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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/139

10:00 a.m., September 16, 1987

M. Camdessus, Chairman
R. D. Erb, Deputy Managing Director

| Executive Directors | Alternate Executive Directors |
|---|---|
| A. Abdallah | E. T. El Kogali |
| | Yang W., Temporary |
| C. H. Dallara | |
| J. de Groote | |
| | E. V. Feldman |
| | A. M. Othman |
| G. Grosche | B. Goos |
| | J. Reddy |
| A. Kafka | |
| | M. Foot |
| M. Massé | G. D. Hodgson, Temporary |
| Mawakani Samba | |
| | I. Al-Assaf |
| G. Ortiz | C. Noriega, Temporary |
| | M. Fogelholm |
| H. Ploix | D. Marcel |
| | G. Pineau, Temporary |
| | G. P. J. Hogeweg |
| C. R. Rye | I. Sliper, Temporary |
| G. Salehkhou | |
| A. K. Sengupta | L. E. N. Fernando |
| K. Yamazaki | M. Sugita |
| S. Zecchini | |

L. Van Houtven, Secretary and Counsellor
R. Gaster, Assistant

Also Present

B. Samoslik, Minister of Finance; K. Krowacki, Director, Bureau for International Organizations, Ministry of Finance; J. Boniuk, Financial Counsellor, Embassy of the Polish People's Republic. African Department: R. J. Bhatia, Deputy Director; R. C. Williams. European Department: M. Russo, Director; P. B. de Fontenay, Deputy Director; M. Guitián, Deputy Director; A. R. Boote, J. Prust, H. O. Schmitt, K. Swiderski. Exchange and Trade Relations Department: L. A. Whittome, Counsellor and Director; S. J. Anjaria, E. Brau, D. Burton, G. G. Johnson, H. B. Junz, M. R. Kelly, C. Puckahtikom. External Relations Department: A. F. Mohammed, Director; D. D. Driscoll, P. C. Hole. Legal Department: W. E. Holder, Deputy General Counsel; H. Elizalde, R. H. Munzberg. Middle Eastern Department: J. G. Borpujari. Research Department: J. A. Frenkel, Economic Counsellor and Director; A. D. Crockett, Deputy Director; M. Goldstein, Deputy Director; E. R. Borensztein, N. U. Haque, M. S. Khan, P. R. Menon, P. J. Montiel, I. Otani, D. Villanueva, P. Wickham, T. A. Wolf. Secretary's Department: C. Brachet, Deputy Secretary. Treasurer's Department: M. A. Lumsden, O. Roncesvalles. Western Hemisphere Department: S. T. Beza, Director. Bureau of Statistics: J. B. McLenaghan, Deputy Director; J. A. J. Bove, M. J. Brimble. Personal Assistants to the Managing Director: R. M. G. Brown, H. G. O. Simpson. Advisors to Executive Directors: A. Bertuch-Samuels, M. B. Chatah, L. P. Ebrill, S. M. Hassan, J.-C. Obame, P. Péterfalvy, Song G., D. C. Templeman, A. Vasudevan, J. E. Zeas. Assistants to Executive Directors: A. R. Al-Abdullatif, J. R. N. Almeida, O. S.-M. Bethel, H. S. Binay, E. C. Demaestri, F. Di Mauro, W. N. Engert, S. K. Fayyad, V. J. Fernández, S. Guribye, M. A. Hammoudi, L. Hubloue, J. M. Jones, S. King, T. Morita, D. V. Nhien, A. Rieffel, D. Saha, G. Schurr, U. Teichmann.

1. POLISH PEOPLE'S REPUBLIC - 1987 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1987 Article IV consultation with Poland (SM/87/219, 8/18/87; Cor. 1, 9/14/87; and Sup. 1, 9/14/87). They also had before them a background paper on recent economic developments in Poland (SM/87/224, 8/27/87; and Cor. 1, 9/14/87).

Mr. Bazyli Samojlik, Finance Minister of Poland, represented Poland.

Mr. Samojlik said that during the first eight months of 1987, industrial production in Poland had grown by 3.6 percent in constant prices, exports in convertible currencies at current prices had grown by 11.4 percent, imports by 4 percent, and that the trade surplus was $714 million. The authorities expected to have an end-1987 surplus of about $1 billion in convertible currencies. There had been a TR 245 million deficit in trade with the ruble area during the same period, and that deficit was expected to reach TR 500 million at end-1987. Wages had grown by 21 percent, money incomes by 25.8 percent, retail prices by about 22 percent, and the money expenditure of the population by 26.7 percent.

The authorities had already started to introduce the market-oriented second stage of economic reform in Poland, Mr. Samojlik continued. They recognized that a critical mass of properly interrelated organizational, economic, and legal measures had to be introduced simultaneously if the desired results were to be achieved--a difficult task. A complex and detailed program, together with a schedule of the specific decisions and needed changes, had already been prepared. The authorities expected that the assistance of the Fund would be available during the implementation of that program.

Mr. Samojlik then made the following statement:

> I would like to begin by thanking the staff for their very competent work in producing the report for the 1987 Article IV consultation. In general, the report gives an accurate analysis of the present position of our economy and displays an understanding of the processes that have brought that position about.
>
> The report has been carefully studied by various government agencies. In many respects its conclusions are shared by my Government--as is evident from the present stance of economic policy and from the wide-ranging plans for economic reform which are now under preparation. The Polish economy is currently undergoing a very significant transformation. In 1988 we plan to introduce a broad program of economic, legal, and organizational changes which will be accompanied by similarly important changes in the instruments used in managing the economy. A main objective of these reforms will be to restructure our economy in such a way as to increase the share of foreign trade in the national product.

Policy will be subordinated to this objective and, in this sense, the changes now being introduced and those that are proposed for the near future are essentially in conformity with the recommendations in the staff report.

My Government is in full agreement that the fundamental precondition for the introduction of effective change in our economic system is the adoption of appropriate policies in the areas of prices and incomes determination, money and credit, and the Government's budgetary operations. In their financial policies my authorities will place great emphasis on controlling credit expansion and eliminating the budget deficit through a reduction in subsidies and a standardization of the tax system. Starting from 1988, our annual financial plans will assume a primary function rather than taking second place to the annual economic plan--essentially expressed in physical terms--as has been the case in the past. These moves are to be carried out in parallel with a reduction in the central allocation of resources and a further liberalization of the price system. Prices will essentially be determined by market forces and will be the decisive factor in allocating resources. An active exchange rate policy will be used to promote foreign trade. These moves also seem to be in line with the guidelines contained in the staff report and it is our view that they will contribute to the creation of a flexible economic system which is capable of adjustment to changes in both domestic and external conditions. It must be understood that in view of the character of the productive structure which has evolved over several decades, and of the ingrained habits of people both as producers and as consumers, it is not possible to introduce all these changes at once. There would appear to be a certain optimal order in which individual elements of the proposed policy package should be introduced. In part, this is because, for certain reforms to be effective, the necessary preconditions must first be created. At the same time, however, we recognize that a certain critical mass of properly interrelated measures must be introduced initially if the reform process is to gain the necessary momentum. It also needs to be remembered that any program of economic reform cannot be expected to bear fruit overnight: rather, the benefits are likely to appear only over an extended period. And, of course, much will depend on external factors beyond our control.

