon between Somalia and the Fund with the objective of developing a medium-term adjustment framework that would form the basis for an intensified collaborative approach to the problem of Somalia's arrears to the Fund."

I note with some interest the use of the term "critical creditors" on page 15 of EBS/88/190. The obligations due to these creditors, which in this case include the African Development Bank in addition to the Fund and World Bank, are assumed to be honored in the period up to end-1988. While this may not be the right occasion to discuss this general issue, I believe it is important that the matter be considered carefully before embarking on a new policy under which the Fund may appear to be deciding which multilateral institutions should be given priority. I am fully aware of the cash flow considerations that are involved, but the matter may have implications for the Fund's relations with other multilateral organizations that should not be overlooked. The staff paper on overdue financial obligations (EBS/88/123) discussed in the Board in July 1988 (EBM/88/107 and EBM/88/108) mentioned priority creditors in the context of shadow programs, but that concept, as it seems to have evolved, was not discussed at that time.

Mr. Rieffel noted that the staff paper on the Government's policies had not been circulated to Directors until less than a week previously and that copies of the staff's opening statement had not been available until the afternoon of the current discussion. Both of those documents had given rise to a number of questions, especially with respect to the contract for a wide-bodied aircraft that had been signed by Somalia a year previously. Rather than raising questions about that contract during the course of the current discussion, it might be useful for the staff to address those questions before the discussion began, so that Directors could bear those issues in mind.

From the information provided in the staff paper, it was not clear when Somalia had made payments for the aircraft it had agreed to purchase a year previously, Mr. Rieffel observed. He had received information indicating that that contract had been signed in September 1987, and the staff had said that $8 million had been paid against the purchase of a $60 million aircraft, but it was not clear when the payments were made. The timing of those payments was quite important, because it related to the timing of the accumulation of arrears to the Fund. In addition, it was not clear whether there was an amount still to be paid before Somalia could take delivery of the aircraft, or whether the amount the authorities needed to pay for delivery had been fully met, and it was just a matter of delivery. In addition, there was no indication of when the aircraft was scheduled to be delivered.

If the contract was signed in September 1987, it would have been inconsistent with the commitment of the Government under its stand-by arrangement with the Fund, which the Board had approved, in addition to an accompanying structural adjustment arrangement on June 29, 1988, three days before Somalia went into arrears to the Fund, Mr. Rieffel remarked. In addition, that stand-by arrangement had included a ceiling on nonconcessional borrowing, and he wondered whether that transaction would have been inconsistent with the agreed ceiling.

The staff representative from the African Department said that the staff did not have precise information about when the contract between the Somali Airlines and Airbus Consortium was signed, but it was the staff's understanding that the contract was signed in October 1987, and that the Government had paid $5 million at that time, followed by $2 million in April 1988, and $1 million in June 1988. The total amount that had been paid by Somalia so far was about $8 million, but the staff did not know the exact amount. For the aircraft to be delivered, another $1 million would have to be paid by the Somali authorities, bringing the total amount to $9.4 million before delivery. The delivery of the aircraft had been scheduled for October 1988, but postponed to March 1989.

As to the question of whether or not the purchase of the airbus was inconsistent with Somalia's stand-by arrangement with the Fund, the Government of Somalia had guaranteed the loan for Somali Airlines, which would be inconsistent with the terms of the stand-by arrangement, the staff representative remarked. However, Somalia had abandoned the stand-by arrangement in mid-September 1987, when it suspended the auction market for exchange.

Mr. Enoch wondered whether the staff had any information on the financing for the airbus purchase, and whether that financing had been guaranteed by an export credit agency. In addition, he wondered whether the staff had any information about whether the aircraft would generate foreign exchange profits or whether it would operate at a loss, draining the foreign exchange resources available to Somalia.

The staff representative from the African Department said that the staff did not have any information on whether the loan had been guaranteed by an export credit agency; it would certainly ask the authorities during the next staff mission to Somalia.

As to whether or not the new airbus would generate profits, Somali Airlines had been realizing profits over the past few years, the staff representative noted. In 1987, Somali Airlines's profits before taxes were approximately So. Sh. 600 million, and its total revenue had been approximately So. Sh. 6 billion. Gross foreign exchange receipts for Somali Airlines had been about $1 million. However, that figure did not take into consideration the purchase of fuel, which the Government imported and paid for in foreign currency. Taking imports of fuel into consideration, the net foreign exchange inflow from the airline would be about $0.6 million.

