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0404

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/153

10:00 a.m., November 6, 1987

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	E. T. El Kogali
	Yang W., Temporary
C. H. Dallara	A. Rieffel, Temporary
	J. Prader
	G. Seyler, Temporary
A. Donoso	
	I. Zaidi, Temporary
	B. Goos
J. E. Ismael	
	J. E. Zeas, Temporary
	C. Enoch
	M. Fogelholm
	I. Puro, Temporary
	W. N. Engert, Temporary
Mawakani Samba	
	A. Ouanes, Temporary
	E. Ayales, Temporary
H. Ploix	
G. A. Posthumus	G. P. J. Hogeweg
C. R. Rye	C.-Y. Lim
G. Salehkhou	M. A. Hammoudi, Temporary
A. K. Sengupta	L. E. N. Fernando
K. Yamazaki	M. Sugita
S. Zecchini	

L. Van Houtven, Secretary and Counsellor
J. K. Bungay, Assistant
S. Woolls, Assistant

Also Present

IBRD: N. L. Hicks, Asia Regional Office; V. Nehru, Africa Regional Office. African Department: A. D. Ouattara, Counsellor and Director; G. E. Gondwe, Deputy Director; D. T. S. Ballali, E. A. Calamitsis, P. Dhonte, I. Kapur, P. Mylonas, R. L. Sharer, W. M. Tilakaratna, R. H. van Til, R. C. Williams. Asian Department: H. Neiss, Deputy Director; D. J. Goldsbrough, E. Gurgen, R. J. Hides, E. A. Milne, B. Nijathaworn, A. Singh. Exchange and Trade Relations Department: S. J. Anjaria, J. Berengaut, E. Brau, L. Hansen, H. B. Junz, P. Leeahtam, K. P. Regling, P. Thomsen. External Relations Department: N. Worth. Fiscal Affairs Department: T. Catsambas, S. K. Chand. IMF Institute: O. B. Makalou; M. A. Bernardo, Participant. Legal Department: P. L. Francotte, J. M. Ogoola. Treasurer's Department: D. V. Pritchett. Advisors to Executive Directors: K.-H. Kleine, G. Pineau, I. Sliper, D. C. Templeman, K. Yao. Assistants to Executive Directors: R. Comotto, E. C. Demaestri, S. K. Fayyad, V. J. Fernández, C. L. Haynes, M. Hepp, L. Hubloue, A. Iljas, S. King, M. A. Kyhlberg, V. K. Malhotra, T. Morita, D. V. Nhien, W. K. Parmena, L. M. Piantini, S. Rebecchini, S. Rouai, V. Rousset, D. Saha, G. Schurr, C. C. A. van den Berg, H. van der Burg, R. Wenzel.

1. PHILIPPINES - SECOND REVIEW UNDER STAND-BY ARRANGEMENT

The Executive Directors considered the staff paper for the second review under the 18-month stand-by arrangement with the Philippines approved on October 24, 1986 (EBS/87/204, 9/30/87; Sup. 1, 10/7/87; and Sup. 2, 10/30/87).

Mr. Rye made the following statement:

My authorities are in agreement with the staff appraisal, and reiterate their determination to put in place the remaining components of the Fund program and the structural reforms to which they are committed. As the staff report has indicated, elements of the structural reform were effected ahead of schedule, where possible.

On the macroeconomic side of the program, real growth reached 5.1 percent in the first half of 1987, while inflation was held to less than 3 percent in the year to September and external reserves were maintained at the equivalent of three months' imports of goods and services. These achievements are significant, especially considering the unfavorable external environment, with rising oil prices and interest rates and delays in expected inflows of foreign investment and external assistance.

As the staff has rightly pointed out, the growth can be traced to a large degree to the structural improvements already implemented, which eliminated monopolistic practices and boosted rural incomes. Structural reforms have also been aimed at removing the rigidities that have hampered more efficient private investment--though the response has been muted by the persistence of political uncertainties.

The continued weakness in private investment and the increasing manifestations of social tension reflect the dislocation generated by the masive decline in economic activity just two years ago and the social costs involved in the authorities' efforts to bring the economy back on the track of sustainable and stable economic growth through a combination of prudent demand-management measures and major structural reforms. My authorities are disappointed that external support in terms of new money flows, specifically official transfers, has not been commensurate with their efforts to re-establish normal economic relationships with the rest of the world. The shortfall, together with weaker than projected prices for and volumes of some traditional exports, which were only partly offset by exceptionally strong growth in nontraditional exports, largely explain why the end-June floor on net international reserves specified in the stand-by arrangement was breached.

Despite such problems, my authorities regard it as imperative to proceed as rapidly as possible in developing a solid foundation for the Philippine economy, based on market competition, minimum government intervention, and the creation of a favorable climate for private sector initiatives.

My authorities' efforts toward these ends are adequately presented in the staff report and the broad principles on which these efforts are based are contained in their Memorandum of Economic Policy (EBS/87/204). I shall highlight only the more significant elements.

In regard to monetary policy, while the acceleration of inflation toward the second half of 1987 was expected, and can be attributed in large part to external shocks, the authorities have opted to keep monetary expansion at a rate lower than originally planned to avoid a rekindling of inflationary expectations. They are therefore asking for a lowering of the ceiling on base money to discourage speculative demand for imports. The efficiency of the Central Bank's open market operations has been enhanced through a more rapid retirement of the Bank's certificates of indebtedness to allow for a quicker development of treasury bills as the main staple of these operations.

On fiscal policy, the comprehensive tax reform which began in 1986 is virtually completed. Only the shift to the value-added tax system remains; this is scheduled to be implemented beginning January 1988. The continuing process of consolidation in the public sector has minimized the administrative constraints on a quicker implementation of public sector expenditures to improve the livelihood of the rural population; the process has also enhanced the probability that the public sector investment target of 5 percent of GNP for 1987 will be achieved notwithstanding initial snags.

In addition, my authorities have reiterated their commitment to maintaining an unregulated exchange market to enhance competitiveness vis-à-vis major regional competitors.

In the area of structural reform, trade liberalization has proceeded at a faster rate than planned: 21 import products originally scheduled for liberalization in end-December 1987 were included in the list of items liberalized in July 1987, and four other items scheduled for liberalization by April 1988 have been included in the list to be liberalized effective end-October and end-December 1987.

Reforms of the govenment financial institutions, which involved the shedding of excess manpower and a reduction in the number of branches, domestic and foreign, have resulted in a return to profitability of these institutions, effectively reducing their demand for public funds and enhancing the prospects of complete privatization of the Philippine National Bank through public stock offerings.

Further progress has been made in the privatization of government corporations. It is important to note here the Government's acceptance of a realistic appraisal of a realizable value of 25 percent of the almost $7.5 billion of nonperforming assets to be disposed of--although, in fact, the recovery rate so far has been around 63 percent.

In sum, despite adverse external factors and political uncertainties, my authorities have kept to their agenda of economic reform. As the supplement issued by the staff has indicated, the political disturbances in late August necessitated certain measures which impinged on the external targets of the program. My authorities took these measures to forestall a possible buildup of massive speculation. Indeed, while the exchange rate appeared to be in line with the economic fundamentals, particularly the developments in trade, there was a substantial widening of the differential between the official and the parallel exchange market rates immediately after the disturbances. As a result of the measures taken by the authorities, this differential has narrowed substantially, with official rates rising and parallel rates falling. In addition, some of the official transfers earlier delayed have now come to hand.

For reasons given by the staff in its report, my authorities are asking for a modification of the net international reserves performance criterion for September and December 1987, an increase in the public sector borrowing requirement (PSBR) and a lowering of base money ceilings and performance criteria for December 1987.

In the face of many difficulties, at home and abroad, the Government of the Philippines is continuing to make vigorous progress with its economic reforms. It deserves, in my view, the full support of the Board.

Mr. Yamazaki said that he was pleased that the adjustment program was generally on track. Although some modifications to the performance criteria had been requested by the authorities, the reasons given were convincing, and he warmly supported the proposed decision.

The authorities' program, which emphasized both adjustment and growth, was bearing fruit, Mr. Yamazaki noted. Real GNP had picked up, and some favorable signs could be seen in private investment. In addition, consumer expenditures were recovering, because of the measures that had been taken to remove the bias against rural development and agriculture. The achievements in structural reform were encouraging. Excessive government intervention and monopoly had already been significantly reduced in many important areas. The reform of the government financial institutions was generally on, or ahead of, schedule, and the financial surplus for 1989 was likely to be larger than originally expected. Import liberalization, which would contribute to export diversification by strengthening the international competitiveness of the economy, was also ahead of schedule. Those results reflected the authorities' commendable efforts. However, it was apparent that the recovery of private and foreign investor confidence was crucial to increasing investment and was therefore still a key factor in the success of the program. Therefore, he hoped the authorities would continue their efforts to consolidate the initial good impetus in that area.

Among the many important public sector reform measures, the expenditures associated with the agrarian reform program were particularly noteworthy, Mr. Yamazaki commented, and it was unfortunate that the details of that program had not yet been specified. He looked forward to seeing the detailed measures and timetables at an early date. As to the effort to improve the financial position of public enterprises, some progress had been achieved: the two major government financial institutions, the Philippines National Bank and the Development Bank of the Philippines had been reformed significantly, and subsidies to public enterprises were being made explicit through the elimination of tax exemptions. Those developments were welcome, but it was hoped that the authorities would take further measures to cut the subsidies to alleviate pressure on the public sector borrowing requirement.

The authorities' monetary policy could, in principle, support private sector investment, Mr. Yamazaki remarked. At the same time, the desired economic recovery should be achieved not through expansionary fiscal and monetary policies, but rather through market-oriented structural reforms. Private sector credit had grown rapidly in the first half of 1987, and a 19 percent increase was targeted for the year as a whole. Concurrently, there had been a slight increase in the rate of inflation, and a cautious approach to credit policy might therefore be suitable. The flexible manner in which the authorities were tightening the base money ceiling for December 1987 was welcome.

Although the overall balance of payments deficit was estimated to be larger than expected, owing to the disappointing level of loan disbursements, it was heartening to know that the trade balance was almost in line with the program target, Mr. Yamazaki added. However, caution was still required in monitoring balance of payments developments. The external position was still vulnerable, and the authorities remained dependent on debt rescheduling to close the financing gap. Moreover, the medium-term outlook for traditional primary commodity prices was not very encouraging. Pressure on the balance of payments was likely to increase as the economy recovered; therefore, the authorities should avoid excess domestic demand by implementing appropriate fiscal and monetary policies and adhering to a flexible exchange rate policy to ensure the international competitiveness of the economy.

Mr. Ismael made the following statement:

I support the proposed decision. I am pleased to observe improvement in the general performance of the economy under the program, and I am particularly impressed by the turnaround of economic activity since mid-1986. Despite the adverse effects of the drought on the agricultural sector, the economy continued to recover during the first half of 1987, because of the significant improvements in the manufacturing, services, and construction sectors. It is also encouraging to note signs of a turnaround in private investment, as reflected in the doubling of applications for new equity investment and the rebound in the private sector demand for bank credit. These improvements have been achieved with a limited impact on the rate of inflation and the balance of payments.

The progress achieved so far can be attributed to the authorities' implementation of the comprehensive adjustment measures under the program, including structural reforms. All the quantitative performance criteria for end-March and end-June 1987 were met, with the only exception being the end-June floor on the monetary authorities' net international reserves. The failure to meet this criterion was not attributable to a laxness in policy implementation, but to various exogenous factors, such as lower than expected official transfers, weaker than expected export prices, shortfalls in receipts under the Economic Support Fund of the United States, and shortfalls in medium- and long-term lending. I regret that because of these factors, the authorities were unable to make the fifth purchase under the stand-by arrangement, and I support the request to lower the floor on net international reserves for September and December 1987 to reflect recent developments in the external sector. Because the deterioration was mainly due to unanticipated movement in the capital account, and since the trade accounts remained broadly on track, I also approve a waiver for end-September 1987--if it is needed, the authorities request it, and the other performance criteria are met. The availability of Fund resources would significantly help the authorities to implement adjustment measures under the program.