The most serious limitation on the speed with which we can implement our reform proposals is the state of the balance of payments and the external debt, both in convertible and nonconvertible currencies. Of critical importance is the current account deficit and the total stock of debt in convertible currencies. In fact, both in absolute and in relative terms, Poland ranks as one of the world's largest debtor nations. This is evident from the ratio of the external debt to convertible currency exports--a ratio which in 1986 was on the order of 600 percent--and from the ratio of our debt service payment obligations to the value of our exports which in 1986 was about 110 percent. These indicators have been significantly affected by the huge drop in export volumes which occurred in 1981/82 and they also reflect the fact that the Polish economy is still to a great extent a closed economy. It is clear that Poland is at the present time unable to meet its debt service obligations fully and we are therefore seeking to enter long-term debt rescheduling arrangements with our creditors.

The staff report stresses the fact that the current account deficit in convertible currencies is equivalent to only some 1 percent of gross domestic product, and this is taken as an indication that the adjustment task facing us is relatively small. We feel that this view takes inadequate account of the fact that the majority of goods sold on domestic markets in Poland simply cannot, for a variety of reasons, be traded on international markets. In our view, a more pertinent indicator of the size of the task facing us is the relationship between the current account deficit and the level of exports of goods and services; this ratio amounted to about 11 percent in 1986. In reality the necessary reallocation of resources cannot be brought about without a long-term process of structural change to bring about a substantial increase in the level of our foreign trade. That is why we have taken what we consider to be a realistic approach: the current account deficit in convertible currencies cannot be eliminated in one or two years even though the simple arithmetic of the situation could be taken to suggest that this would be feasible.

I would like to stress that the measures that are easiest to introduce to improve the current balance have already been taken and their effect has been fully realized. The current deficit in convertible currencies has been reduced from $3.2 billion in 1981 to about $0.6 billion in 1985 and 1986. This change, however, has been attained primarily through a severe reduction in imports: on average, the value of imports in the period from 1982 through 1986 was some 40 percent below the level of 1981. Over the same period exports of goods and services fell from about $8 billion to less than $6 billion. A second factor that has contributed to the improvement in the current account position has been the large increase in private transfers. However, it would be unwise to assume that the rapid increase in these receipts will be maintained indefinitely. It should also be remembered that a number of external factors in the period 1982-86 worked to Poland's disadvantage. There was a deterioration in the terms of trade and, for reasons that were not purely economic, our economy was completely cut off from external support. Moreover, our export performance was adversely affected by various protectionist measures in other countries. While the situation is now changing, some of these factors continue to influence our balance of payments performance. In the latest balance of payments scenario that was presented to the recent Fund mission we have assumed a normalization of our relations with our creditors and improved access for Polish exports to foreign markets.

Attainment of current account balance in convertible currencies will depend mainly on our increasing the rate of growth of exports. We have not assumed any change in the terms of trade and the increases in export receipts will be brought about through raising volumes. Taking into account the import intensity of our economy, particularly in the traded goods sector, and also taking into account the reduction in imports that has already taken place, we are unable to contemplate any further lowering in imports. This would inevitably cause a decline in production and an erosion of our productive capital stock which would end all prospect for repayment of our external debt. Accordingly, the balance of payments scenario presented to the Fund mission has assumed that exports will grow at an annual rate of 6.3 percent and that imports will grow at a rate of 3.7 percent. The growing trade surplus that would result would allow us to achieve balance on the current account in convertible currencies in 1991. We consider that this is already a formidable task but, with a cooperative approach from our creditors, we believe that it can be accomplished.

I would like to note that per capita real consumption continues to be lower than it was at the end of the 1970s: in 1986 it was 4.5 percent lower. This is one of the key reasons why we have encountered difficulties in trying to link wages more closely to productivity and why we face considerable potential inflationary pressures. It also seriously affects the pace at which economic reform can proceed. However, because of the decapitalization of our productive capacity, we intend to ensure that the rate of growth of investment remains above that of consumption.

The staff report suggests that in order to balance the current account in convertible currencies sooner than we now plan, it could be possible to shift a portion of our current exports to the ruble area to the convertible area instead. This suggestion partly derives from the fact that our trade and current account positions in nonconvertible currencies were practically in balance in the first half of this year. I would like to note that a part of this improvement resulted from a terms of trade improvement. I would like also to note that a redirection of exports from the ruble to the convertible currency area would probably be self-defeating, in that the likely response of our trading partners would be to reduce deliveries of goods to Poland which can be sold on convertible currency markets.

It should be stressed that the projected growth rate of export volume in the period 1988-91, on average 6.5 percent, is higher than the likely rate of growth of world trade over this period. This would mean that, unlike during the 1960s and 1970s, Poland would be increasing its share in world trade. The support of the Fund, the World Bank, and our creditors is essential if we are to achieve our goals, especially that of restoring equilibrium to our external accounts. The appraisal in the staff report of the present position of the Polish economy and of the policies that my Government is already implementing and will be implementing in the future is such that it justifies a positive response to our readiness--which we have already indicated--to start negotiations with the Fund on an adjustment program supported by a stand-by arrangement.

Mr. de Groote made the following statement:

Poland's case more than any other evokes a feeling of unfinished work: Poland's membership in the Fund was in itself a momentous decision, both because it indicated that country's intention of adopting new economic orientations, and because it gave hope of alleviating, for the West, the difficulties resulting from Poland's indebtedness. These hopes have not yet been fulfilled. Political tensions had to be resolved by the Polish Government before economic choices could again be given priority attention, and the Fund's membership had to become used to a renovated relationship with Poland. The time has now come to go forward, so that Poland can derive the advantages it could expect from its membership, and so that the Fund can provide the assistance which is part of its mission to provide. Poland's recovery is going to be a Poland/Fund matter, or it is not going to occur at all. Indeed, the Fund can give crucial assistance to Poland in setting up an overall reform of its economic system, and can give the Polish Government the backing necessary to improve public understanding in Poland that the reform plan now being envisaged is not just one more reform plan in a succession of abortive attempts, but a real strategy for change. The challenge is serious: the possibility that an important European country, with strong agricultural and industrial infrastructure, could remain trapped in a major liquidity crisis for many years to come, with a perilous supply situation, is unacceptable. This is a matter of concern both for Poland and for the Fund itself.