Mr. Adachi asked whether the Somali authorities could increase Somalia's ability to repay the Fund by selling or canceling the airbus contract.

The staff representative from the African Department explained that the Government of Somalia would have to pay about $8-9 million a year for the aircraft for the next 12 years. That represented about 10 percent of Somalia's export receipts, based on 1988 figures. Undoubtedly, payments for the aircraft would reduce the amount of foreign exchange available for servicing other debts, including payments to the Fund.

Mr. Goos asked what Somalia's net foreign exchange earnings would be after the aircraft was put into operation.

The staff representative from the African Department said that the staff did not have any information on the possible contribution the aircraft could make to Somalia's total foreign exchange earnings.

Mr. Rieffel made the following statement:

> The pattern of adjustment in Somalia over the past eight years has been one of fits and starts. In June 1987, a new reform effort supported by both a stand-by arrangement and a structural adjustment arrangement was begun. Three days after the Board approved those arrangements, Somalia fell into arrears to the Fund, and less than three months later, it completely abandoned its reform program.
>
> The alternative policies put in place by the Somali authorities in the fall of 1987 exacerbated imbalances and weaknesses in the economy, and the authorities began to reassess their policies at the beginning of 1988. A new adjustment push that is surprising in its scope and pace is currently taking place. We commend the authorities for this change of course, and we commend the staff for its success in helping the authorities see the advantages of comprehensive and early reforms.
>
> In general, my authorities support the approach being taken by the staff in this difficult case, and we regard the approach as basically consistent with the views of the Board, as reflected in its report to the Interim Committee on overdue financial obligations. More specifically, we believe the staff was right in emphasizing the need for immediate implementation of policy reforms by Somalia without waiting for the formulation of a fully financed program. Furthermore, it was appropriate to design an approach that assumes that arrears to the Fund would not rise above the level prevailing at end-June 1988. In addition, we agree that the staff should return to Somalia in October 1988 to begin work on a medium-term framework, and to refine the content of a program for 1989.

Extensive commentary on Somalia's policies is not necessary, as they are thoroughly covered in the staff paper, and we generally concur with the staff. The budgetary measures that have been taken are a major step in the right direction, but we remain concerned about the level and composition of expenditures. Monetary policies have been substantially improved, but we remain concerned about the negative real interest rates, and about the financial situation of the commercial bank. The new exchange rate system appears to be working smoothly, but further adjustments will be needed to improve the competitiveness of Somalia's exports. We are especially pleased with the structural measures that have been announced over the past few months. We have the impression that Somalia is generally at the stage in its structural reform efforts that was expected under the structural adjustment arrangement approved in 1987, and is perhaps further ahead than that in a number of areas.

The list of measures provided in Attachment I of the staff paper is impressive, and we understand that all the measures that were to be implemented by September 15, 1988 have been implemented with one exception--the appropriate disposition of the airbus contract. My authorities are very concerned about this contract. We are troubled by the fact that it represented a major violation of the limit on nonconcessional borrowing contained in the stand-by arrangement that was in effect at the time the contract was signed, and the fact that payments were being made to initiate this transaction at a time when Somalia was incurring arrears to the Fund. We note that financing for the airbus is not included in the staff's balance of payments projections for 1988 or for the medium term. We would appreciate some more information on the implications for external financing and eliminating arrears to the Fund if the contract is not canceled.

On the assumption that proceeding with the purchase of this--or any comparable--aircraft would significantly increase the financing gaps identified in the policy framework paper covering the period 1989-91, my authorities consider that this investment calls into question the feasibility of arranging external financing to support a medium-term program that is strong in all other respects. We urge the authorities to work quickly to find ways, other than the purchase of new aircraft, to upgrade the fleet of the national airline and we were pleased to note, from the staff's opening statement, that the authorities have asked the World Bank to help in this regard. Moreover, we presume that the governments participating in the Airbus Consortium attach great importance to helping Somalia eliminate its arrears to the Fund, and would, therefore, support the staff on this matter. More generally, we view the case under discussion to be an example of how lending decisions by well-intentioned creditors can interfere with the treatment of the Fund as a preferred creditor and undermine the efforts of the Fund and the World Bank to help member countries formulate and implement economic programs leading to sustained growth and balance of payments viability. In dealing with countries in arrears to the Fund, it is especially important to avoid working at cross-purposes. Thus, we support the cautious approach being taken by the staff.