I support the request to increase the December 1987 ceiling on the public sector borrowing requirement to accommodate the increase in the government deficit that resulted from the shift in net interest costs associated with the accelerated substitution of treasury bills for central bank bills, which was not included in the program projections, and is expected to improve the efficiency of treasury bill auctions.

With regard to the monetary program, I agree with the staff that continued priority should be given to keeping inflation under control and to easing pressure on the balance of payments. While I continue to believe that more flexibility is needed in selecting and setting monetary targets for developing countries, I support the proposal to lower the ceiling for base money for end-December 1987. I hope that the authorities will not have undue difficulty in meeting this target in the future.

Mr. Ayales made the following statement:

My authorities support the decisions recommended in the staff paper, including modifications to performance criteria under the program, since the Philippine authorities remain committed to the program and the basic policies seem to be on track. The nature of the two main modifications, namely, to the ceiling on public sector borrowing requirement and to the target for net international reserves, is clear. With respect to the former, the adjustment in interest charges will reflect the Government's financial situation more realistically. As to the request to lower the floor on net international reserves, it is clear that the lower than expected disbursements of official transfers were largely beyond the control of the Philippine authorities.

The performance thus far under the stand-by arrangement seems to be satisfactory. The impressive reactivation of the economy--one of the main objectives of the economic program--is very encouraging: it is expected that the rate of growth for the year will exceed the level estimated at the time of the first review in April 1987. Although the rate of inflation is higher than it was during the second half of 1986, it remained very moderate; this is a clear indication of prudent monetary management and, given the dynamic changes being experienced by the Philippine economy, it is a significant accomplishment. I welcome the efforts to improve financial intermediation, as a means of supporting investment activity.

I commend the authorities for the financial performance of the public sector during the first half of 1987: both the government deficit and the combined deficit of the nonfinancial public corporations were below the programmed levels, in spite of shortfalls in both revenues and expenditures. Full implementation of the fiscal reform, however, should contribute to a lowering of the deficit to GDP ratio to more manageable levels in the near future.

With respect to the external accounts, the weaker than expected balance of payments outcome for the first half of 1987 is worrisome. However, this outcome appears to have been caused by factors largely beyond the control of the Philippine authorities. While the shortfall in official transfers explained most of the deterioration in the current account--the trade balance remained on track--the capital account was significantly affected by lower than expected medium- and long-term capital inflows. This, in turn, has affected medium-term projections. In fact, the residual financing gap after debt rescheduling will average over $1 billion annually for the next four years and will have to be financed by the resumption of spontaneous new lending. My authorities are extremely concerned about this situation for two reasons: if economic growth is to remain robust, further import growth may be necessary, and recent developments in international capital markets may cause slower growth of international trade, which could impinge on both export volume and the price of raw materials. In addition, my authorities concur with the staff's view that, although adequate external financing is indispensable for the success of the country's adjustment and growth efforts, the resumption of spontaneous lending depends very much on the stabilization of the domestic political situation.

Under the present circumstances, international support may contribute to improving private sector confidence, thus stimulating badly needed domestic and foreign private investment. Although investment is expected to grow at a very satisfactory rate of 23 percent during 1987, the stock of capital will not fully recover from previous falls. It is clear that the Philippine authorities are making strenuous efforts to improve the environment for investment, and the measures they are taking to tackle the economy's deep-seated structural problems are an important step in the right direction. My authorities are impressed by the significant improvement achieved in the rehabilitation of the two major government banks, the import liberalization program, the fiscal program containing revenue and expenditure reforms, and the comprehensive reform program for the privatization of public corporations. These initiatives have played a crucial role in the revival of the economy and are setting the stage for continued success in economic performance in the near future.

Given the authorities' commitment to the economic program, the support of the international financial community may significantly contribute to the successful implementation of substantial structural reforms, which are the cornerstone of the present development strategy.

Mr. Fernando made the following statement:

At the first review under the stand-by arrangement in April 1987, this chair reaffirmed its support for the stand-by arrangement, encouraged by the conviction that the Philippines is a prime example of adjustment with growth. Economic recovery is now a fact, and a continuation of this progress is expected. The authorities have demonstrated their continuing commitment to fundamental reform, and their strong and comprehensive effort deserves greater recognition by official and private creditors through a better timed and more adequate financial support package. The staff paper draws attention to shortfalls in reaching certain targets in the context of lower than expected support from foreign creditors. Without fuller support from all parties, the growth momentum would be at risk and could undermine the adjustment program. This chair's principal concern with respect to the adjustment effort is the inadequacy of the investment effort. The scope for private sector activity has been greatly expanded through macroeconomic adjustment, changes in structural policies, the low value of the peso, and freer access to imported components and technology. My authorities have noted the higher level of credit availed by the private sector according to the latest available data. I wonder if this level of credit is investment oriented, and whether it signifies less uncertainty about the political situation. If the lack of political stability is still an important impediment to private domestic and foreign investment, perhaps greater room should be provided for an enhanced impetus through public sector investment. I agree with the staff that, despite the political factor, the authorities should persevere in addressing areas of policy that are supportive of private enterprise.

Another cause for concern is the fact that even maintenance expenditure has been affected by the general restraint on public sector expenditure. This problem has to be remedied quickly, because the lack of maintenance will directly contribute to reduced efficiency and rapid obsolescence. Although the current recovery has been facilitated by the room for increased capacity utilization, sustained future growth requires new investment. The authorities have projected growth for 1988 at 6.5 percent, and the staff should comment on the growth sectors underlying this projection.

The authorities are to be commended for the formulation of detailed plans for privatization, and implementation is under way. However, public response to these investment opportunities is likely to be affected, as was private investment, by the continuing lack of confidence in the political system. The large supply of treasury bills in the market would also be competing for available public savings. I wonder what the capital market's capacity to respond to the Government's privatization drive would be if the political factor were ignored. These developments should be carefully assessed to determine the extent to which they may interfere with privatization and other necessary adjustments.

> The recent acceleration of prices should be carefully watched. Even though the growth of broad money was below target rates, the high level of currency holdings and large outward capital movements call for moderating policies. I sympathize with the authorities who face a dilemma with respect to capital flows. Until now, there has been great concern about defending the exchange rate based on the assumption that the outflows could be reversed. However, since the level of international reserves was inadequate for this extra function, there may be no alternative but to allow a market clearing rate to develop. My authorities support the proposed decision, including the modifications of the performance criteria for net international reserves, the public sector borrowing requirement, and base money.

Mr. Enoch said that it was encouraging that the adjustment program remained basically on track, particularly the growth targets, which had appeared to be very ambitious but so far had been largely achieved. That success was attributable, in part, to the wide-ranging structural reform measures the authorities had implemented, and it demonstrated that appropriate structural reforms could have a rapid impact on growth. However, to maintain the momentum of growth, a prolonged recovery in private investment was needed.

The revised Omnibus Investment Code was a clear statement of the authorities' commitment to the increasing investment incentives, Mr. Enoch commented. However, much remained to be done. For example, while there had been an encouraging response to the debt equity scheme, only a relatively small proportion of applications for new equity investment had been approved. He wondered whether the staff could explain the small number of approvals. In their memorandum, the authorities had indicated that they were planning further changes in the divestment program to enhance its attractiveness, and the staff should comment on the nature of those changes. Fiscal and monetary policies had an important role to play in promoting a recovery in investment, Mr. Enoch added. Of course, restoring private sector confidence might require some time, given the current political uncertainties. The authorities were under pressure to increase expenditures in a number of areas, but it was important not to risk the gains already achieved by adopting expansionary policies. In that connection, the expectation that the overall government deficit for 1988 would rise rather than fall, as initially anticipated, was somewhat worrying. Although the inflation rate remained relatively low, it might soon rise to double digit figures, and there was an obvious risk that expansionary policies could put further upward pressure on prices. After all, only three years earlier the rate of inflation in the Philippines had been over 50 percent, and dormant expectations of high inflation might easily be reawakened. A high or rising inflation rate would hardly contribute to promoting the needed recovery in investment and, once embedded, might require severe remedial action. The recent uncertainties regarding the rate of inflation had, not surprisingly, led to some downward pressure on the exchange rate. As a consequence, the authorities had missed the end-September 1987 net international reserves performance criterion; under the circumstances, some drawdown of reserves to counteract the instability of the exchange market would not be unreasonable. However, he agreed with the staff that reserves should not bear the entire burden of economic uncertainty for a prolonged period. In that connection, the authorities might need to carefully consider making appropriate adjustments to the exchange rate or to interest rates.

The progress that had been achieved in public enterprise reform was encouraging, Mr. Enoch remarked. Significant strides have been made to improve efficiency and increase the simplicity of the system. It was important that progress be maintained to avoid any slippages in the program of divestiture. In that connection, the fact that some public enterprises had been given renewed special fiscal privileges in the form of tax exemptions was a cause for concern. The authorities should be encouraged to avoid such distortions wherever possible and to reverse the special fiscal privileges they had granted.

The strength and comprehensiveness of the authorities' adjustment program had been widely commended by the Executive Board when it approved the stand-by arrangement in October 1986, Mr. Enoch recalled, and subsequent events had helped to confirm that evaluation and to demonstrate the underlying strength of the Philippine economy. Growth had picked up significantly despite the continuing political uncertainties. Maintaining the momentum of the adjustment program apparently was the only way to achieve the growth the authorities desired. He supported the proposed decision.

Mr. Engert made the following statement:

> The staff paper reports a welcome return to robust real growth in the economy. Macroeconomic policy has generally been prudent, and significant progress continues to be achieved in the area of structural reform. The economic strategy, however, envisioned a resumption in private sector investment that would sustain growth following the withdrawal of fiscal stimulus. While the staff paper suggests that there are some encouraging signs of a turnaround in private investment, there is still considerable uncertainty regarding its strength and sustainability. While investor confidence continues to be affected by political developments, the authorities can assist its return through a continuing, visible, and sustained application of the policies and reforms contained in the economic program, with particular emphasis on control of the government deficit.
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> Fiscal performance during 1987 has been encouraging, but the significant expansion of capital and maintenance expenditures planned for the second half of 1987 requires an increase in efficiency of allocation. In this connection, it would be

bear some responsibility for its willingness to finance the excesses of a corrupt government and to support nonviable projects. One striking example of such banking practices is the $2.2 billion construction of the Bataan nuclear power plant in a well-known earthquake zone and just five miles from a volcano. The initial construction cost does not include the continuing interest charges of about $350,000 a day, the loan fees, or any of the other charges which the Philippine people are obliged to pay for a plant that may never produce a single watt of electric power.

The financial community has to realize that without new financial support, it will be virtually impossible to rebuild and restructure the Philippine economy. Careful consideration should also be given to such realistic methods of easing the debt burden as interest capitalization, linking payments to export earnings, debt conversions, or even debt forgiveness to facilitate the growth-oriented reforms which are necessary for Philippine political and economic viability.

The authorities should resist the pressures which various groups are sure to exert in favor of maintaining the status quo. Political challenges should not discourage the authorities from taking decisive economic policy actions, especially in areas where those actions can crucially affect the political situation and produce a positive feedback toward economic recovery. One very sensitive area in this respect is land reform. The economic development of the Philippines cannot go much further without a well-designed and successful land reform. Given the difficulties that emerged during previous attempts at reforming land-ownership patterns, it would be interesting to know if the present scheme sets the conditions for meaningful improvement in both land ownership and agricultural production. I wonder whether the Government has considered encouraging cooperative farming approaches.

Another opportunity for economic policy action is increasing the tax to GNP ratio, which would strengthen the Government's ability to intervene and enhance its credibility. I disagree with the doctrine that insists that any government intervention in the economy amounts to harmful interference, and that every society should be affected by government as little as possible, and ideally not at all. The authorities should continue to reject these dogmas; in the present circumstances, the Philippines needs a strong central government which is capable of implementing long overdue economic and social reforms.

Even though the per capita income level is well within the stipulated limits and the authorities have met all the other eligibility criteria, the Philippines has not been granted access to IDA resources, apparently because those resources are already stretched so much that no new countries can be taken on.