The staff documents bring out the possible basis for the restoration of the Polish economy, under the aegis of the Fund. First, a sustainable balance of payments position in the coming years can only result from a systemic adjustment; demand management alone will not do. Mr. Samojlik has clearly recognized this point, in section 3 of his written introductory statement: a reduction in the extent to which resources are centrally allocated, and a liberalization of the price system, are absolute preconditions for a better balance of payments position. Only measures of this nature, supported by the flexible exchange rate policy to which the Polish authorities are committed, can develop Poland's exports beyond their current depressed level. In other words, the Polish Government must rapidly reduce the administrative and inward-looking character of the country's system of economic management, and work to restore the market-oriented transmission mechanisms.

Only these mechanisms can create direct and transparent links between the Polish economy--including enterprises and individuals--and the world market. Without such links, no adjustment can take place. Administrative interference with these transmission mechanisms must be radically cut back and the size and role of the budget drastically altered.

I very much agree with Mr. Samojlik's important point that a "critical mass" of measures has to be introduced initially, and I strongly urge the Polish Government to avoid the danger of gradualism. The documents before us show that inefficient allocation mechanisms pervade the entire economic system--leading us to the conclusion that a radical change is required.

The Polish Government now intends to consider a comprehensive systemic reform package--including measures relating to prices, wages, fiscal and monetary policy, foreign trade, banking, the ownership of enterprises, and entrepreneurial motivation. All these measures must be integrated into a clear strategy, they must be coherent with one another, and they must include an announced and agreed timetable for their introduction. All this seems an important precondition for the success of Poland's negotiations with the Fund. These negotiations should normally lead to an important involvement of the Fund in Poland's future. Indeed, one could not conceive of eliminating the subsidies and allowing for major price increases without providing Poland with sizable resources with which to maintain its supply position during this transition period. The liberalization of the Polish economy is going to unleash major forces that cannot be forecast with any precision. The Fund's intervention is therefore fully justified because this systemic program has obvious balance of payments implications.

The necessary demand-management measures in the Polish economy should be in harmony with the progress of the systemic reforms. As long as the transmission mechanisms are missing, enterprises cannot be profit oriented and the budget has to remain lax. Traditional performance clauses, such as the control of liquidity, the manipulation of the exchange rate, and interest rate adjustments, cannot be efficient unless they are geared to an overall framework which makes their operation possible. Given the present willingness of the Polish authorities to consider a comprehensive, systemic reform package, it would therefore be advisable for the staff to fine-tune its demand-management proposals to each stage of the reform process. Along those lines, I see no need to accord absolute priority to a balance of payments objective, as long as it is understood that the balance of payments has to improve as a result of the adopted measures. If we fix balance of payments objectives too soon, we run a major risk that the restoration of the Polish economy will be jeopardized by the attempt to attain a given external objective at all costs, including the cost of growth prospects in subsequent years. I am sure that the Polish authorities will be willing to rely on the Fund's expertise in the design of an appropriate stand-by arrangement, and in the development of a matching set of performance criteria.

Finally, I wish to emphasize this chair's opposition to the export-retention accounts. As the cases of some other countries clearly indicate, a system of retention quotas does not allow the balanced export-oriented development of the whole national economy, and disrupts cooperation among domestic enterprises. Poland is not the first centrally planned economy to experiment with this administrative method. Knowing that it has failed to produce the desired effects in the other cases, the Polish authorities should be advised to seek other solutions which will be in line with the needed reform package.

I wish the Polish authorities much success in the major endeavor of overcoming the failures of previous policies and reorienting their economic strategies in a more fruitful direction, a direction congruent with the Fund's own views on Poland's future and consonant with the legitimate ambitions of Poland's population.

Continuing, Mr. de Groote said that the staff report provided the Board with a thorough but somewhat sobering analysis of the Polish economy and the severe problems that that country faced. Some recovery in Poland's economic performance had been achieved since the dislocation of the early 1980s. The current account deficit to the convertible currency area had been reduced from $3.2 billion in 1981 to $0.7 billion in 1986, and some restoration of output growth as well as some gains in productivity had taken place. Despite that progress, the performance of the Polish economy left much to be desired: in 1986, real output still lagged some 7 percent behind its peak level of 1978; inflationary pressure had intensified; the current account deficit in convertible currencies had not improved during the first half of 1987 compared with the same period of 1986; and the external debt in convertible currencies was increasing, with the large and growing arrears currently reaching almost $5 billion.

He therefore welcomed the fact that the authorities had announced plans for a second stage of economic reform, Mr. de Groote continued. There was, however--as the staff had noted--an urgent need to develop a concrete and comprehensive set of measures, with a precise timetable, from the many proposals being discussed. He strongly welcomed the authorities' plan to introduce a broad program of economic, legal, and organizational changes in 1988. In the context of such a program, the authorities should strive for measures that were mutually reinforcing. Experiences in other economies of a similar structure had shown that isolated reform steps in some areas could easily increase problems in others, thereby discrediting the reform approach and raising public concern, not to mention opposition by certain affected groups. A comprehensive blueprint for reform and for the implementation of the first steps should provide the necessary basis for fruitful discussions with the staff on a Fund-supported adjustment program. Such a program should center on the elimination of excess demand. Only then would it be possible to reduce the rate of inflation, further loosen price controls, and free up resources for higher exports.

Mr. Grosche said that the staff had correctly urged the authorities to correct the existing loose stance of financial and incomes policies--exemplified in 1986 by direct subsidies which had reached 40 percent of public expenditure. Those subsidies needed to be reduced. Moreover, monetary expansion had to be curtailed, and interest rates increased to positive levels. Wage increases should match productivity gains more closely. Action in those areas was a necessary prerequisite for the successful implementation of a broader-based reform program, aimed at the development of a more market-oriented system of resource allocation.

The authorities correctly intended to focus on price and exchange rate liberalization, Mr. Grosche noted, together with reforms of the state enterprises, which would be given more responsibility for the results of their operations. Such reforms would have to include a limitation of credit growth to enterprises--currently the main vehicle of monetary expansion as such credit was used partly to cover losses. More use should be made of the newly introduced provision with regard to closing down inefficient enterprises. Clearly, those and similar measures had to be taken with the aim of achieving higher returns on investment in the enterprise sector. Structural change, together with better external adjustment, could also be fostered by establishing joint ventures between Polish and foreign enterprises. The authorities had in 1986 enacted a law setting up the legal framework for such ventures, but cumbersome procedures had apparently prevented the production of tangible results.