The Board's report to the Interim Committee on overdue financial obligations refers specifically to the possibility of establishing support groups to help ensure that the external financing needed to clear arrears and support strong programs materializes in a timely fashion. An early resolution of the aircraft problem would make it easier to establish such a group for Somalia.

We would be receptive to some modifications of the proposed decision to better reflect the specific circumstances of the case under discussion. In addition, the staff should prepare a brief report to the Board on developments in Somalia following its discussions with the authorities in October 1988. This report should cover the status of measures being implemented in the remainder of 1988, the progress made in negotiating a policy framework paper and in formulating a program for 1989, the progress made in making payments to the Fund as they become due, and any developments with respect to the Airbus contract. We would not anticipate a need for the Board to discuss the report, which might be issued roughly mid-way between now and the next formal review of Somalia's overdue obligations, although a discussion could, of course, be requested by an Executive Director.

Mr. Enoch made the following statement:

The staff papers under discussion indicate that, since the previous discussion on the 1988 Article IV consultation with Somalia (EBM/88/99, 6/24/88), Somalia has made significant moves toward the implementation of a program of adjustment that will provide a sustainable basis for the clearance of arrears. Important measures, both macroeconomic and structural, have been implemented and are planned; and a commitment has been made to avoid the accumulation of further arrears. These developments are welcome. They are certainly very timely. The arrears problem in Somalia is in its relatively early stages, and it would provide a useful spur to the Fund's handling of the arrears problem if an ineligible member, such as Somalia, could be set firmly on the road to settling its obligations. If Somalia's current policies can be consolidated into a comprehensive adjustment program within the scope of a policy framework paper, and if the authorities can live up to their commitment to stay current on future Fund arrangements, the Fund should offer a positive response in the spirit of intensified collaboration. At the donors' meeting on September 9, 1988, my authorities indicated a willingness to support a shadow program through cofinancing World Bank lending once the World Bank approves that plan.

However, at this crucial stage, it has been discovered that the authorities have compounded their own problems by contracting a substantial external loan on commercial terms, despite a debt service ratio of 156 percent after rescheduling, for an aircraft for the national airline. This seems particularly regrettable in that down payments were made on the aircraft--equivalent to 10 percent of annual export earnings--while arrears were accumulating to the Fund, with only SDR 0.1 million having been paid since the declaration of ineligibility. There must be doubts about whether the arrangements being put in place to rescue Somalia from its arrears problem can succeed, given the burden of the proposed aircraft purchase, not to mention the unfortunate signal that that purchase will send to donors and the doubts it creates about the authorities' commitment to cooperate with the Fund. If the purchase cannot be shown to be viable in terms of generating foreign exchange, the authorities should reconsider whether they need this aircraft, or whether they can identify alternative ways to save this foreign exchange. I welcome the information in the staff's opening statement that the authorities have asked the World Bank to undertake an analysis of alternatives to the purchase of new aircraft to upgrade the fleet capacity of the national airline, such as through leasing second-hand aircraft. In light of the fact that delivery is expected at an early date, there may be scope for using an aircraft broker to sell their contract. My authorities stated during the September 9, 1988 donors' meeting that they are willing to consider funding an expert under their technical assistance program to examine options that might be available to the authorities in this area.

Somalia's track record of cooperation with the Fund has not been impressive. I hope that on this occasion the authorities will adhere to their present undertakings. If they do, the timetable in the staff papers for further progress toward clearing arrears appears to be realistic, in particular the intention to formulate a policy framework paper by the end of 1988, and to introduce a shadow program at that time. The staff paper notes that if the shadow program leads to a structural adjustment arrangement, it could be made for 30 percent of Somalia's quota. However, I hope that the measures the Somali authorities would be prepared to take would in time justify access to the enhanced structural adjustment facility, which would provide substantially more resources. By that time, Directors will hopefully have reached agreement on retroactive access to the enhanced structural adjustment facility for countries demonstrating strong commitment, and a good track record.

With respect to the proposed decision, I recognize that the Fund will be reviewing its procedures concerning overdue obligations and, until then, many Directors do not wish to spend time redrafting decisions. I am willing to go along with the consensus in support of the draft decision, but ask the Board to consider two amendments. First, the Board should note and welcome the authorities' commitment to stay current on future obligations to the Fund. Second, it should note and welcome the authorities' intention to negotiate a policy framework paper by the end of 1988. These are key elements in the arrangements to rescue Somalia from its arrears problem, and it is, therefore, appropriate to note them in the Board's decision. In addition, I support Mr. Rieffel's suggestion for the staff to report to the Board on its October 1988 consultations with the authorities.