> One consequence of this exclusion is that the Philippines is being forced to contribute to IDA, albeit indirectly, through the mechanism by which World Bank income coming from interest payments by borrowers, including the Philippines, is transferred to IDA. Another, more serious consequence, is that the Philippines is being excluded from access to the Fund's structural adjustment facility. The scarcity of IDA resources is not a valid reason for determining that one member should be allowed access to the structural adjustment facility while another should be excluded. If complete access to IDA's resources is not possible, the Philippines should be granted at least symbolic access in order to qualify for access to the structural adjustment facility.
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> When asked if he wanted to be president of the Philippines, the late Ninoy Aquino once said yes, but not immediately after Ferdinand Marcos, given the enormous problems of corruption and debt. The next president after that, he said, would also experience severe difficulties, and only the third president after Marcos would have any chance of success. Fortunately, these predictions have not come true. Thanks to her skills, President Aquino has been able over the past 18 months, to lay the foundation on which to rebuild a shattered economy. Ninoy Aquino's remarks, do, however, help us to better understand the difficulties that the present Government has been encountering, and the kinds of help which will be required from the international community to make President Aquino's efforts successful.

Mr. Donoso said the he welcomed the fact that the GNP of the Philippines had been growing at a rate of about 5 percent during the past 12 months. That this recovery had not negatively affected either the inflation rate or the external position was especially important. Domestic demand, mainly consumption and construction, had been expanded to induce the recovery of production. In addition, demand for durable equipment had also strengthened from a depressed level, and the recovery of gross domestic investment to 17 percent of GDP, compared with 13.4 percent in the previous year, represented an important achievement. Although highly dependent on construction and consumption, the expansion of domestic demand had helped to obtain a fast recovery of GDP. In the future, it would be important to monitor the composition of demand to ensure that the constraints imposed by the external situation would not lead to a deterioration in growth prospects.

After a degree of normalization had been restored with regard to the country's access to external financing and control of capital flight, it would be reasonable to maintain a modest current account deficit, Mr. Donoso commented. The staff had estimated the current deficit to be about 2.5 percent of GDP for the adjustment period ending in 1992, which was consistent with the projected fast reduction of external debt as a proportion of GDP over the medium term. However, the renewed access to foreign savings had been limited thus far. To sustain growth, the economy required increased national savings and structural reforms to enhance the role of the private sector in a more competitive environment.

According to the staff, the authorities attached great importance to the program of structural reforms, Mr. Donoso noted. It was difficult, however, for the Board to determine the importance of those reforms. For example, the staff reported that 296 government corporations had been analyzed and, following a review by the Presidential Commission on Government Reorganization, the Department of Budget and Management, and the Committee on Privatization, a recommendation had been made to abolish 58 corporations and to privatize 127. In what framework was the Board to judge the importance of the recommended plan? The same conclusion was also applicable to some of the other proposed reforms. The Board had not been given sufficient information to judge the structural reform program, a task that the Board should certainly undertake.

The authorities' intention to reduce the rate of monetary expansion below the original program target was welcome, Mr. Donoso remarked. The authorities should maintain a flexible approach to exchange rate management to ensure the necessary evolution of the external accounts over the medium term. In addition, the authorities should keep the public sector finances under review to avoid pressure on the availability of resources for private sector investment. The program supported by the stand-by arrangement was generally on track, and he had no difficulty in supporting the proposed decision.

Mr. Zeas said that he broadly agreed with the staff appraisal. The proposed decision was acceptable.

The Philippine authorities were to be commended, particularly for the progress that had been made in rehabilitating the economy, for the low rate of inflation, and the strong performance of nontraditional exports, Mr. Zeas commented. The improvement in economic performance had come as a result of important structural reforms in areas such as the public sector institutions, the coconut industry, the sugar industry, and agriculture. The only performance criterion not observed during the first half of the stand-by arrangement period was the floor for the net international reserves, and the causes of that nonobservance were beyond the authorities' control, such as weaker than projected prices for some traditional export products, shortfalls on official transfers, and higher than expected foreign interest rates. The nonobservance of the reserve target in June 1987 had prevented the Philippine authorities from making the fifth purchase under the 18-month stand-by arrangement. Since the causes of the nonobservance were entirely exogenous in nature, the request for a modification of the performance criteria was acceptable. Purchases under the stand-by arrangement should not have been suspended because the nonobservance of the net international reserves performance criterion was due entirely to exogenous factors. He wished the authorities success in their efforts to promote further growth by fostering the increase of productive investment with appropriate macroeconomic policies and the needed reduction of political tension.

One aspect of the medium-term outlook that was of particular concern was the foreign debt projections, Mr. Zeas continued. The staff had pointed out that the external gap for 1988-92 was approximately $1.2 billion a year after the 1987 foreign debt refinancing agreement. That gap included a goal for gross international reserves equivalent to three months of imports of goods and services. Given the high debt to GDP ratio expected for the next five years of 70 percent, and the high debt service ratio, which was expected to average over 28 percent over the next five years, the high goal for gross reserves recommended by the staff was questionable. For instance, he wondered what the financing gap would be, if the goal for gross reserves were lowered to only two months of imports of goods.

Mr. Yang made the following statement:

It is most encouraging to note that, in spite of some political unrest, the Philippine economy continues on its course of strong recovery. The strength of consumer demand has stimulated investment and, as a result, new equity investments are increasing significantly. Moreover, the wide-ranging structural reforms are largely on track, and exports, particularly nontraditional exports, have maintained strong growth. Although the rate of inflation has begun to edge upward under the pressure of higher demand, it is still under control. Agreements to reschedule debt with the Paris Club have been concluded, and the multiyear rescheduling agreement with commercial banks is progressing well. However, because of the delay in the disbursement of official transfers and the higher interest payments, the international reserve position is expected to fall short of the program target. But, as the authorities have pointed out, these developments are temporary and reversible in nature. Overall, the performance of the Philippine economy is satisfactory, and the authorities' request for modifications of performance criteria on net international reserves, the public sector borrowing requirement, and base money under the stand-by arrangement are justifiable, and I support the proposed decision.

Since I am in broad agreement with the staff appraisal, I have only a few comments. Agriculture affects a large part of the population, and the authorities apparently recognize the vital importance of agrarian reform in invigorating agricultural production, relieving rural poverty, and enhancing social stability. In fact, broad principles of the agrarian reform program have already been set by presidential decrees, but the detailed provisions still must be decided by the Congress. The uncertainty surrounding the provisions of the land reform has apparently already had some negative effects on the agricultural sector. Further information on this issue would be helpful.

Obviously, confidence is a critical factor in sustaining the current economic recovery. External assistance could be in the form of an acceleration of official transfers by major donors, not only to reverse the deterioration in the external payments position, but also to strengthen public confidence and, thereby, support the new Government's efforts to reform a mismanaged economy.

I strongly support the authorities' intention to adopt an exchange rate policy which is flexible and sensitive to developments both in trading partners and major competitors to maintain the competitiveness of Philippine exports in world markets. This policy stance is particularly important at present, given the urgent need to protect international reserves.

Mr. Puro made the following statement:

I welcome the economic progress that has taken place in the Philippines since our previous review in April 1987. The positive trend is clear: growth has accelerated, while the inflation rate has remained rather moderate. Nevertheless, there has not been a resurgence in productive private investment, which is a key to the sustainability of the recovery and to the entire outward-looking economic strategy.

The authorities have tried to encourage the confidence of both domestic and foreign investors by undertaking structural reforms and by conducting an accommodative monetary policy. So far, this has not been sufficient to restore the strength of private investment, as the political situation, in particular, has remained fragile. As there are no quick fixes for boosting investment, the only avenue open to the authorities is the resolute continuation of improvements in the economic and political environments. With regard to the economic environment, improvements can best be accomplished by firmly implementing the adjustment measures under the stand-by arrangement.

This is not to deny that much has already been achieved, or is in progress, in the area of structural reform. In particular, I endorse the recent steps taken in trade liberalization, which will be most useful in improving the soundness of the incentive structure, and, accordingly, will need to be continued.

A second area of major importance is the tax reform, which will have wide-ranging consequences in contributing to narrowing public sector deficits in the future. The tax package should now be fully completed, including the introduction of a value-added tax. Similarly, the reform programs for the government financial institutions and the public corporations have to be continued.

While structural reform has proceeded in many respects, setbacks have occurred. I am particularly concerned about the partial restoration of the tax exemption privileges of the National Power Corporation and the electricity cooperatives, which seem likely to conflict with the plan to dismantle subsidies and establish sound pricing principles. Although structural policies are in the forefront of the effort provide a solid basis for investment, and for the entire Philippine economy, it is particularly important to the viability of the program that short-term targets in the fiscal and monetary areas are in line with the longer-term goals. Therefore, the authorities should strictly adhere to the policy targets for the fiscal deficit and conduct a monetary policy that prevents an acceleration of inflation.

The recent deterioration in the balance of payments and the loss of reserves may have increased pressure to regulate the exchange market to protect reserves. Under the circumstances, the authorities' reiteration of their commitment to maintaining an unregulated exchange market has to be welcomed. As to the use of the exchange rate to support reserves, overreaction in the short term should be avoided to prevent deviating from the policy of maintaining a competitive exchange rate to contribute to the development of a sound and diversified export structure. The requested modifications of the performance criteria seem to be broadly appropriate, and I support the proposed decision.

Mr. Posthumus said that the gains in the economic performance of the Philippines were significant. The recovery of GNP at an annual annual rate of more than 5 percent in 1987, and the structural reforms which had been implemented remarkably well were particularly impressive. The slowdown in price increases since 1984 was also impressive, even though there had been an acceleration since 1986, the rate of inflation was relatively low, with a 3 percent increase for the year until September 1987. Although the program may have been too optimistic in some respects, the overall policies gave confidence.

There might be some difficulty in achieving the performance criterion for net international reserves, given the latest developments, including the uncertainties in speculative developments since September 1986, the Mr. Posthumus added. The fact that the Central Bank had become a net seller of foreign exchange was worrisome. Perhaps a more flexible exchange rate could prove to be useful against speculative capital outflows; but given the inflationary pressures, the authorities should conduct such a policy with prudence. He wondered whether there would be a role for interest rate policy in stemming speculative capital outflows.

Another issue was that of tax policies, particularly the restoration of some traditional tax exemptions, which was worrisome, Mr. Posthumus remarked. The staff had rightly pointed out that problem, and perhaps those exemptions should be reversed. He supported the proposed decsion.

Mr. Dallara made the following statement:

> Like other Directors, I commend the authorities for the progress achieved since the previous review, including key aspects of economic performance--particularly real growth--and the implementation of both the macroeconomic and structural elements of this program. In fact, the Philippine effort is an excellent example of a comprehensive adjustment program embodying formal commitments both on the macroeconomic and structural sides, facilitated by effective and close collaboration between the Fund and the World Bank. It is perhaps one of the better cases in which the collaboration between these two institutions has been complementary and not redundant, and has reinforced the efforts of each institution. Nevertheless, there are some worrisome signs on the macroeconomic scene at this stage; and some potential structural reforms, perhaps particularly in the area of liberalization of direct foreign investment, remain to be tackled in a decisive way. I hope that the Fund will play a role in reinforcing efforts in both of these areas.
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> The achievement of real GNP growth of 5 percent over the past 12 months is still rather modest, although the only slight rise in the rate of inflation and the continued rough balance in the current account are positive factors. I feel slightly uneasy about some of the macroeconomic developments and prospects, which are having adverse effects on the exchange market, international reserves, and the outlook for private investment and a durable economic recovery. The most recent manifestation of this problem is the lack of compliance with the end-September 1987 performance criterion for net international reserves. My authorities would welcome some further explanation by the staff of the implications of this development for the remainder of the program year.
>
> My authorities are rather encouraged by some aspects of the economic recovery which have emerged clearly since the latter part of 1986. The annualized growth rate of nearly 18 percent for durable equipment in the first quarter of 1987 is particularly welcome, as is the substantial growth of both government and private construction. On the other hand, I wonder what brought about the 4-5 percent growth rate for public consumption over the last three quarters.