As their targets for external adjustment showed, the authorities did not currently foresee a progressive move toward current account equilibrium--to be reached by 1991--Mr. Grosche noted. While that new target marked an encouraging change from prior positions, a more rapid adjustment than was currently foreseen was certainly desirable, given the need for the normalization of external financial relations. The question, however, was whether more rapid adjustment was feasible, a question on which there were still differences of views between the staff and the Polish authorities. He appreciated the arguments put forward by Mr. Samojlik, particularly the argument that the majority of goods sold on the domestic market could not be sold on foreign markets because of the inflexibility of the Polish economy. A further curtailment of imports was also difficult, if not unwarranted, and current account equilibrium would have to be brought about mainly by increasing exports. Nonetheless, that issue would have to be further reviewed. As the staff correctly stressed, the swing needed to reach balance was on the order of only 1 percent of GNP. And provided that the right policies were in place--including a further depreciation of the zloty--more resources should become available for exports even in a system still hampered by a number of structural impediments. In that context, it was noteworthy that the current account with the nonconvertible area, having shown a deficit for nearly ten years, had now reached equilibrium. Forecasted surpluses in the future should even allow the reduction of indebtedness with the nonconvertible area.

It would be difficult to engage Fund resources in a Fund-supported adjustment program if the prospects for reaching a viable balance of payments situation in the short to medium term were blurred, Mr. Grosche said. The monetary resources of the Fund had to be repaid in a relatively short period of time, and it would therefore be of great comfort if there were the prospect of reaching a current account equilibrium somewhat earlier than was now scheduled. He agreed with Mr. de Groote that the current account equilibrium would have to be reached as a result of the adoption of appropriate policies, rather than by making it a target to be precisely planned and reached. But without some idea of a current account goal, it was difficult to implement the correct policies.

While he favored an early start for negotiations on a Fund-supported adjustment program, Mr. Grosche concluded, he felt that more information was warranted if negotiations were to be fruitful--particularly with regard to a clear outline of the reform strategy and the current account objectives.

Mr. Hogeweg made the following statement:

> Poland's present situation stems from a period of rapid expansion in the 1970s and the connected emergence of external current account deficits. The resulting debt accumulation led to a crisis situation in the early 1980s when interest rates rose and creditor confidence collapsed.
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> At this juncture there are a number of encouraging signs, such as the increase in real economic growth and exports, the increased awareness of the authorities of the necessity to work toward current account surpluses with the non-ruble area--and Mr. Samojlik's statement clearly indicates an understanding of the need for a more efficiently functioning economy. These gains are currently overshadowed by domestic demand pressures that have caused a rapid increase in prices and an increase in the current account deficit with the non-ruble area. Moreover, it is a matter of considerable concern that arrears on the external convertible debt are increasing while at the same time nonconvertible debt has been reduced and foreign exchange reserves are rising.
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> In these circumstances, I agree with the staff's appraisal. Poland's external debt burden implies an urgent need for further movement toward generating current account surpluses. Apart from reducing the level of debt, such movement will promote an environment conducive to debt reschedulings precisely because it reduces Poland's dependence on them. I do not fully agree with the argument that the current account deficit can be easily reduced because it is only 1 percent of GNP; here I sympathize with Mr. Samojlik's

argument relating the size of the deficit to the level of exports. However, even though the percentage change needed in exports is large, it is necessary in view of the heavy debt service burden.

The two key areas are the exchange rate and appropriate demand management. On the exchange rate, I have little to add to the staff's argument that the Polish authorities should aim at an exchange rate at which all exports are commercially viable. Such a move will of course be useful only if accompanied by measures to make the external trade system more liberal, allowing a full pass-through of the effects of exchange rate changes to producers.

The second key area is demand management, and in Poland's case that will mean action to rein in the large increases in real wages. An important avenue in this respect will be to bring key prices more in line with those on world markets. Measures are also needed to enhance the financing discipline of enterprises. These include appropriately positive real interest rates and price competitiveness among enterprises. Such measures--by contributing to a more efficient management of enterprises--might also have beneficial effects on the allocation of labor, which in turn might reduce the tightness of the labor market and thus remove one of the pressures for higher wages. In these areas it seems that there is potentially scope for a large World Bank role.

Furthermore, we could as a first step welcome the introduction of a retention scheme that allows exporters to retain part of their foreign exchange receipts and to dispose of it freely. In the longer run, however, the export incentive function of retention accounts should be taken over by the exchange rate itself.

The policy package contained in the present staff appraisal is comprehensive and ambitious--the only way in which lasting results can be achieved. The staff is right to note that partial measures could be counterproductive, and might make the social and political acceptance of a more comprehensive package more difficult. Poland seems a classic case in which excess domestic demand resulting from lax credit and wage policies has been countered by administrative controls. Such an approach only fights symptoms, while the staff policy package addresses the roots of the problem. However, the impact of market signals in an economy depends on its structure, and administrative constraints of course tend to diminish that responsiveness.

As Mr. Samojlik noted, it is not possible to introduce the whole package overnight. The Polish authorities are well aware that certain preconditions must first be created--but also that a critical mass of properly interrelated measures must be initiated to lift the adjustment effort off the ground. This problem of the dynamics of adjustment is relevant not only to Poland, but more generally to economies that use administrative measures widely. I would be interested to hear the staff's comments on this issue.

I support the proposed decision.

Mr. Sliper made the following statement:

I was encouraged by Mr. Samojlik's statement. He has adopted a positive approach to the staff report and to the process of reform that lies ahead for his Government. The Polish authorities do seem to have identified the key areas for liberalization and are committed to implementing the needed measures.

Both Mr. Samojlik's statement and the staff report clearly present the policy choices facing the Polish authorities. In essence, the key issue is the pace of adjustment. The staff conclusion seems clear: "There is an urgent need to distill from the many proposals now under consideration a concrete and coordinated set of measures that focus on the economy's most pressing problems."

In coming to a judgment about the required adjustment, four interrelated factors should be taken into account: the history of the reform process in Poland during this decade; the attitude of the Government; the role of market interventions in a centrally planned economy; and the current debt situation.

The reform process in the 1980s has been circuitous. At various stages the authorities seemed to make great strides, only to reverse them later, some totally and others partially. I refer particularly to 1982, when a very comprehensive reform program was implemented but the liberalization measures were substantially reversed in 1983. The time now seems right for another sustained effort without the reversals that have characterized the previous liberalization measures.

The Government does seem willing to continue with the reform process, and the fact that the Government is generating many ideas is encouraging. As Mr. Samojlik recognizes, the Government's attitude to reform is vital, and the staff report highlights the key ingredients of credibility and sustainability necessary if a comprehensive reform program is to be undertaken.

There is a temptation to wish for a widespread liberalization. However, given the historical and political framework, this is obviously not feasible--a point nicely expressed in Mr. Samojlik's comment on the dilemma of needing a critical mass versus wanting all the changes at one time. The consensus that the authorities need to be selective is therefore welcome. This does however mean a shift from detailed control of the economy to a focus on the major levers of change, including interest rates and the decentralization of pricing decisions. There seems to be agreement as to the major areas in need of reform: demand restraint--including lower wage demands and restricted credit to the public enterprises--plus reform of both the pricing and the trade and payments systems.