Mr. Faria said that, although Somalia's track record had not been as satisfactory as desired, the authorities had recently begun to implement substantial corrective measures--as Mr. Finaish had highlighted--to contain the economic and financial deterioration and resume economic growth, which should enable Somalia to meet its obligations, particularly to the Fund, in a more timely fashion. He hoped that the forthcoming review of the implementation of policy measures in Somalia which was scheduled to take place in October 1988 would lead to an agreement between the Fund and Somalia on a comprehensive program of adjustment, that would have the support of the Fund and would help Somalia find a way to settle its arrears expeditiously.

He welcomed the authorities' intention to pay all forthcoming obligations to the Fund and to ensure that overdue financial obligations to the Fund at end-December 1988 did not exceed the level prevailing at end-June 1988, Mr. Faria commented. In that sense, he supported the amendments to the second paragraph of the draft decision proposed by Mr. Enoch. In addition, he strongly supported the amendment to the third paragraph of the draft decision proposed by Mr. Finaish, for the same reasons that had been put forward by Mr. Finaish.

Besides urging Somalia and other countries in arrears to meet their obligations, Mr. Faria concluded, the Fund and the international community should assist those countries and help create conditions that would enable them to settle their arrears to the Fund and remain current in their obligations.

Mr. Al-Assaf stated that his authorities regretted Somalia's continued nonobservance of its financial obligations to the Fund. The failure of Somalia to settle those arrears increased the burden on other users of

Fund resources that were current in their payments. Therefore, he urged the authorities to give the highest priority to settling Somalia's arrears to the Fund.

Without minimizing the seriousness of the problem, the situation of Somalia was more promising than it had been a year ago, when the authorities had decided to reverse the policies adopted in early 1987 in conjunction with the Fund-supported programs, Mr. Al-Assaf noted. According to Mr. Finaish and the staff, the authorities were implementing measures aimed at stabilizing the financial situation and holding off the economic decline, which could provide the basis for a more comprehensive program of adjustment. As to the latter program, he looked forward to a staff report on such a comprehensive program, or even better, a discussion of a policy framework paper for Somalia in early 1989.

Another encouraging factor was the commitment of the authorities not to increase the level of overdue obligations in December 1988 from the level prevailing at end-June 1988, and more important, their intention to settle those obligations, Mr. Al-Assaf commented. The Board should recognize a member's willingness to settle its arrears to the Fund, and, for that reason, he supported the proposed decision with the amendments proposed by Mr. Finaish and Mr. Enoch.

Mr. Noriega said that he shared Mr. Finaish's concern about the economic situation in Somalia. Indeed, the economic troubles were extremely pressing, but unfortunately the civil unrest in the northern region precluded bolder actions on the economic front. The scope for maneuver was, therefore, much reduced.

It was heartening to note that the authorities had once again modified the thrust of their policies and were seeking closer collaboration with the Fund, Mr. Noriega remarked. The measures being adopted, as outlined by Mr. Finaish, and the economic program for the second half of 1988 constituted a serious step toward regaining control of the economy. However, that program was clearly unsustainable, because the planned domestic adjustment was insufficient to redress the decline in the economic situation and, at the same time, service foreign debt.

While foreign support was indispensable, past policy slippages, difficulties in coordinating foreign support, and even open departures from the guidelines agreed by the Fund and Somalia, led his authorities to have reservations about the short-term prospects for the Somali economy, Mr. Noriega continued. The authorities would have to provide the Fund with clear and continuous signals of their commitment to the current course, before they could elicit more external financial and technical support. In that context, his authorities considered the clearance of arrears to the Fund to be of paramount importance.

Mr. Rebecchini stated that he joined previous speakers in commending the authorities for the policy measures that had been recently introduced, as mentioned by Mr. Finaish. Those measures represented difficult policy decisions and a substantial step in the right direction.

However, he agreed with the staff's evaluation that, so far, those measures fell short of what would be required under a Fund-supported program, Mr. Rebecchini commented. Additional efforts were needed particularly in the fiscal area. Corrective action should be taken with respect to many aspects of the budget, as previous speakers had outlined.

His authorities appreciated the Government's intention to tackle structural issues, and the recent measures that had been introduced in that connection were welcome, Mr. Rebecchini remarked. He looked forward to the completion of plans to reform nonviable enterprises and the banking system, and he hoped that those plans would include precise timetables for implementation.