The public sector is undergoing a remarkable transformation, and progress has been made in reducing the size of the combined public sector deficit. At the same time, there will be considerably greater transparency in financial relationships throughout the sector. These changes make it somewhat difficult to clearly assess recent fiscal developments. The combined deficit projections for 1988--higher than originally targeted and higher than in 1987--are somewhat worrisome. I wonder if the projections indicate some slippage in the adjustment effort which could undermine the challenge--which the staff correctly highlighted in its appraisal--of providing the right environment for a recovery of private sector investment, both domestic and foreign. Staff comments on this aspect of the program would be welcome. The deficit of not only the National Government, but also the 14 public corporations is expected to increase in 1988. In particular, the overall cash deficit of the National Power Corporation is expected to increase. At the same time, a tax exemption has been restored for the National Power Corporation, which tends to erode a newly reformed tax base. I share the staff's concern about any generalization of such exemptions.

Excellent progress is being made in the overall fiscal and tax reform efforts. The tax reform is to be virtually completed with the introduction of the value-added tax at the beginning of 1988. Considerable progress has occurred since the last review under the stand-by arrangement on the reorganization and partial privatization of the nonfinancial corporations, and the reform of the government financial institutions appears to be generally on schedule. I commend the authorities for their persistent efforts in this area, in spite of the very obvious resistance in some quarters.

In the monetary area, I welcome the decision to tighten the ceiling on the growth of base money. In addition, access to credit for the private sector for 1987 appears to be adequate to facilitate continued economic recovery. However, developments in the current account are somewhat disappointing, despite the good performance in nontraditional exports. While the staff correctly cites a shortfall in official transfer income, it appears that the rise in non-oil imports and the fall in service receipts have also been significant contributing factors to the payments outcome this year. I would welcome any staff elaboration on this.

Like other Directors, I have some questions about the current exchange rate policy. While I understand the desire to resist downward pressure on the rate, arising from what the authorities hope are temporary political uncertainties, the magnitude of recent Central Bank intervention is somewhat worrisome.

Looking at the medium term, the balance of payments and debt forecasts have not changed very much since the review in April 1987. Although the ratio of debt to GNP will have decreased significantly by 1992, it will still remain high. A substantial amount of almost continuous exceptional financing after debt relief will be required if the assumed 6.3 percent annual growth rate for that period is to be achieved.

Mr. Zecchini said that the current discussion was taking place against the backdrop of the favorable results of the recent policies which had aimed at coupling external adjustment with growth. The correct fulfillment of policy commitments and the timely adaptations of the policy orientation in the face of some undesired developments, like those on the inflation front, had borne the expected fruits: the growth rate had increased substantially; the public sector deficit was basically on target; inflation remained subdued; and structural reforms were proceeding on time. However, more remained to be done to consolidate the recovery process by relying on stronger private investment. In that respect, he shared the staff's view that the recovery of fixed investment remained the key issue for a successful and durable recovery of the economy. In that connection, he would comment briefly on the policy setting that was required to bring about more favorable economic conditions for private investment on the part of both domestic and foreign enterprises. He would also touch upon the evolution of aggregate demand and structural policies.

While the fiscal policy targets for 1987 had basically been met, projections indicated that the 1988 objectives envisaged by the program would not be achieved, Mr. Zecchini remarked. In fact, the consolidation process would be somewhat reversed, as the ratio of the public sector deficit to GDP was likely to increase. It was essential that the reduction of fiscal imbalances proceed in line with the program objectives. Further deficit reductions would release resources for private investment, reduce the upward pressure on interest rates, and strengthen the credibility of the Government's program. Therefore, in the coming year, the authorities should consider additional corrective measures, focusing mainly on the revenue side of the budget. Since the correction required to reach the 1988 fiscal deficit target was relatively modest, in the order of ₱ 4.5 billion, or less than 1 percent of GDP, and since tax revenues as a percentage of GDP were still relatively low, approximately 12 percent, the fiscal target could be easily achieved by increasing revenues to about 13 percent of GDP. In that respect, some scope seemed to be available for improving tax administration and collection and for reducing the erosion of the tax base as a result of tax exemptions. More scope might also be available in the area of structural reforms of public finances. For instance, privatization of some state controlled companies might boost both revenues and investment in the private sector.

On the expenditure side, he saw very limited scope for additional cuts, Mr. Zecchini continued. The target levels of public capital and maintenance expenditures should be maintained, if not increased, to provide an appropriate complement to private investment.

The authorities needed to carefully monitor the expansion of monetary aggregates in view of the two distinct objectives of protecting official reserves, even in the face of losses of confidence due to the political uncertainties, and of avoiding an excessive tightening of credit conditions that could curtail investment expenditure, Mr. Zecchini observed. In that respect, the moderate tightening of policy envisaged for 1988 seemed appropriate.

A flexible exchange rate policy would play a crucial role in fostering private investment by providing incentives for an export-led growth, Mr. Zecchini considered. The recent buoyant performance of nontraditional exports was a clear sign of the unexploited potential which still existed in that area. In managing exchange rate policy, the authorities must take greater account of the developments of the real exchange rate vis-à-vis major regional competitors. Since the establishment of the new exchange rate system at the end of 1984, no gains in competitiveness had been achieved with respect to such competitors, although external competitiveness vis-à-vis trading partners had increased by 20 percent. In the case of the Philippines, which faced strong regional competitors, global competitiveness should appropriately be measured by taking into account the real exchange rate with competitors and trading partners.

The process of structural reform could consolidate the recovery and enhance the growth potential of the economy, Mr. Zecchini continued. In addition to the successful completion of reforms in the public sector, in trade liberalization, and in market restructuring which were already at an advanced stage of implementation, the authorities should consider going ahead with the land reform. He understood that the availability of adequate foreign financing was a crucial element for the effectiveness and the viability of land reform. To that end, official donors should fulfill their commitments by offsetting the significant shortfall in official transfers that had occurred that year. The Philippine authorities were among the first to adopt an innovative scheme for debt equity conversion. Since the scheme had been operational for more than one year, he would be interested in hearing an assessment of the effectiveness of that mechanism. In conclusion, he supported the proposed decision and the requested modifications of the performance criteria.

Mr. Hammoudi said that the second review under the stand-by arrangement suggested that the economy was bound to gain further growth momentum over the medium term while maintaining external viability. It was remarkable that all the performance criteria except for the floor on net international reserves had been met, despite political and financial difficulties. Since mid-1986, economic performance had gradually improved. It was estimated that in the first half of 1987 the real GNP had increased by 5.1 percent over the previous year, despite the effects of the drought on the agricultural sector. The manufacturing, services, and construction sectors had been the main contributors to growth. The desired turnaround in private investment had also begun, although at a slower than expected pace, while the foundation for a more rapid resumption of efficient private investment had been established through wide-ranging structural reforms.

The measures which had been undertaken by the authorities to implement structural reforms were impressive and courageous, especially those in the trade, industrial, public enterprise, and financial sectors, Mr. Hammoudi commented. He noted with satisfaction the substantial progress that had been made in this regard despite the adverse external factors and political uncertainties, emphasized by Mr. Rye in his opening statement.

The significant gains in the Philippine economic performance had been achieved with minimal negative impact on the inflation rate, which was 6 percent during the 12-month period ending August 1987, and on the competitiveness which increased roughly 20 percent, Mr. Hammoudi said. In the first half of 1987, the balance of payments, particularly the capital account, was less favorable than anticipated, reflecting the larger use of trade facilities, and the shortfall in the capital account, which, although partly offset by stronger short-term capital inflows, remained far below expectations.

Mr. Ouanes made the following statement:

> Like other Directors, I am encouraged by the performance of the Philippine economy. The authorities deserve to be commended for the turnaround from negative economic growth to high positive real growth rates; in fact, growth is expected to accelerate in coming months. Moreover, substantial progress has been made in reducing macroeconomic imbalances, in accelerating structural reforms, and in restructuring the external debt.
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> The most helpful factor, so far, in the acceleration of growth has been the amount of idle capacity present in the economy. However, it is clear that to sustain growth, a combined effort between the public and private sectors to accelerate investment expenditure will be needed. In turn, the level of investment will depend on the progress in improving the fiscal position and implementing a number of structural reforms. It will also critically depend on restoring confidence in the Philippine economy. Clearly, strict adherence to the present program objectives will go a long way toward fostering the appropriate environment for the needed expansion in private domestic investment and attracting much needed foreign direct investment. However, restoring confidence will depend, in the final analysis, on the extent to which present policies are judged to be effective and sufficiently strong to achieve the stated objectives. Convincing policy actions and flexibility will be crucial. Therefore, I urge the authorities to stand ready to adapt their policies as developments warrant. There are four important areas of concern: the recent acceleration in the inflation rate; the expected increase in the consolidated public sector deficit; the increased uncertainties in the external sector; and the adverse trend in foreign exchange reserves.

Given the importance of the external sector for growth, employment, and the solution of external debt problem, it is essential that exchange rate policy be flexible and realistic. Restoring competitiveness to the economy will depend not only on flexibility, but also on the authorities' ability to contain cost increases, particularly wages, and to prevent the recent inflationary tendencies from taking a firm hold.

The achievements to date are impressive and commendable. However, the medium-term outlook remains uncertain and fragile. I urge the Philippine authorities to maintain the momentum of adjustment and to strengthen their efforts in the areas mentioned. I support the proposed decision.

Mr. Zaidi made the following statement:

The picture of the Philippines' economic performance under the stand-by arrangement that emerges from the present review is mixed. On the one hand, there have been positive results: the economy has swung from a sharp decline, which reduced real GNP by over 10 percent in 1984-86, to a recovery at an annual rate of about 5 percent during the past 12 months; and considerable progress has been made on a wide range of structural reform measures in the program. On the other hand, performance has fallen short of the program objectives in some respects, as reflected in the breach of the performance criterion for end-June 1987 and the requested modification of two other performance criteria for end-September 1987 and end-December 1987. However, the program is basically on track, and I support the proposed modifications.

The program currently being reviewed is clearly designed to provide for the structural reforms needed to improve the resource allocation process and to enhance the competitiveness of the economy. Although it is not necessary to comment in detail on the program, I wish to stress the importance that should be attached to increasing the efficiency of the public sector and to widening the market orientation of the economy. The changes in trading and marketing practices in the sugar and coconut sectors have played an important part in the economic recovery, and the lifting of monopoly elements in domestic and external trade is encouraging. In addition, further agrarian reform measures are anticipated.

Another key area of structural reform is the tax system. Although the tax rates in the Philippines are relatively high, the ratio of tax revenues to GNP is much lower than the average for comparable countries. The tax collection machinery needs to be strengthened, and the introduction of the value-added tax scheduled for January 1988 is welcome. The staff has noted that the value-added tax will contribute significantly to the efficiency and elasticity of the tax system over the medium term, and while it was not designed as an explicit revenue-increasing measure, it is now expected to yield P 2 billion more in revenue than the taxes to be replaced. Given the relatively low tax revenues and the pressures on the fiscal position, the value-added tax should have been designed explicitly to raise revenue in addition to its original objectives.

The attempt to contain inflation will need the support of a cautious monetary policy. Although consumer prices declined slightly in 1986 and the program target for 1987 was 5 percent, it is now projected that consumer prices will rise by 8 percent in 1987. This increase in the inflation rate is a cause for concern, and the commitment of the authorities to take a cautious monetary stance, including the proposed lowering of the monetary base limits is welcome. The authorities should be encouraged to monitor the monetary situation carefully, because during the first half of 1987, the Central Bank had to extend substantial emergency assistance to two banks that were encountering severe liquidity problems. In addition, currency holdings have continued to grow, and the anticipated decline in the currency deposit ratio from the peak of early 1987 has not occurred. Since the behavioral relationships underlying the monetary targets in the financial program have been subject to more than the usual degree of uncertainty, it is important to pay particular attention to the behavior of monetary aggregates as well as interest rates to ensure their consistency with other policy objectives. The proposed lowering of the floor for net international reserves is understandable, given the deterioration in some aspects of the external environment that was largely outside the control of the authorities, including an increase in foreign interest rates and the slower than expected disbursement of official transfers. The staff paper presented the quantitative limits on domestic financial policies. Table 15 of EBS/87/205, Supplement 1 (10/7/87) shows that the revised ceiling for the monetary base for December 31, 1982 is larger than the original ceiling, even though the authorities are proposing a modification to lower the ceiling for the monetary base. The reason for this modification was explained in the footnotes of the staff paper: the revised ceilings for December 1987 and March 1988 are inclusive of the allowable margin for overperformance of net international reserves. The staff should comment on why it was necessary to include the allowable margin in the ceiling given in the supplement to the staff paper, but not in the original paper. I support the proposed decision.