I was particularly impressed by the recommendation to allow interest rates to become positive. The current situation, with negative rates of about 13 percent, is severely distorting savings and investment patterns, exemplified by the high proportion of investment in buildings--about 63 percent of total investment. I would also urge caution in the use of physical targets with regard to investment, and consider that absolute priority must be given to the efficiency of the investments rather than to their quantity. In this regard, I am pleased to see in Mr. Samojlik's statement that financial plans will receive higher priority than the physical targets expressed in the economic plans.

The report does bring home the very serious nature of the debt arrears that have built up. Mr. Samojlik's statement underlines the difficulty of transforming the economy so as to generate convertible currency surpluses above the levels envisaged in the present plan. This transformation must nonetheless remain an absolute priority for the Government in substantially reducing the arrears during the next few years.

While the Polish authorities wish to begin discussions on a possible stand-by arrangement with the Fund, we believe that the Government must translate the commitments included in Mr. Samojlik's statement into a concrete plan of action with a definite timetable. Thus there is still some way for the Government to go in firmly agreeing to an adjustment program before a stand-by arrangement can be concluded.

Mr. Zecchini made the following statement:

The recovery of the Polish economy which started four years ago continued at an accelerated pace in 1986. Output growth increased in both the industrial and the agricultural sectors, and so did the rate of growth of investment and consumption expenditures. However, the adjustment of the current account deficit came to a halt, and price increases exceeded official targets, indicating the difficulties still facing the Polish economy.

While I agree with the broad thrust of the staff appraisal, I wish to focus my remarks on the two areas where additional efforts are called for to overcome such difficulties: external imbalances and economic reform. Notwithstanding the reduction of the external imbalances achieved so far, further improvements in the reduction of the current account deficit are necessary because the burden of external debt is still large. The ratio of convertible currency debt to exports has not declined from its peak of 1982. Moreover, the total stock of external liabilities has continued to rise at a significant rate, fueled by overdue interest that in 1986 was equivalent to approximately 10 percent of the total stock of debt in convertible currencies. Therefore, I welcome the authorities' commitment to eliminating the deficit in convertible currencies by 1991. This is a commendable development as it reflects the request of the Executive Board in last year's consultation. Quickening the pace for redressing the external imbalance is desirable to reduce the heavy external debt burden, to boost the creditworthiness of the country in the financial markets, and to restore normal financial relations with external creditors.

To ensure external adjustment, the staff recommends three main courses of action: lowering the growth of domestic expenditure, implementing economic reform more vigorously, and slowing down current account adjustment with the ruble area. The last recommendation seems questionable, since it might appear quite discriminatory and perhaps ineffective in curbing the overall external deficit. As for the recommendation to slow the expansion of domestic expenditure, I would suggest a less drastic approach than that supported by the staff, for two reasons. First, output and investment conditions have not yet fully recovered to the pre-crisis levels, as is clearly indicated in Table 3 of the staff report. Second, in view of recent adjustment experience, the authorities may be right in arguing that the existing rate of growth of real consumption--almost 2 1/2 percent annually--is the minimum that could be accepted socially. Moreover, the broad reforms of economic structures that are required--as well as improvements in labor productivity--can be easier to achieve in a context of generally rising household incomes.

This leads to the area of economic reforms, the key to a sustained and balanced development process. I welcome the authorities' renewed commitment to the implementation of the intended reforms. Efforts should be aimed at abandoning fully fledged central planning, at decentralizing economic decisions, and at increasing financial discipline. The authorities should promptly adopt firm decisions on the scale and the scheduling of these reform measures, thus dispelling uncertainties.

Demand policies should be aimed at controlling the expansion of aggregate demand and, above all, at improving its composition by favoring viable fixed investments. To achieve this, the expansion of the real money supply should be kept in check by monetary and fiscal measures rather than through price increases. The latter would, in fact, clearly conflict with the objective of reducing inflationary pressures and improving external competitiveness. We agree with the staff on the need to check credit expansion to enterprises, but only to the extent that that does not affect investments in sectors which are considered competitive in foreign markets. It is more important to curb the monetary financing of public deficit spending.

The restoration of real positive interest rates is also a necessary and long-overdue step toward financial discipline. However, I do not accept the staff recommendation that "it would be important to allow enterprises to pass on the effect of higher interest costs in their selling prices." Rising interest costs are appropriate to the extent that they allow optimal use of the relatively scarcer factor of production, i.e., capital, and consequently spur enterprises to offset this rising cost with productivity gains. To this purpose, full translation of rising costs into prices is not advisable. Moreover, if full pass-through is allowed, real interest rates will tend to remain negative, since any increase in nominal rates will tend to be offset by an equal increase in the expected output prices.

Great care should be taken to avoid restraining capital investment in those sectors that are or can be internationally competitive and that can offer good opportunities for a rapid expansion of exports. In those sectors, any decline in investment expenditures should be offset by improvements in production efficiency so as to leave levels of output and competitiveness stable.

As for external policies, further improvement in the present exchange rate arrangements are necessary both to have an effective tool for expenditure switching, and to foster the establishment of an appropriate price structure that reflects the relative scarcities of resources, including foreign exchange.

Despite the recent adjustments of the official exchange rate, a significant gap still exists with respect to the free market rate; for instance, the rate at which transactions are concluded in the retention system.

To improve the exchange system, it is necessary to maintain an adequate degree of flexibility in the exchange rate strategy and to remove distortions and constraints that prevent exchange rate movements from having a full impact on the decisions of economic agents. To this end, we support the staff recommendation that the so-called "submarginal method" of exchange rate determination be abandoned. The level of net foreign earnings should be the appropriate criterion for setting the exchange rate level. Moreover, levies, subsidies, administrative controls, and restrictions should be scaled down in order to extend the area where the allocative function of the exchange rate can be felt. Such improvements should be realized in parallel with the reform of the domestic price system in order to avoid adding distortions. And while we recognize that the recent introduction of a foreign exchange retention system might constitute an incentive to export, it should be regarded only as a temporary arrangement and as a step toward a system of market-determined foreign exchange flows.

In spite of the recent significant depreciation of nominal exchange rates, competitiveness--if appropriately measured--appears to have been restored to the level of 1982. Such a level is not however to be taken as an equilibrium value, given the unsustainability of the current account deficit at that time. Therefore, in light of the remaining significant inflation differential, a further realignment of exchange rates will be called for. The authorities should implement a flexible exchange policy while restraining domestic prices. An anti-inflationary stance for financial policy is particularly necessary in view of the implementation of price liberalization measures, which will allow the development of some upward pressure on domestic prices.

At the core of the structural reforms of the Polish economy lies the restructuring of the price system. The reform should aim at improving transparency and reducing uncertainty for investment and production decisions as well as for consumption choices. To this end, we welcome the authorities' intention to restructure relative prices and to achieve domestic financial equilibrium. The functioning of the price system should also be enhanced in order to improve the financial structure of the economy, which appears to be at a very inadequate level of development. Efforts should be made to expand the range and the number of financial instruments and institutions, to reduce the extensive controls on credit allocations and credit sources, and to expand the scope of market instruments in the conduct of monetary and credit policies. In addition, the reform of the price system must be supplemented by--and integrated with--a parallel improvement of the tax system in the direction of a more uniform and less discretionary system.