As to the purchase of the new aircraft, he fully shared the concerns of the staff, given the additional significant burden that purchase placed on Somalia's existing debt obligations, Mr. Rebecchini continued. In addition, he agreed with most of the comments made by Mr. Rieffel. The fact that an early resolution of the contract would facilitate the establishment of a support group for Somalia should be underscored. He supported the amendment to the second paragraph of the draft decision proposed by Mr. Enoch.

Mr. McCormack commented that his chair was disappointed that Somalia had not yet been able to eliminate its arrears to the Fund. Since the small payment made around the time of the Article IV consultation with Somalia in June 1988 (EBM/88/99), no further payments had been received from Somalia, and its arrears to the Fund and other creditors had continued to accumulate rapidly. The economic situation urgently required resolute action to redress financial imbalances, and thus, lay the basis for the elimination of all arrears. Therefore, the news that, as a forerunner to a more comprehensive program of adjustment, the authorities were implementing measures intended to stabilize the financial situation was welcome. In addition, the authorities' intention to make payments to the Fund, which would prevent arrears from rising above the level prevailing at end-June 1988, would provide added evidence of their willingness to cooperate with the Fund.

Somalia's recent track record of economic management was marked by the weak implementation and sometimes erratic shifts in the direction of economic policy, Mr. McCormack considered. The magnitude of imbalances, including heavy, debt-servicing commitments and large financing gaps projected over the medium term, made it vital for Somalia to quickly adopt a credible adjustment path. The program outlined in EBS/88/190 seemed broadly appropriate as a first step in that direction.

His authorities attached particular importance to the early adoption of a realistic exchange rate and to improved budgetary management, which had been a major source of structural weakness in the Somali economy, Mr. McCormack went on. The flexible approach being implemented for exchange rate management was welcome. In addition, he supported efforts to strengthen tax collection, especially through greater emphasis on tax administration. However, that effort must be complemented by radical improvement in expenditure management. In that connection, the authorities needed to carefully assess their priorities within the context of severely limited resources if a better allocation was to be achieved.

In light of the debt management problems, like other Directors, he had been surprised by the authorities' decision to undertake the purchase of an aircraft under financial conditions that could place added pressure on both the fiscal and external accounts, Mr. McCormack commented. A review of that decision was warranted, and he welcomed the staff's indication of a proposed analysis by the World Bank.

If Somalia was to obtain the confidence of the financial community in pursuing of its objective of achieving a sustainable balance of payments position and long-term growth, the authorities would need to demonstrate a commitment to the sustained implementation of a program of sound economic management, Mr. McCormack stated.

As to the proposed decision, he could support the amendments suggested by Mr. Finaish and Mr. Enoch, Mr. McCormack concluded. However, with respect to the amendment put forward by Mr. Finaish, it might be more appropriate to indicate that the development of a medium-term framework could--as opposed to would--form the basis for an intensified collaborative approach.

Mr. Adachi said that his authorities welcomed the recent adjustment efforts made by the Somali authorities as a first step. However, those measures would not provide a sufficient basis for sound economic management. Once again, he urged the authorities to redouble their efforts toward comprehensive adjustment.

With respect to the purchase of a new aircraft, he shared the serious concern expressed by Mr. Rieffel, Mr. Adachi continued. The authorities should take appropriate action on that issue, as suggested by Mr. Enoch.

He supported the proposed decision, with the amendments suggested by Mr. Enoch, Mr. Adachi concluded. In addition, he supported the amendment proposed by Mr. Finaish, as amended by Mr. McCormack, since Mr. Finaish would convey to the authorities the view that the measures taken, thus far, fell short of the comprehensive adjustment program which could provide a sufficient basis for the intensified collaborative approach. He sympathized with Mr. Noriega's concern that the Board's report on the approach to overdue financial obligations to the Fund had not yet been submitted to the Interim Committee, but would go along with the majority of the Board on the matter.

Mr. Finaish thanked the Directors for their interest in Somalia and for their advice.