The staff representative from the Asian Department said that there had been a major obstacle to the completion of the debt rescheduling negotiations between the Philippines and its commercial bank creditors, namely, a dispute among the banks regarding the private debt of a domestic company that threatened to keep 17 banks out of the financing package and thus jeopardized the entire agreement. The staff had been informed on November 5, 1987, however, that the banks in New York had informed all the other banks concerned that that dispute had been resolved, and that final agreement on the debt rescheduling was now expected, although not necessarily by the previously set deadline of November 15, 1987. The banks had subsequently asked to move that deadline to December 22, 1987 to allow more time for other minor issues to be resolved.

Directors had asked a number of questions about the medium-term outlook and about the omission of a discussion on that outlook in EBS/87/204, Supplement 1 (10/7/87), the staff representative noted. Two main factors affected the medium-term outlook: the Fund and the authorities did not anticipate a need for a concerted new money package from the banks until at least the end of 1988; and there was a need for rescheduling loans due through 1992, which the banks' multiyear rescheduling agreement would provide, at least according to the banks. However, the Philippines would still need additional financing, owing to the residual financing gap, which was expected to average \$1.2 billion a year over the next four or five years. Reducing the reserve target envisaged under the proposed program to the equivalent of only two months of imports of goods would reduce the financing gap by about \$2.5 million a year on average. It was the staff's view that the financing gap currently projected under the proposed program was not impossible to manage, in view of the historical trends of official and other disbursements to the Philippines. The staff considered that if the past trend of pipeline disbursements were maintained, the projected amounts of additional necessary financing would not be impossible to obtain. However, the amounts needed would increase on average later in the medium term; they were relatively small in the coming months.

The staff had not included the balance of payments outlook for the medium term in its paper, because there had been no major changes in the medium-term projections since the first review, in April 1987, the staff representative explained. The only major change that had taken place in the Philippines since the first review was that investor confidence had not been restored in line with the program's expectation. Because that decline would threaten the program's growth targets, the staff appraisal had emphasized the domestic investment and growth prospects. Of course, these also affected the external outlook.

Various questions had been raised about official transfers, the staff representative added. Shortfalls had occurred both in official transfers above the line of the current account and in inflows of medium- and long-term capital. Compared with the first review, the estimate for official transfers had been reduced by about 25 percent, and less than half of the reduced amount had been received by the time of the September 1987 performance review discussions. Since that time, only one major disbursement had been received, although other disbursements were targeted before the end of the year. Also, the estimate for loan disbursements had been revised downward by 20 percent, with less than half received by the third quarter. Those shortfalls were, to some extent, related to the slower than expected recovery in public investment. On the issue of the foreign exchange reserve, the staff had been urging the authorities to make greater use of the exchange rate to limit and, indeed, to reverse the loss of reserves. Of course, a very prompt reversal of recent exchange rate developments and a sharp recovery of official bilateral disbursements were needed to meet the program targets for net international reserves for the remainder of the year. In this absence, those targets would also not be met.

Monetary policy had been used to some extent to support the external policies, the staff representative commented. The substantial Central Bank sales of foreign exchange in the market had been allowed to result in an absolute decline in base money, and in the past two months, all categories of domestic interest rates had risen by 2 percentage points, the staff representative noted. Therefore, the tightening of monetary conditions had had some effect on the market, but the Government had preferred being a seller in the market to using exchange rate policy actively.

The growth in public consumption over the past three quarters was related to the restoration that was being achieved in the important areas of maintenance and operations, health, and education, the staff representative said. There had been sharp declines in those expenditures since late 1983. At least from the supply side, there should be a significant improvement in agricultural production in 1988, as that sector recovered from the drought and responded to the dismantling of monopolies, and the effects of those developments on producer prices were felt. The staff expected continued recovery in the manufacturing sector, but its concerns regarding investor confidence arose particularly in regard to that area of the economy. Sustaining a manufacturing recovery would require a substantial broadening of the investment base, and switching the basis of the recovery from consumption to investment. Of course, enhancing investor confidence would also depend on the reduction of the present political uncertainties in the Philippines.

As to privatization, several government agencies were selling assets, including the Asset Privatization Trust, which dealt primarily in sales of assets of government financial institutions, the staff representative continued. Receipts from sales of assets were running ahead of schedule, owing partly to the fact that the best assets had been sold off first. In addition, it was expected that by October 30, 1987 at least the first group of 86 corporations identified for privatization would have submitted precise privatization programs to the Government. In some cases the programs had already been submitted; however, in others, the Government had agreed to a two to four week extension of the original deadline, although it did not expect planning for privatization to be delayed beyond that period. There had recently been a strong reinforcement of government policy on privatization by the President, and some of the important public sector companies, like the airlines and some large hotels, which were considered to be outside the program, would be brought into it, at least in some measure.

Applications for new equity investments under the debt equity scheme from August 1986 to mid-October 1987 had exceeded the expectations of the authorities, the staff representative remarked. The Central Bank had received over 250 applications for such investments with a total value of $1.2 billion. Of those applications, over 100, with a value of $272 million, were in the preferred categories of investment. However, it should be noted that of the 250 applications received to date, only 10 had been approved. A new circular had been issued recently outlining new regulations and guidelines for the debt equity scheme. The main change was that the list of preferred investments was expanded to include investments in banking and the acquisition of nonperforming assets that were being disposed of by the Government. The fee structure had also been raised, but it had been graduated according to the proportion of fresh money that was brought in by the investor. Because the discount for Philippine debt in the secondary market had increased in recent months, the authorities believed that the new fee structure would maintain the desired investment incentives. The provision in the old regulations regarding a minimum funding requirement through the Philippine Investment Note scheme--the so-called PIN scheme--had been ended, and the authorities were pursuing the debt equity scheme to a much greater extent. Of course, there was some doubt as to whether the capital markets would absorb the investment, but progress so far had been good.

On wage policy, a bill before Congress, which had been proposed by the Administration, sought to increase minimum wages by 15-20 percent for agricultural and other workers, and several other proposals had been put forward by other parties, the staff representative noted. If the Administration's proposal were to be approved, it would mark the first increase in the minimum wage in the private sector since November 1984. Those measures had not yet been approved, however, and their possible impact on producer costs was unknown. However, wages in the private sector were generally above the proposed minimum wages.

Congress was also expected to decide on the crucial aspects of the land reform scheme, including compensation values, terms of compensation, and limits on land, the staff representative continued. The Government planned to implement land reform in a pragmatic way: not by establishing a fixed limit on land, but by taking into account the impact of productivity. Therefore, the reform would be flexibly applied in different regions, depending on the crops concerned. The new land reform scheme would primarily affect sugar and coconut lands, which involved over half of the country's population. However, there had been agreement among the reform committees in Congress that some transfers could proceed under the old land reform scheme and involve lands taken over by the Government. The expenditures related to those land transfers were included in the 1987 budget.

As Mr. Zecchini and other Directors had noted, there was a clear potential for offsetting the apparent rise in the overall fiscal deficit by a further improvement in revenue performance, the staff representative from the Asian Department commented. The planned tax revenues, amounting to 12 percent of GDP, were on the low side, and there was scope, through better administration, to raise them; the staff had recommended doing so to the authorities. The value-added tax, which was to be introduced in January 1988, would be a revenue-increasing measure. The authorities expected to raise ₱ 2 billion in net revenue enhancement through the value-added tax scheme and planned to abolish some other taxes. However, the value-added tax proposal was still before Congress, although the Administration expected it to be approved as planned.

Mr. Posthumus said that although the staff had advised more flexibility in exchange rate policy, he wondered whether more flexibility in interest rate policy would also be appropriate. The staff had said that the sale of foreign exchange had led to an increase in interest rates, but there were other ways to achieve such an increase. The disadvantage of flexibility in exchange rate policy was that it could lead to an increase in inflationary pressure.

The staff representative from the Asian Department said that the authorities had adjusted monetary policy to bring about a reduction in base money during the past four weeks, and, as a result, interest rates had risen by 2 percentage points. At stake was a trade-off between a further tightening of monetary policy that would increase interest rates and a more active use of exchange rate policy. The authorities were then to avoid stalling the recovery through stimulating increases in interest rates.

Mr. Rye said that the Government's program was being pursued vigorously in the face of many internal and external difficulties. Maintaining the momentum of the adjustment program was essential if the authorities were to achieve their growth objectives. The authorities would certainly agree with the many Directors who had highlighted the key role of private investment. Of course, some degree of political stability was necessary; to a considerable degree, economic progress, the determined pursuit of the program, and political stability would be very closely linked.

He agreed with Directors on the central importance of maintaining a firm stance against inflation, although one or two Directors had perhaps overstated the significance of the recent acceleration, Mr. Rye remarked. Of the current inflation rate of about 8 percent, at least 1 percentage point was due to the acceleration of oil prices, and perhaps as much as 2 percentage points were due to the effects of the drought on food prices. The drought had been severe in some of the southern areas of the Philippines. The underlying rate of inflation was therefore perhaps not far from the 5 percent that had been projected for 1987. Nonetheless, he agreed that controlling the inflation rate remained crucial to the success of the program in general, and to keeping the fiscal deficit under firm control and to maintaining flexibility in exchange rate policy, in particular.

The shortcomings in performance were relatively minor in the context of the overall performance, which in general had been admirably deliberate and vigorous, Mr. Rye continued. Some of the problems reflected simply the cost of having a democratic form of government. As Directors knew, economic purity did not always win out under a democracy, which also sometimes resulted in slow decision making. For example, several competing land reform proposals were being discussed in Congress, and whatever was decided through the legislative process would then have to be negotiated with the Administration. The Administration had inherited what could only be described as a ramshackled and demoralized public sector, Mr. Rye remarked. Massive efforts had been made to reform that sector. Those efforts had certainly been bearing fruit, but the reformation process took time. The Philippines' public service was still far from being a model of efficiency, and its inefficiency had resulted in some areas in shortfalls in the progress that had been originally hoped for.

The announcement that negotiations between the authorities and the banks were resuming was significant, Mr. Rye said; it showed the Government's commitment to implementing the adjustment program, despite the voices that had been raised against it in the Philippines. Another one of the prices of democracy was that alternative views could be expressed--and expressed very loudly.

He hoped that in due course the Executive Board would give careful consideration to the matter of the Philippines' eligibility to use the structural adjustment facility and the enhanced structural adjustment facility, Mr. Rye commented.

The Executive Directors then took the following decision:

1. The Philippines has consulted with the Fund in accordance with paragraph 4(c) of the stand-by arrangement for the Philippines (EBS/86/222, Sup. 2, 10/28/86) and the second paragraph of the letter dated September 18, 1986 from the Minister of Finance and the Governor of the Central Bank of the Philippines.

2. The letter dated September 28, 1987 from the Governor of the Central Bank and the Undersecretary of Finance, with annexed Memorandum on Economic Policy, will be attached to the stand-by arrangement, and the letter dated September 18, 1986 with annexed Memorandum, as modified, shall be read as supplemented and modified by the letter dated September 28, 1987 with annexed Memorandum.

3. Accordingly,

(i) the limit on the public sector borrowing requirement referred to in paragraph 4(a)(i) of the stand-by arrangement shall be as specified in paragraph 2 and Table 2 of the Memorandum annexed to the letter dated September 28, 1987;

(ii) the limit on base money referred to in paragraph 4(a)(ii) of the stand-by arrangement shall be as specified in paragraph 7 and Table 2 of the same Memorandum; and

(iii) the limit on net international reserves of the monetary authority referred to in paragraph 4(a)(iv) of the stand-by arrangement shall be as specified in paragraph 8 and Table 3 of the same Memorandum.

4. The Fund decides that the review contemplated in paragraph 4(c) of the stand-by arrangement is completed and that the Philippines may proceed to make purchases under the stand-by arrangement. Moreover, the Philippines may proceed through November 15, 1987 to make purchases that shall not cause purchases under the arrangement to exceed the equivalent of SDR 128 million and that shall not be subject to the performance criteria set out in paragraph 4(a) and (b) of the stand-by arrangement.