The Fund should constructively consider the Polish authorities' readiness to implement an adjustment program with the support of Fund resources on the basis of the merits of the program, without preconceptions, and while abiding by the principle of equal treatment of members in similar conditions.

Mr. Foot said that his authorities welcomed the recent revision that had been made to Poland's medium-term balance of payments scenario, bringing forward the rate of projected improvement in the current account balance on convertible currencies. However, like the staff, his authorities believed that it was in Poland's own interest for the adjustment to be more rapid still, and that that was feasible if suitable demand restraint and structural reforms were pursued. His authorities did not agree that there was some minimum rate of consumption growth around which an adjustment program had to be framed. Rather, they started from the position that unless there was adjustment, consumption growth would not be possible at all. His authorities urged Poland to adopt an integrated adjustment strategy on that basis within the context of a Fund-supported program. Sustained export-led growth was the only way in which the present heavy debt burden could be borne. While he agreed with Mr. de Groote that future Fund relations with Poland would imply a link between the details of demand management and the pace and nature of structural reform, he more strongly disagreed with Mr. Grosche on the role of the current account in the adjustment process: the current account balance could not be just a residual factor. The outcome had to be one that reassured creditors of the ultimate viability of the Polish economy. At the forefront of those creditors would be the Fund, were it to make its own resources in support of the adjustment program.

The main elements that would have to be integrated into such a program had been outlined by the staff, Mr. Foot continued. As the Polish economy was so complex and so new to the Fund's experience, he sought only to emphasize the importance that should be attached to a few points.

First, an interest rate policy that reasonably quickly offered the prospects of positive real interest rates and a general tightening of financial discipline was very important, Mr. Foot remarked. That had become clear during the last year or so in the context of another European member. The illogicalities of the current credit policies and the associated investment decisions was well illustrated by the staff report, which showed an enormously high concentration of fixed investment in 1986 on buildings, and a massive stock of uncompleted investment projects, many of which had a rather doubtful economic rationale.

If the authorities were able to introduce a more efficient market-oriented system, they were likely to find over time that the same volume of resources could be put to more productive use than at present, Mr. Foot considered. Of course, adjustment such as the transition to positive real interest rates would be very difficult to achieve, particularly after the first momentum of adjustment measures had been used up.

Second, suitable budgetary targets and control systems would have to be of primary concern, Mr. Foot said. The reduction of direct subsidies had to be a priority, together with the introduction, over time, of a more uniform and less discretionary tax system. The control of spending, and revenue plans once made, was also vital, and he was interested in Mr. Samojlik's views on the likely success of recent proposals to correct recent deviations from forecasts. Every country had to face the prospect of revenue shortfalls and expenditure overruns, but the authorities must be able to monitor developments as they occurred and to direct them back on track once deviations had been detected.

Third, continued adjustment of the exchange rate was necessary, as distortions in relative prices would thereby be reduced, Mr. Foot considered. A more general point was that adequate and timely data would have to be available both to the authorities and to the Fund. The staff update on developments in the trade position during the first half of 1987 had contained a rather bewildering array of figures.

As Mr. Samojlik had noted, it was not possible to introduce all the desirable changes at once, and no program of economic reform could bear fruit overnight, Mr. Foot concluded. Nevertheless, urgent action was required if Poland was to realize anything like its economic potential, and if it was to benefit from a full normalization of relations with its creditors. With suitable commitment from the authorities and the development of detailed plans, the Fund should, in his view, give appropriate financial support.

Mr. Hodgson made the following statement:

I strongly concur with the staff's assessment of the Polish economy and needed policy reforms.

During 1986, there was some acceleration of the pace of recovery, as well as an encouraging increase in manufactured exports and in labor productivity in the industrial sector. However, I continue to be concerned about the uneven pace at which broad, systemic policy reforms have been implemented, and the implication of this for Poland's external position and for the normalization of relations between Poland and its creditors. The generally loose stance of financial and incomes policies during the past year is another source of concern, and has led, among other things, to a further increase in the inflation rate and to an increase in the current account deficit with the convertible currency area.

The staff has argued forcefully that the Polish authorities can achieve a balanced current account position more rapidly without sacrificing various domestic objectives. There are two possible problems with that view. First, it might be argued that the shift of productive resources from the nontraded to the traded goods sector would require both time and additional investment. Second, it might be argued that it is difficult to shift specific goods from domestic consumption and the nonconvertible currency area to the hard currency area in the form of exports. While these arguments might be true in the short term, they ignore the opportunities available through more efficient investment, and through improved export possibilities for primary and intermediate goods. Even if Polish finished goods are not immediately competitive in the convertible currency area, there are other export possibilities that have not yet been tapped. Third, the Polish authorities have argued that relatively rapid per capita income growth is needed to maintain a minimum level of public support for sustained adjustment. However, as the staff notes, per capital income has virtually returned to the level of 1980, a level which at that time exceeded the economy's capacity to produce. I therefore tend to agree with the staff that the urgency of further real increases in per capita consumption is open to question.

Mr. Samojlik has indicated that his authorities would like to begin discussions on a possible stand-by arrangement with the Fund. We can support the initiation of such negotiations, but the Polish authorities need to recognize that the current structure of economic policies and the pace of external and internal adjustment are not adequate to justify financial support from the Fund. Without significant reforms, we would have concerns about Poland's capacity to meet its repayment obligations to the Fund, particularly in light of Poland's continuing failure to meet commitments to other creditors, even after rescheduling.

Any stand-by arrangement would require clear indications that the Polish authorities had achieved a critical mass on policy implementation. I agree with Mr. de Groote's comments on the need for broad, systemic reforms. Tighter demand management must also be part of a stand-by arrangement.

I would emphasize three specific areas. First, there is a need for stronger control of credit to encourage greater financial discipline by enterprises. One element of that tighter credit policy would be the introduction of positive real interest rates. Second, domestic demand pressures would have to be reduced through a closer matching of wage increases to productivity gains. Third, and perhaps most important, the authorities would need to establish the right price and exchange rate signals, and permit these signals to operate in a more flexible economic environment in order to promote better resource allocation and to ensure that an adequate level of resources is made available to the traded goods sector of the economy. Prior actions in some form would be an important signal of the authorities' intentions.

Any stand-by arrangement would also require that the authorities quickly normalize relations with official creditors. The ongoing discussions between Poland and the Paris Club have not been productive, and Poland continues to have substantial arrears on all its rescheduling agreements with official creditors. These relations must be normalized if the goal of balance of payments sustainability underlying a stand-by arrangement is to be achieved.

If the authorities are not able to implement broad, systemic reforms, there would seem to be little alternative but to return to much tighter financial and incomes policies. That surely would be a less efficient, less effective, and very unpopular route to follow.