With respect to the contract for the airbus, the authorities understood creditors' concerns about the foreign exchange budget, particularly at a time when the authorities were seeking aid on concessional terms, Mr. Finaish commented. However, the contract had already been signed, and it was clear that canceling the contract would have political implications with respect to questions of sovereignty, as well as having financial and legal implications. Somalia had already paid $8 million for the airbus; and that payment would be lost if the contract were to be canceled. As the staff had made clear, however, the authorities were considering alternatives, and they had been in touch with the World Bank. The matter needed to be considered carefully. As Mr. Goos had pointed out, the foreign exchange earnings that the additional airbus could generate as compared with the costs involved was a relevant question. The Somali authorities had been in contact with the Fund's management on the airbus issue. They were not withholding any information from the Fund; in fact, the head of Somali Airlines had met with the Fund staff, particularly from the African Department, concerning that matter.

The Acting Chairman noted that Directors had agreed to amend the second paragraph of the draft decision along the lines proposed by Mr. Enoch. However, with respect to Mr. McCormack's suggestion to amend the proposal by Mr. Finaish to replace the word "could," with the word "would," he asked Directors whether they had any comments concerning the wording of paragraph 3.

Mr. Rieffel and Mr. Prader indicated that they considered the word "could" to be most appropriate.

The staff representative from the Treasurer's Department said that it would be preferable to use the word "could," because the Fund was noting that discussions between the staff and the authorities were going to begin, but there was no certainty about the result of those discussions.

Mr. Enoch pointed out that the word "could" had two different connotative meanings: first, that the discussions between the authorities and the staff would be aimed at developing a medium-term framework that "might" form the basis of an intensified collaborative approach, and the second, that "the authorities and the staff would be able to" form the basis of such an approach. From that standpoint, he had a slight preference for Mr. McCormack's proposal to use the word "could."

However, the Fund was urging the authorities to begin discussions that would form the basis for an intensified collaborative approach, Mr. Enoch explained. Use of the word "would" would indicate that the Fund was urging the authorities to do as much as possible--in other words, to develop a medium-term framework that was so strong that it would form the basis for such an approach.

Based on those connotative meanings, Mr. Enoch concluded, he could support either wording.

Mr. Finaish said that his primary concern was that he did not want the Somali authorities to receive the impression that if they put forth the greatest possible effort and reached an agreement with the Fund concerning the medium-term framework, that effort only "might" result in an intensified collaborative approach. He did not want to send the Somali authorities a signal that the results of their efforts might be uncertain.

After a further brief discussion, the Executive Board took the following decision:

1. The Fund has reviewed further the matter of Somalia's continuing failure to fulfill its financial obligations to the Fund in light of the facts and developments described in EBS/88/191 (9/9/88).

2. The Fund deeply regrets the continuing failure by Somalia to fulfill its financial obligations to the Fund, which are placing a financial burden upon other members and reducing Fund resources needed to help others. While welcoming the modest payment made by Somalia since the declaration of ineligibility, the Fund notes that this represents only a modest effort on the part of Somalia to meet its financial obligations to the Fund. The Fund welcomes Somalia's intention to ensure that its overdue financial obligations do not exceed the level of end-June 1988 but, nevertheless, continues to urge Somalia to make full and prompt settlement of its arrears to the Fund the highest priority and to take all necessary actions in this respect.

3. The Fund welcomes the economic measures implemented recently by Somalia as important initial steps in the right direction. The Fund urges the authorities to sustain and strengthen their adjustment efforts and notes that discussions will begin soon between Somalia and the Fund staff with the objective of developing a medium-term adjustment framework that would form the basis for development of an intensified collaborative approach to the resolution of the problem of Somalia's arrears to the Fund.

4. The Fund notes that the Interim Committee will be discussing the Executive Board's report on overdue financial obligations to the Fund in September 1988. The Fund will review the matter of Somalia's overdue financial obligations to the Fund again and consider further action within four months from the date of this decision in light of those discussions and of actions taken by Somalia in the meantime to settle its arrears to the Fund, and to formulate and begin implementing a comprehensive economic adjustment program.

Decision No. 8983-(88/148), adopted
September 14, 1988

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/88/147 (9/14/88) and EBM/88/148 (9/14/88).

3. NICARAGUA - 1988 ARTICLE IV CONSULTATION - POSTPONEMENT

Notwithstanding the period of three months specified in Procedure II of the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, as amended, the Executive Board agrees to extend the period for completing the 1988 Article IV consultation with Nicaragua to not later than October 24, 1988. (EBD/88/250, 9/12/88)

Decision No. 8984-(88/148), adopted
September 14, 1988

4. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to Executive Director as set forth in EBAP/88/225 (9/9/88) and Correction 1 (9/12/88).

Adopted September 14, 1988

APPROVED: April 4, 1989

JOSEPH W. LANG, JR.
Acting Secretary