Decision No. 8722-(87/153), adopted
November 6, 1987

2. GHANA - REQUEST FOR EXTENDED ARRANGEMENT AND REQUEST FOR STRUCTURAL ADJUSTMENT ARRANGEMENT

The Executive Directors considered the staff paper on Ghana's request for an extended arrangement and for an arrangement under the structural adjustment facility (EBS/87/207, 10/2/87; and Sup. 1, 10/16/87), together with a policy framework paper (EBD/87/247, 9/30/87).

The Executive Directors took note of the following statement by the Managing Director:

There follows for the information of Executive Directors the text of a memorandum that I have received from the President of the World Bank to serve as the basis for my statement on the matter to the Board. This text summarizes the main points covered by the Executive Directors of the Bank and IDA in their October 13, 1987 discussion in the Committee of the Whole of a paper entitled "Ghana: Policy Framework Paper."

1. The Executive Directors of the Bank and IDA discussed on October 13, 1987, in a meeting of the Committee of the Whole, the paper entitled "Ghana: Policy Framework Paper."

2. The Directors commented favorably on the progress that had been made to date under the Government's economic recovery program and expressed their support for its continuation as outlined in the policy framework paper. Ghana's sustained effort in many areas, especially its careful but steady movement

toward a realistic and flexible exchange rate, was praised and its GDP growth of 5 percent a year since 1984 was highlighted as an example of adjustment with growth. The Directors cautioned, however, that continued progress was dependent on implementation of the measures summarized in the paper--and these are comprehensive in nature--and on adequate external assistance.

3. The Directors commended the Government for the special actions being taken to minimize the social costs of adjustment. With respect to retrenched government workers, the group most directly disadvantaged by the reform program, the Directors expressed a general concern about their employment prospects. Staff responded that this concern would be taken into account through the provision of retraining facilities, adequate compensation packages, and the adoption of a phased approach to layoffs. The Directors also expressed support for the Government's action program aimed at the most vulnerable groups which, as a result of their already inadequate incomes, were thought likely to suffer during the adjustment process. The Directors were informed that donors would participate in a December conference to discuss the financial needs of the program.

4. While encouraging the Government's continued liberalization of the exchange and trade system, the Directors emphasized the importance of supporting measures especially in the areas of fiscal and monetary policy. In this respect, they noted the Government's intention to generate a fiscal surplus which would, in turn, allow the private sector adequate access to credit while maintaining the overall balance of payments target. They also noted the recent liberalization of interest rates and the proposed measures to improve the efficiency of financial intermediation.

5. The Directors commented that the GDP growth target of 5 percent a year would require a strong supply response from the private sector. The proposed gradual increase in the farmgate price of cocoa to 55 percent of the world market price and the general improvement in incentives as a result of the more realistic exchange rate were welcomed as important stimulants to the private sector. It was also noted that the program of public sector expenditure is designed to support the supply response by weighting it heavily toward rehabilitation of economic infrastructure, especially the road network.

6. Concern was expressed about the administrative capacity of the Government to implement the proposed package of reforms. In response, staff pointed to the special technical assistance project recently approved by the Board which is designed to strengthen the analytical and managerial capabilities of the central ministries. In addition, the public enterprise project discussed earlier today provides support for the Government's program of divestiture and rationalization of state-owned enterprises.

7. While noting that external financing requirements are fully met for the duration of the program, the Directors expressed concern about Ghana's debt overhang and its dependence on cocoa as its main source of foreign exchange. They commented favorably on the pledges made at the May 1987 conference and urged donors to support, as they had done in the past, a program which was one of the most ambitious and long-lasting reform efforts in sub-Saharan Africa.

Mr. Salehkhou made the following statement:

On May 4, 1987, the Executive Board had the opportunity to review the economy of Ghana and Directors welcomed the increasing attention being given by the Government to structural issues. They encouraged the authorities to work out an economic and financial program that would meet the criteria for Fund support under the extended Fund facility and the structural adjustment facility.

Since then, while continuing with success the implementation of the Economic Recovery Program, the authorities decided to strengthen their adjustment efforts in the context of a medium-term program for 1987-90, prepared in close collaboration with the staffs of the Fund and the World Bank and in support of which they are requesting these medium-term arrangements.

After achieving the macroeconomic objectives of the program for 1986, the authorities maintained their adjustment efforts with the implementaton of a wide range of structural measures to improve the overall economic environment and to further liberalize the economy. In this regard, incentives to the agricultural sector were improved through a substantial increase in producer prices for cocoa, Ghana's main export crop, from 25 percent of the world market price for the crop year 1986/87 to 40 percent for the 1987/88 crop year. Other administrative prices have also been increased so as to reduce or eliminate subsidies. In order to improve resource mobilization by the banking system, interest rates were liberalized in September 1987 by freeing most deposit rates and abolishing maximum lending rates. Moreover, an auction market for treasury bills has been introduced on October 15, 1987.

On the external side, the official exchange rates were unified and access to the auction market was widened to cover service and transfer payments, as well as 50 percent of the value of all goods previously excluded from the "A" licensing scheme. Retention of foreign exchange by some state enterprises was also reduced so as to increase the surrender of foreign exchange to the banking system. These actions were accompanied by a tight fiscal policy with the introduction of a set of tax measures to increase revenues and reforms in public expenditures to improve their efficiency. The profit in petroleum products resulting from the lower import prices was converted into an excise duty on the main items other than kerosene. Substantial progess was also achieved in the reduction of the size of the civil service with the removal from the payroll of about 15,000 surplus staff.

All in all, substantial progress has been achieved since 1983 in improving the country's economic and financial performance. Real GDP, after a decline by 4.7 percent in 1983, is expected to increase for the fourth year in a row, inflation was reduced from 123 percent to 35 percent between 1983 and 1987, and a sizable overall balance of payments surplus will be recorded in 1987 for the first time in several years.

Notwithstanding the considerable improvement achieved during the past four years, the authorities recognize that the country's external payments position is still vulnerable to adverse developments in the international environment, the debt service burden remains heavy, inflation is high, and the growth of real GDP is constrained by inadequate savings, insufficient incentives, and infrastructure bottlenecks. In view of the magnitude of these problems, the authorities have decided to pursue their adjustment efforts in the context of a medium-term policy framework for 1987-90, which constitutes the second phase of the Economic Recovery Program. As indicated in the policy framework paper, the basic objectives of the program are: to achieve an annual rate of growth of real GDP of 5 percent; to reduce the annual average rate of inflation to 8 percent in 1990; and to generate significant overall balance of payments surpluses which would be consistent with the elimination of the remaining external payments arrears.

To achieve these objectives and reach, by the end of 1990, a viable external payments position, the authorities will continue to implement appropriate structural and financial policies. In this regard, Table 2 of the policy framework paper indicates clearly the variety of the measures and strategies of the program and the specific timing for each action. It is seen by the authorities as a helpful tool to monitor closely the program's implementation and to introduce appropriate corrective measures, as needed.

Special emphasis will be placed by the authorities on the improvement of incentives for efficient sectors through a flexible exchange rate policy, exchange and trade liberalization, and higher producer prices in agriculture. In this context, further widening of the auction market for foreign exchange is expected to be conducted no later than January 31, 1988. Service and transfer payments will be progressively liberalized, with a view to achieving complete liberalization by the end of the program.

To encourage cocoa production and exports, producer prices will be increased progressively. Concomitantly, a reduction in the operating costs of the Cocoa Board will be achieved mainly through cutbacks in unrelated activities, staff reduction, and plantation divestiture. During the program, the authorities intend to complete the restructuring of public finances through a progressive introduction of revenue measures, restraint on the growth in government expenditures, and strengthening of expenditure control and monitoring. Public investments will be geared toward the rehabilitation of existing infrastructure, especially in the transport sector, so as to sustain the economic recovery.

A major emphasis is being placed on the reform of state enterprises with the adoption of a two-year plan of corrective action to strengthen management and government monitoring. Furthermore, 30 state enterprises have already been identified for outright sale, conversion into joint ventures, or liquidation. Other measures including limiting access of state enterprises to government resources, restoring financial discipline, and reducing overstaffing are also envisaged.

Regarding the financial sector, and after liberalizing almost all interest rates and introducing an auction market for Treasury bills, the authorities intend to activate the securities market and to establish a discount house in order to develop an active money market. Such measures will promote the holding of cedi-denominated assets and will help channel resources to the most productive sectors. The Bank of Ghana will also rely more on indirect credit control and strengthen banking supervision.

The Ghanaian authorities are committed to strengthen their efforts in order to establish a firm base for sustainable growth and a viable external position. However, they share the staff conclusion that their adjustment will also need external support through substantial official external assistance on highly concessional terms and continuous trade-related credits from foreign commercial banks. Such support would help the authorities to improve the external payments position and to reduce the heavy debt service burden.

Mr. Enoch made the following statement:

In the past, Ghana has set something of an example in Africa and, with its efforts under the Economic Recovery Program, it is resuming such a role. The staff papers before us set out the extreme difficulties from which Ghana is extricating itself and the commitment with which its efforts have been made. It is particularly impressive that the authorities maintained the momentum of their adjustment program in the face of renewed economic difficulties earlier this year. It is gratifying that these continued efforts are now bringing successes: growth this year, although below the original target, is nevertheless significant, and the rate of inflation is expected to drop rapidly.

Ghana's program is predicated on a very ambitious rise in both the savings and the investment ratios, compared with their levels of the past few years. In this connection, it is somewhat worrying that the actual outcome now expected for this year is likely, on both counts, to be lower than envisaged earlier. This is no doubt associated with the upsurge in the rate of inflation and the result that real interest rates may well have turned negative for the early part of this year. I welcome the authorities' moves last month to eliminate maximum interest rates on domestic savings, which should undoubtedly help. More generally, attention must be paid to the maintenance of sound monetary policy and the establishment of a stable financial environment, which will rebuild and maintain the confidence necessary to mobilize effectively and allocate efficiently the resources of the country.

In this connection, the exchange rate also will be vital in establishing the incentives necessary to underpin the export effort that the staff's medium-term scenarios show to be essential to Ghana's external prospects. Ghana has already achieved much through the adjustment of its currency, but the significant differential remaining between the official and parallel market rates indicates the scope for further adjustment in the exchange rate. The further liberalization measures recently undertaken and proposed by the authorities with regard to both the exchange system and interest rates are therefore particularly welcome, and I would urge speedy completion of their implementation.

The framing of monetary policy with a view to restoring confidence in the financial system must also be directed toward the control of inflation. I concur with the staff that the high rate of inflation is a source of particular concern. This problem could undermine the entire adjustment effort; therefore, further measures might be considered aimed at a faster deceleration of inflation, and in particular to avoid further bouts of disruptive price instability.

Extended arrangements have in general had a rather mixed track record; with the suggested revival of such programs, Ghana's request becomes something of a precedent. The strength of the measures that are being undertaken and the commitment demonstrated by the authorities fully justify the requests being made for the extended arrangement, as well as an arrangement under the structural adjustment facility. Moreover, the severe structural problems faced by Ghana and the authorities' appropriate choice of a medium-term framework within which to address those problems are most likely to be best served by such multiyear arrangements. In addition, it is important to note--particularly if we are contemplating more frequent use of extended arrangements--that the multiyear program supported under the structural adjustment and extended Fund facilities is clearly aimed at the achievement within the program period of medium-term external viability, including the removal of restrictions on current payments and transfers, the elimination of external payments arrears, and the full normalization of relations with creditors. Such objectives, clearly defined and fully supported by requisite policy measures, must be considered essential to the viability of multiyear facilities. In no way should an extended arrangement be perceived as somehow reducing the reality of the economic problems or the required degree of adjustment.

The structural reforms contained in Ghana's program appear to be in the right direction and are a welcome continuation of the momentum of adjustment under previous Fund-supported programs. In the latter respect, I especially welcome the continuity achieved between the last stand-by arrangement and the new arrangements, represented by the establishment of performance criteria for the interval between them. However, I have a concern about the administrative weaknesses that, according to the staff, have "emerged as serious obstacles to the full success of the authorities' economic and financial policies." Many of the problems experienced with extended arrangements in the past stemmed from administrative difficulties in implementing a multiyear program. It would be unfortunate if this situation were to recur. Significant technical assistance has already been extended by the Fund and World Bank, but I wonder whether anything more can be done.