Mr. Yamazaki made the following statement:

I continue to believe that the authorities' key strategy should be to shift more resources from domestic absorption into exports, in order to tackle the serious and deteriorating external debt situation--a point stressed by many Executive Directors during last year's consultation. I accept the optimistic position of the staff that this task does not necessarily imply an undue cut in needed domestic resources--if adequate efforts are made on structural reform and demand management. My comments will therefore be focused on the structural reforms associated with the demand-management policy.

One of the major tasks for the authorities is clearly price reform. I welcome the measures taken since 1982 in this area, but prices still embody considerable distortions caused by regulations and subsidies. This price distortion has resulted in a weak and lagged pass-through of international price changes. Therefore, it is doubtful whether the substantial depreciation of the zloty has really contributed to an increase in export incentives or to a decrease in the demand for imports. I strongly urge the authorities to simplify the regulations and to phase out the equalization payments scheme at the earliest possible time.

In the face of the stubborn high inflation rate, price reform must accompany adequate demand-management policy.

Negative interest rates have been the main vehicle through which credit to the enterprises has been expanded, causing investment to be biased toward construction and hence to be somewhat inefficient. To achieve efficient investment spending, overall positive interest rates are imperative. In addition, a large portion of total investment is now subject to a long gestation period. While I recognize the need for maintaining a higher growth rate of investment, as the level of the gross fixed investment in 1986 was still below the level in 1978 by some 25 percent in volume terms, a large commitment to investments with a long gestation period can impose a considerable burden on the economy. In this context, I wonder if the Polish investment program is being conducted in a sufficiently flexible manner.

Incomes policy can also play an essential role in curtailing demand. In contrast to investment, consumption almost reached the 1978 level in 1986, supported by a steady recovery in real household disposal income. In order to subdue the excess demand pressure caused by high consumption, wage increases should be moderated to an appropriate level.

In concluding, the momentum for restructuring the economy induced by the economic reform measure in 1982 has weakened and is dissipating, and renewed and front-loading measures are now necessary. Visible improvement in the economy is necessary in order for Poland to regain creditworthiness in the eyes of the international financial community. In this context, the authorities' intention to achieve a current account balance in convertible currencies by 1991 is an encouraging sign, and I welcome the comprehensive reform program envisaged for 1988. Finally, I generally endorse the staff appraisal and support the proposed decision.

Mr. Fogelholm made the following statement:

The Polish authorities are still confronted with a central task: to move the economy in a direction in which relative prices and market instruments in general will have a much more predominant role than at present, and, at the same time, to decentralize decision making in the economy at the enterprise level. Clearly, far-reaching policy measures are necessary--as evidenced by Polish economic developments in recent years and by the precarious debt situation. This chair hopes that the Government will be able to implement swiftly all the policy reforms detailed in Mr. Samojlik's statement.

The staff report provides a well balanced and thorough analysis of economic developments and policies in Poland. As one of the few centrally planned economies among Fund members, sound assessment of the Polish economy represents a particular challenge both to the staff and to the Board. In formulating its recommendations, the staff has taken due account of the economic structure of Poland, and I endorse the thrust of the staff's appraisal.

The elimination of the current account deficit by 1991 is a formidable task requiring, during the coming years of difficult transition, both the improvement of the present level of production, and simultaneously increased market shares abroad. In this context, like Mr. Grosche and Mr. Hogeweg, I agree with Mr. Samojlik, rather than with the staff, that the required shift of production from servicing domestic demand to servicing foreign demand in the convertible area will be much more cumbersome and will require more time than envisaged by the staff. On the other hand, I agree with the staff that an important part of the strategy to improve export performance is the removal of rigidities caused by the present selective subsidy and tax system. The overall competitive performance should be ensured by an appropriate exchange rate policy. I would be interested to hear Mr. Samojlik's views on the huge statistical discrepancies between the payments and customs data on trade as depicted on page 1 of SM/87/219, Supplement 1.

Based on current policies and projections, a large part of real growth--estimated at 3 percent annually--will be absorbed by domestic demand--estimated at 2.5 percent annually. The high level of domestic absorption is in part caused by continuing real wage increases and credit expansion to enterprises. I do have some sympathy with the Polish authorities who are concerned about meeting the need to ensure a positive growth rate in domestic expenditure over the next few years. However, from a purely economic point of view, it is even more imporant, at this stage of the transformation of the economy, to exploit the growth potential of the economy by curbing domestic demand and by executing an early and effective implementation of structural reforms.

The large credit demand of enterprises is certainly stimulated by the existence of negative real interest rates, currently approximately 12 percent. An inflation rate of 18-20 percent, combined with nominal interest rates of 5-6 percent, is clearly not conducive to sound decisions on either investments or savings. Thus the introduction of positive real interest rates would improve the efficiency of investment decisions while at the same time stimulating private savings.

In conclusion, the Polish authorities' intentions to continue with the reform of the economy are most welcome, and I hope that the Polish authorities will intensify their cooperation with the Fund in these efforts.

Mrs. Ploix made the following statement:

I share most of the staff's conclusions. Indeed, my authorities consider that the external position of Poland, esepecially the accumulation of arrears vis-à-vis public creditors, is a matter of serious concern; they note with satisfaction the Polish authorities' determination to face this worrisome situation, but feel that this determination must still be demonstrated by practical reforms.

I will concentrate my comments on the overall situation of the Polish economy, and on the need for more rapid adjustment.

There are some favorable developments in the Polish economy: the recovery in real output continued with strong growth in 1986, above the level forecast; the gains in labor productivity in the industrial sector; and the growth in manufacturers' exports after several years of decline.

However, real output is still below its pre-crisis level--about 15 percent below its level in 1978--and fixed investment remains significantly below its pre-crisis level. The external financial position within the convertible area remains disquieting and is expected to deteriorate further. I note the significant amount of external debt, the permanent recourse to debt rescheduling, and the emergence of considerable arrears, almost all owed to

Paris Club creditors. My authorities also regret that the Polish authorities discriminate in the debt repayments in favor of the commercial banks, to the detriment of official creditors.

Many other aspects remain worrisome: the growth of domestic demand is not under control, while consumption per capita is nearly the same as 1980 levels and is clearly unsustainable given the massive external disequilibrium. This situation is due in particular to excessive increases in real wages and the rapid expansion of credit to the enterprise sector. This failure to control domestic demand has caused inflationary pressures far exceeding official projections. For 1987, all these tendencies will probably persist, and it seems difficult to foresee any significant improvement in Poland's external financial position. A more rapid adjustment must therefore be implemented.