Finally, given Ghana's debt burden and its vulnerability to adverse external developments, it must continue to rely on assistance from the international community for some time. My Government intends to continue its support of Ghana's adjustment efforts and, with other donor countries, has so indicated at recent meetings of the Consultative Group. It is important for donors to demonstrate flexibility in making their assistance available on a timely basis, and for Ghana also to receive the support it deserves from commercial banks. Further assistance from the Fund should become available from the enhanced structural adjustment facility, of which Ghana is likely to be one of the early beneficiaries; if so, this will have implications for the outlying years of the arrangements that are now being put in place.

Mr. Mawakani made the following statement:

I welcome the request from Ghana for continued Fund support under a three-year extended arrangement and arrangements under the structural adjustment facility. I also support the proposed decisions.

Over the past four years, Ghana has established an excellent record of far-reaching macroeconomic policy formulation and determined program implementation. The remarkable progress made to stem a decade of economic and financial deterioration is well described in the staff papers. However, the staff analysis and the authorities' policy framework paper make it clear that, despite the successful implementation of Ghana's Economic Recovery Program, structural and financial weaknesses impeding the attainment of the country's growth potential still persist in the economy. Given that these weaknesses require more time to be dealt with effectively, it is indeed appropriate that the authorities have decided to pursue their adjustment efforts in the context of a comprehensive medium-term program, and I endorse the general thrust of the policies embodied in that program.

During our consideration of Ghana's request for the stand-by arrangement that expired in mid-October, I stated that "firm policy implementation under an extended arrangement is not only crucial but its monitoring is equally important if slippages are to be avoided." This view is more relevant now than ever. I urge the authorities to continue to persevere in program implementation and monitoring of developments, the more so since the recent weaknesses in management and implementation capacity jeopardized the overall success of their Economic Recovery Program. In this regard, I am pleased to note that the World Bank has approved a special technical assistance project aimed at strengthening the analytical and managerial capabilities of the key ministries.

A key element in the authorities' new strategy for achieving a sustained rate of economic expansion under conditions of stable prices and a viable external payments position is the need for a significant increase in the rate of domestic investment. In support of the major steps that have successfully been taken in the exchange rate area, the authorities need to strengthen their efforts to mobilize domestic savings. It seems therefore appropriate for the fiscal program to focus on additional measures for increasing revenue relative to GDP and containing expenditure growth. It is encouraging to note that total revenue in relation to GDP is expected to increase in 1988. However, such an increase is predicated upon the continuation of the reform of the income tax administration and a positive response of taxpayers to the equity- and efficiency-oriented restructuring of the income tax. It is therefore of paramount importance that tax reform developments be carefully monitored to detect any deviation at an early stage.

The emphasis on fiscal policies aimed at improving the overall allocation of public expenditure and restraining its growth is appropriate. However, I note that the reduction of the size of the civil service is to be the cornerstone of the authorities' efforts to restructure the allocation of public expenditures. As Mr. Salehkhou mentioned, about 15,000 civil servants have been already removed from the payroll, and future reductions are expected. On this issue, the Executive Directors of the World Bank have expressed concern about the employment prospects for those being laid off. I share this concern. As I understand it, the World Bank staff will adopt a phased approach to this problem. In the circumstances, a more flexible approach seems the best course of action, and we would like to see the Fund staff move in that direction. Perhaps Ghana could be included in the sample countries for the upcoming study on the impact of Fund-supported adjustment programs on the poor.

The Government's resource mobilization efforts and the steps being taken to restrain public expenditure growth should help to enhance public savings as well as to free domestic financial resources for stimulating private sector activities. I cannot but concur with the staff that tight fiscal and monetary policies are essential to bring the rate of inflation under control in order to facilitate the efficient functioning of the foreign exchange auction and the maintenance of a prudent incomes policy.

To realize the projected steady increase in the domestic savings rate over the period 1987-90, every effort should be made to intensify private savings mobilization. In this respect, the proposed measures to enhance financial intermediation and the recent liberalization of interest rates are steps in the right direction.

I was surprised to see that access to Fund resources under the extended Fund facility was set at 120 percent only. I would appreciate staff comments on the proposed access limit, which is rather low for an extended arrangement. The projected substantial reduction in Fund exposure during the program period gives room for a much higher access to support Ghana's adjustment efforts.

In sum, the structural and financial measures embodied in the medium-term adjustment program are far-reaching and should go a long way in tackling the structural and financial difficulties confronting the country. The success of the program will hinge on a strict adherence to these measures and on the provision of substantial external financial assistance on concessional terms. In view of Ghana's excellent record of program implementation, I am confident that the authorities will carry through their commitment. I hope that the international financial community will also play its part.

Mr. Ouanes made the following statement:

I welcome the medium-term approach proposed by the authoriies to consolidate the gains achieved since 1983. The authorities have demonstrated their resolve to continue with the adjustment process, while at the same time strengthening the supply side of the economy. Their track record in the implementation of previous stand-by arrangements is good and fully justifies a long-term commitment by the Fund in the form of arrangements under the extended Fund and structural adjustment facilities in support of Ghana's restructuring efforts. I therefore endorse the proposed decisions.

There are a number of obvious advantages in combining an arrangement under the structural adjustment facility with an extended arrangement. First, the combination ensures that structural reform and supply-side policies are being supported by appropriate and well-monitored financial policies. Second, it provides adjusting countries with the necessary longer-term financial commitment and a phased flow of resources throughout the period of restructuring, while introducing more flexibility with respect to the pace of adjustment on both the macroeconomic and the structural adjustment sides. Third, the two arrangements are of the same duration and will have mutually supportive benefits. There is also the beneficial impact on the country's external debt profile.

I agree with the thrust of the proposed arrangements; the objectives of attaining balance of payments surpluses, and, particularly, fiscal surpluses throughout the adjustment period, are commendable. The balance of payments surpluses would indeed be needed to help eliminate the country's remaining external payments arrears, thus restoring full normalization of Ghana's relations with its creditors. After having re-established broad balance in the fiscal position, the authorities now aim at achieving increasing fiscal surpluses designed to exclude government investment fully matched by foreign resources during the adjustment period. This objective is commendable as it is not only consistent with the reduction in the weight of the public sector in economic activity, but it is also needed for the envisaged sharp increases in both domestic savings and gross domestic investment.

In this context, I am encouraged by the authorities' determination to reform the state enterprise sector, and in view of the emerging administrative weaknesses, I agree with them on the importance of strengthening the managerial skills at all levels, public and private. Much can also be achieved in terms of efficiency and savings by a comprehensive, orderly divestiture and rationalization program.

The program of reducing employment in the public sector is commendable; it will help reduce the burden on the budget, improve the financial performance in public enterprises, and, most important, it will provide the private sector with the necessary labor force for its own expansion. In this context, I urge the authorities, as they persist in their present efforts, to pay due regard to the social and other costs. A phased approach to layoffs and redeployment would reduce any potential disruptions to public services, while cushioning the impact on the labor force.

The growth performance of the economy has been very impressive; real growth rates have been robust in recent years, permitting a significant improvement in per capita incomes. Furthermore, the programs before us aim at strengthening supply-side incentives by keeping producer prices competitive and by using the exchange rate tool in a flexible manner within the context of continued financial discipline. This approach, together with the commendable efforts by the authorities to rehabilitate and modernize the country's infrastructure, should help in maintaining the pace of economic expansion and, more important, in making such an expansion more broadly based. However, given the most recent sharp acceleration in the inflation rate, I urge the authorities to avoid slippages and to be especially vigilant in this area.

Notwithstanding this word of caution, I believe that the achievements to date of the Ghanaian economy are highly commendable and are worthy of our support and the support of the international community.

Mr. Goos made the following statement:

I commend the authorities on the continued good performance under their adjustment program as well as on their resolve to persevere in their stabilization efforts. In general, it appears that the undertakings for the years ahead--if implemented as outlined in the staff papers--will constitute further important steps toward domestic and external viability, and therefore they deserve the Fund's support.

Without questioning the authorities' commitment to adjustment and their excellent track record in that regard, I do nonetheless see considerable uncertainties down the road that could endanger the eventual success of the program. As explicitly acknowledged in the staff papers, Ghana continues to face major financial and structural problems--problems that might be even more difficult to overcome than those that have been tackled so far. And here I might make two points. First, one has to note that many of the structural impediments appear to be related to privileges enjoyed by vested interests, so that attempts to revamp those privileges might meet with strong political resistance. Second, since the earlier reform measures are already bearing fruit, as reflected in the much-improved performance of the economy, the population at large is not likely to greet further decisive reform measures with great enthusiasm. In any event, it is clear that the reforms agreed under the program are absolutely essential for the restoration of an overall sustainable position, and in particular to provide a durable basis for the authorities' growth objectives.

Other major uncertainties arise from rather optimistic assumptions about the willingness of Ghana's external creditors to provide concessional funds to finance substantially increasing deficits in the external current account. At the same time, the staff's sensitivity analysis of the medium-term balance of payments outlook suggests that the program could run into substantial financial gaps, owing to its high vulnerability to changes in the underlying assumptions. In view of these uncertainties and risks, I wonder whether a more conservative program design than the one agreed with the authorities would not have been more appropriate--and by this I mean a design that places more emphasis on domestic and external adjustment and less on maximizing short-term growth.

I recognize of course that structural reforms in particular are easier to implement in an environment of growth. However, there are clear risks of failure in any adjustment strategy that forces growth--notably through extended borrowing and government expenditures--before the necessary conditions for an autonomous recovery of private sector activity have been created. The likely consequences of such a failure are self-evident--namely, increased domestic and external imbalances, which would be at the expense of economic growth. Thus, it appears that nobody would be well served by setting overambitious growth targets, the more so because I fear that they could breed disillusionment and adjustment fatigue.

Against this background, it is certainly reassuring to note from the staff paper that the authorities are expected to "respond effectively to changing circumstances." However, in view of the substantial uncertainties that I have just mentioned, I believe that the authorities would be well advised--as a minimum--to formulate, in cooperation with the Bank and the Fund, additional adjustment measures of a precautionary nature that could be implemented without delay, should the need arise to counter unexpected adverse developments. With these observations, I can support the staff appraisal and the proposed decisions.

Before concluding, I have a more general question that is prompted by today's revival of the extended Fund facility, which has been inoperative for such a long time. Assuming that Ghana's request meets all the requirements of the extended Fund facility--and I have no reason to question this assumption--I wonder what makes Ghana's program so special that it qualifies for an extended arrangement, in contrast to all the other countries that have adopted similar comprehensive adjustment programs in the past and that have been supported only under stand-by arrangements. If I recall correctly, one major reason for the protracted inoperation of the facility has been the rather high rate of program failures under extended arrangements, which makes me wonder what makes the staff confident that Ghana's arrangement will be more successful than previous ones. Finally, I can support the observations of Mr. Enoch in regard to the requirements of the extended Fund facility arrangements, particularly his reference to the need to seek a substantial liberalization of trade and payments relationships and also the normalization of relations with external creditors.

Mr. Sengupta commented that he wondered on what basis Mr. Goos had come to the conclusion that the failure rate of extended arrangements had been greater than that of stand-by arrangements. He also wondered whether it was correct to say that because Mr. Goos considered Ghana's growth projections overly optimistic, he was willing to accept a fall in the rate of growth in order to meet the balance of payments targets. It seemed that such a stance was contrary to the recent thinking of the Board.

Mr. Goos responded that in suggesting that the authorities aim for a somewhat less ambitious real GDP growth goal than their current target of 5 percent, he had not implied that they should forgo any growth possibilities. His concern had been that if the assumptions underlying the growth targets were too optimistic, and the authorities' policies were tailored toward those assumptions, any deviations from those assumptions could cause the program to run off track, with the attendant risk of adjustment fatigue.

As for the comparative success of extended and stand-by arrangements, his impression was based on recollection and thus he had requested additional information from the staff on that point, Mr. Goos observed. It had seemed that many of the countries with extended arrangements had had difficulty in maintaining the three-year framework and that it might be better to have a series of one-year programs, which offered more flexibility.

Mr. Sengupta suggested that another way of achieving the desired flexibility was to include clearly specified contingency mechanisms that would take effect if the assumed growth did not occur.

The Acting Chairman asked Mr. Goos whether he had a contingency facility in mind for such circumstances.

Mr. Goos replied that while he largely agreed with Mr. Sengupta's point, he did not want to use the words "contingency facility." The point about Ghana's program had been that it would be appropriate and advisable to have available precautionary measures that could be implemented if unexpected developments threatened its success.

Mr. El Kogali made the following statement:

I commend the authorities for their far-reaching adjustment efforts, which, with Fund support, have begun to create a favorable environment for growth and a possibility of a viable balance of payments position. After a decline of 4.7 percent in 1983, real GDP grew by 8.7 percent in 1984 and thereafter by about 5.0 percent annually, representing an impressive improvement in the country's economic performance. Apparently this success story has resulted not only from the substantial liberalization and flexible exchange rate policies but also from the relatively large inflow of external capital. As illustrated in Table 6 of EBS/87/207, Ghana's domestic adjustment measures have been supported by substantial external resource inflows from the Fund as well as from bilateral sources--something that is lacking in many Fund-supported programs in other African countries. Perhaps this explains why Ghana has performed relatively well, whereas many other African countries have not.

Nevertheless, it is clear from the staff papers that Ghana faces major structural and financial problems. Of great concern are the infrastructural bottlenecks, inadequate savings, the high rate of inflation, the apparently insufficient incentives, and the heavy debt service burden--all of which could seriously constrain the growth of real GDP. Added to these constraints is the fact that the Ghanaian economy, like other African economies, is highly vulnerable to adverse developments in the international environment. This factor has been clearly emphasized by Mr. Salehkhou, and it underscores the need for diversification of the production base.

In recognition of these structural rigidities, the authorities are tackling the problem in a medium-term framework through a comprehensive adjustment program for 1987-90. The basic assumptions, targets, and policy content notwithstanding, the program objectives appear somewhat ambitious, and will require timely external assistance in the form of grants and concessional loans from official multilateral and bilateral agencies as well as a favorable response from commercial lenders. However, a worrisome aspect of the program is that the maturity structure of Ghana's external debt could result in a heavy debt-servicing burden that might seriously undermine the achievement of growth objectives. Projections are that external debt service, excluding repayments to the Fund, will be 28.2 percent of total exports in 1987, rising to 31.9 percent in 1990; and if repurchases to the

Fund were included, the annual debt service ratio for the program period would average 52.7 percent. In this connection, I read with serious concern the staff statement to the effect that no debt rescheduling is being envisaged. While it is true that the bulk of Ghana's debt is to multilateral institutions, I would like to stress that without some debt relief it will be very difficult, if not impossible, for Ghana to sustain the growth momentum.

I welcome the wide range of measures embodied in the program, particularly those designed to liberalize prices and the exchange and trade system, mobilize additional revenues, strengthen financial discipline, and promote mobilization of financial savings and their allocation to the most productive sectors. To achieve this, much hinges on the strong performance of the agricultural and industrial sectors, and the policies described in the policy framework paper regarding these sectors must be effectively implemented. However, I wonder whether some of the stabilization measures would not be inconsistent with aspects of the medium-term structural and growth objectives of the program. For instance, although there is a need to bring down the rate of inflation, the rapid rate of deceleration expected to be achieved by 1990 through very tight fiscal and monetary policies might undermine growth. It is therefore essential to monitor closely the structural and growth impact of the policy measures.

The Ghanaian experience with three successive stabilization programs in the years 1983-87 provides a useful lesson that could, in general, be applied to African economies. While the implementation of such programs might in certain circumstances lead to a turnaround in economic activity, fundamental structural and economic imbalances could nevertheless remain. To address this characteristic problem of the low-income countries, the Ghanaian authorities have set out a comprehensive medium-term program, which I fully endorse, and I support their requests for both an extended arrangement and arrangements under the structural adjustment facility. I hope that Ghana's extended arrangement will mark the beginning of an effective reactivation of the extended Fund facility, and I urge the Board to be liberal in its treatment of similar requests, particularly from the low-income countries.

Mr. Rieffel made the following statement:

We continue to be impressed by Ghana's progress since 1983 in establishing the basis for sustainable growth and a viable external payments position. We are also impressed by the degree of cooperation between the Fund and the Bank that appears to exist in this case. For these reasons, we support Ghana's requests for an arrangement under the structural adjustment facility and for an extended arrangement. However, we have several concerns that are related to procedural issues.

We are impressed by the speed with which the exchange rate system is being liberalized, and we believe that the Research Department should study Ghana's experience closely in order to draw lessons for other countries. We place considerable importance on the objective of completely liberalizing service and transfer payments by the end of June 1990.

Price controls are maintained for only a few essential goods, but these goods have not been identified. Do the authorities intend to eliminate most or all of them by the end of June 1990? In either case, more information is needed to judge progress in this area, and we are surprised by the absence of a section on price controls in the timetable of the policy framework paper.

It is also difficult to judge the pace of progress in the parastatal sector. We see commitments to identify 30 state enterprises for sale, liquidation, or conversion, but the documents before us provide little context. Do these 30 enterprises represent 10 percent of the parastatal sector or 90 percent? More generally, after three more years of Fund support, will the parastatal sector be paying its own way or will it still be dependent upon budgetary support or other direct or indirect forms of support?

Another area of concern is the cocoa price, which may be the single most important price in the economy. We applaud the decision to raise the producer price to 55 percent of the world market price for the 1989/90 crop year, but this jump over two years seems to be equal to the jump that was made for the current crop year alone, which makes it look as though the pace of progress is slowing down. Also, it is not clear from the information in the documents that 55 percent as an objective for 1989/90 is better than a higher figure such as 65 percent. In this connection, we note the importance of reducing the costs of the Cocoa Marketing Board. Fertilizer operations will be privatized by mid-1990 and mechanization services will be discontinued on a similar schedule. Why can these objectives not be reached by mid-1989 or sooner?

The policy framework paper suggests that the forestry sector is an important one, and consequently we were surprised that it was not mentioned in the timetable. We urge that the program to improve forestry management be in place in 1988/89 rather than in the final year of the program. Impressive progress has been made in reducing the size of the civil service. We are pleased that the reductions to which the authorities are committed are not backloaded, as they have been in some other programs.

As for monetary policy, we welcome the establishment of an auction market last month for treasury bills, and would appreciate any information the staff may have on the initial reaction. We believe that loosening controls on sectoral credit allocation is a sufficiently important objective to be included as a structural benchmark for either the structural adjustment arrangement or the extended arrangement. Along the same lines, it is difficult to imagine continued economic progress in Ghana without speedy action in strengthening the banking system. We understand that the World Bank is preparing an $80 million credit for financial sector adjustment, and we would welcome some elaboration from the World Bank representative on the scope and the objectives of this credit.

Finally, despite the generally excellent progress made since 1983, there have been two costly episodes of slippage. Further episodes of the same kind would be most regrettable.

We see three procedural issues: the fact that the second tranche under the extended arrangement is based on performance before the arrangement begins; the alignment of the program cycle with the budgetary and policy planning cycle; and the choice of an extended arrangement rather than a stand-by arrangement.

On the first of these issues, only in exceptional circumstances can we support releasing funds for performance before an arrangement begins. The staff argues that Ghana's circumstances are exceptional, and we are inclined to agree. In particular, we note that Ghana has met 13 quarterly tests since 1983 with only one waiver, and that Ghana's request might have been considered before September 30 if the Board had not been preoccupied with the Annual Meetings.

The second issue--the alignment problem--is more difficult to evaluate. The staff seems to be arguing that we are getting four years of sound policies with three years of financing, but another view is that the expiring stand-by arrangement and the new extended arrangement involve a substantial degree of overlap. In general, we would urge the staff to negotiate programs that are aligned with the budget year, even if it means some frontloading of the financing provided by the Fund to bridge a gap from an earlier program. At the same time, we recognize that many adjustment measures do not depend on the budget, and in Ghana, measures have been adopted steadily under programs that have not been aligned with the budget.

The choice of an extended arrangement raises three distinct issues. The first is whether Ghana is "ready" for such an arrangement. In this connection, we note that the staff appraisal of Ghana's stand-by request--approved by the Board just a year ago--stated that "program implementation and monitoring in Ghana remains weak." Generally, we do not believe it is prudent for the Fund to enter into extended arrangements with countries where implementation and monitoring are weak. Such arrangements should be limited to countries with a record of strong performance, where there is reason to believe that additional financing from the Fund after the completion of the arrangement will not be necessary. We have examined carefully Ghana's particular circumstances, and in the end, we have concluded that Ghana's record of performance justifies the choice of an extended arrangement. I join Mr. Enoch in emphasizing the importance that we attach to the 1989/90 objective of balance of payments viability in the context of a liberalized payments system, the elimination of arrears, and normal relations with creditors.

The second issue is the design of the extended arrangement. Our impression from reading the staff papers is that the structural adjustment arrangement is doing all the work, and the extended Fund facility resources are simply piggy-backing on it. In one sense, this is comforting; it suggests that the policy framework is as comprehensive and aggressive as feasible in Ghana's case. This explanation may not stand up to scrutiny, however. The objectives in the second and third years of the program are no better defined than in other cases where the structural adjustment arrangement was not complemented by an extended arrangement. Consequently, we must say that in the future, we would not wish to see other extended arrangements presented to the Board that do not provide clear evidence that the country concerned is making an effort beyond that expected under a structural adjustment arrangement alone. In particular, we would want to see the policy measures to be taken in the later years of the program described with considerably greater specificity.

The third issue is the absence of any structural performance criteria. How can an arrangement specifically designed to address structural weaknesses contain performance criteria that are strictly financial in nature? We have expressed interest in the possibility of "reviving" extended arrangements, but extended arrangements that are indistinguishable from three consecutive one-year stand-by arrangements of the classic variety are not what we had in mind.

At the recent Annual Meetings, Secretary Baker proposed the establishment of an external contingency facility to help cushion Fund-supported programs from the adverse effects of unforeseen, exogenous developments. As we studied the case of Ghana, we were struck by the risk that the objectives of Ghana's program would not be met because certain assumptions about exogenous factors used in designing the program were optimistic. In our discussions of the external contingency facility in the weeks to come, it may be useful to keep the case of Ghana in mind.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/87/152 (11/2/87) and EBM/87/153 (11/6/87).

3. RELATIONS WITH GATT - CONSULTATIONS WITH CONTRACTING PARTIES - FUND REPRESENTATION

The Executive Board approves Fund representation at the consultations with the CONTRACTING PARTIES to the GATT on Brazil and Korea to be held in Geneva during the week of November 23, 1987, as set forth in EBD/87/278 (10/28/87).

Adopted November 2, 1987

4. BHUTAN - TECHNICAL ASSISTANCE

In response to a request from the Bhutanese authorities for technical assistance in the fiscal field, the Executive Board approves the proposal set forth in EBD/87/279 (10/28/87).

Adopted November 2, 1987

5. NIGER - TECHNICAL ASSISTANCE

In response to a request from the Nigerien authorities for technical assistance in the fiscal field, the Executive Board approves the proposal set forth in EBD/87/280 (10/28/87).

Adopted November 2, 1987

6. TOGO - TECHNICAL ASSISTANCE

In response to a request from the Togolese authorities for technical assistance in the fiscal field, the Executive Board approves the proposal set forth in EBD/87/282 (10/30/87).

Adopted November 3, 1987

7. ASSISTANT TO EXECUTIVE DIRECTOR - EXTENSION OF OVERLAP PERIOD

The Executive Board approves the recommendation of the Committee on Executive Board Administrative Matters relating to the extension of the overlap period for the appointment of an Assistant to Executive Director as set forth in EBAP/87/236 (10/30/87).

Adopted November 3, 1987

8. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 87/62 and 87/63 are approved. (EBD/87/281, 10/29/87)

Adopted November 4, 1987

9. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAP/87/237 (10/30/87) and EBAP/87/240 (11/3/87) and by an Advisor to Executive Director as set forth in EBAP/87/237 (10/30/87) is approved.

APPROVED: June 20, 1988

LEO VAN HOUTVEN
Secretary