My authorities are interested in the medium-term scenario that the Polish authorities describe. It envisages a progressive reduction in the current deficit after 1986 and its complete elimination by 1988; this scenario thus marks an improvement over last year's. However, its success presupposes a rigorous implementation of reforms already announced by the Polish authorities. But, as the staff noted, although the general measures have been decided, mechanisms for their introduciton have yet to be determined. Recent experience shows that the implementation of such a reform process generally takes a long time; and even if such a scenario were to be achieved, it would not be sufficient to satisfy debt service repayments. Therefore, my authorities are convinced, like the staff, that a more rapid adjustment is indispensable. Such an adjustment should aim at three primary goals: an increase in the rate of output, slower growth in domestic expenditures, and slower current adjustment with the nonconvertible area. The achievement of these goals obviously requires firm demand-management policies, in particular the control of real wages and the introduction of positive real interest rates. It also requires flexible management of the exchange rate. However, such measures will have an impact only if they are complemented by large and important structural measures: price reform, a steep reduction in administrative intervention in the allocation of resources, and strengthening of financial discipline must all take place as soon as possible. Such an adjustment is not easy, for social reasons particularly; however, we encourage the Polish authorities to demonstrate their firm and orthodox commitment by rapidly implementing a strong, comprehensive economic program.

In this context, my authorities wish to see Poland conclude a stand-by arrangement with the Fund. In their opinion, such an arrangement is absolutely essential to the conclusion of a definitive agreement with Paris Club creditors.

Mr. Noriega made the following statement:

Poland is embarked on a deep structural adjustment program, of which the most outstanding element is the market orientation that is being given to the economic decision-making process. This program was bound to face difficulties, partly as a consequence of introducing an environment of which Poland has little experience, partly because it is not yet clear how far the authorities are willing to go in this direction, and partly because the external environment continues to be uncertain. However, I mention these difficulties only as a reminder that we should calmly and objectively look into the current situation to find out if the program continues to move in the right direction.

It is most reassuring to learn from Mr. Samojlik's statement that the Polish authorities in many respects share the views of the staff and remain committed to their original program, and that in the near term they intend to increase the share of foreign trade in the national product. I welcome these developments and encourage the authorities to persevere with the measures that have been adopted and with those recently announced.

I am confident that the authorities are well aware of the complexities facing policy design at this juncture, and I will therefore add only three brief comments.

With regard to price and exchange rate liberalization, I am somewhat puzzled by the lack of reference in both the staff report and the statements of previous speakers to the compatibility between relative prices in the convertible area and those in the nonconvertible area, and the advantages or disadvantages that this situation poses for Polish foreign trade. My question to the staff is twofold: since the two-price ratios may be taken as given, can Poland profit from arbitraging between these two areas? Under these conditions, does exchange rate liberalization favor the Polish economy?

Mr. Samojlik points out that it is self-defeating to redirect exports from one area to the other if the only objective is to improve the external accounts with the convertible area, but in the longer run there could be some gains from trading with two different areas. On the other hand, the direction in which the exchange rate and domestic prices move during the process is not obvious.

With respect to the quantitative scenarios which the staff report presents in an appendix, the comparison between the second and third scenarios only illustrate that further adjustment today, at the cost of lower rates of growth, will allow for faster growth in the future--an apparently simple trade-off. But lacking a deeper discussion on the costs of adjustment, one cannot decide which alternative generates greater total welfare.

The comparison between the first and second scenarios is more interesting and more complex. I wonder how the staff computes the increase in the "underlying" rate of growth of GDP. The background paper and the staff report indicate that unemployment has remained negligible, and that productivity has been rising. In such circumstances, how can the likelihood of the scenario be judged? If labor services cannot be expected to grow much faster, how would the proposed measures impinge on growth in the short run?

The staff emphasized price liberalization, including prices of goods, foreign exchange, and credit. This emphasis is not balanced by a discussion of, and eventually a recommendation regarding, institutional rigidities in each of those markets. Much can be done in dealing with institutional rigidities with, perhaps, a faster impact on productivity and growth than acting on price liberalization at this time.

I support this program and endorse the proposed decision.

Mr. Yang made the following statement:

The recent performance of the Polish economy has generally been encouraging: output growth was strong in 1986, and this trend is expected to continue in 1987; industrial production has improved thanks to increased productivity; and exports have also increased significantly. More important, the ongoing economic reform has entered its second stage, and a greater effort has been made to implement the reform program. In sum, it is heartening to see that the economic adjustment over the past years has resulted in considerable improvement, and continuing efforts by the authorities--if effectively undertaken--are expected to result in an even better economic performance.

However, the problem of excess demand, and the resultant inflationary pressure, still remains. I agree with the staff that the rate of credit expansion should be reduced; any slippage in this area will undoubtedly cause further difficulties in demand management. Any overrun in budgetary expenditures should definitely be avoided, and a firm stance on wage restraint is also required.

Poland's overall debt and payments situation remains tense, and it is therefore vitally important to continue to expand exports, particularly to the convertible areas. In this respect, measures to adopt better export incentives and a more flexible foreign exchange management approach are encouraging. Experience has shown that an overhasty adjustment has severe economic and social costs for adjusting countries, which is why emphasis is now placed on growth. In the case of Poland, the authorities are determined to reduce the current deficit progressively, and to achieve a balanced current account in convertible currencies by 1991. I am inclined to agree with the authorities that this is already a formidable task, and creditors' cooperation may well be needed.

With regard to Poland's economic reform, the greatest need is to strengthen the financial discipline of the state enterprises. The market mechanism can play a meaningful role in enhancing the enterprises' efficiency only when enterprises are fully responsible for their own profits and losses. If administrative control by the Government is reduced, then enterprises should be put in a position in which they can no longer rely on bargaining with the Government for subsidies, tax relief, and material and credit supplies. They must be required to bear full responsibility for their own decisionmaking.

Another important issue is reform of the domestic price structure. The authorities' intention to reduce existing price distortions and to phase out price controls is most welcome, and their gradual adjustment of prices in the face of mounting inflationary pressure is quite understandable. For the relative price adjustment to proceed smoothly and without it giving rise to higher inflation, aggregate demand must be firmly controlled.

The economic reform program should be a comprehensive one, even if its implementation is somewhat cautious due to lack of experience. Any piecemeal approach would tend to create an environment in which fragmentary reform measures may not fit into the existing unchanged system, and the resultant effects may seriously deviate from those that were originally intended.

I understand that the authorities and the staff have been discussing the possibility of a stand-by arrangement for Poland, and my authorities believe that, at this critical stage, it would be most helpful if the Fund could provide important assistance to Poland's economic reform.

Mr. Fernando made the following statement:

My authorities broadly agree with the staff report and Mr. Samojlik's statement with respect to policy direction and objectives. It is not a matter merely of the authorities' intentions to address the deep-seated problems of imbalance, rigidities, and suboptimal utilization of productive potential through a series of structural reforms aimed at reallocating resources through the interplay of market forces. The authorities have demonstrated their commitment to reform over a widening area of the economy and have sustained these policies over time. Many deficiencies, of course, still remain. But the progress achieved so far--and the authorities' diagnosis of the problems and their perceived intentions--make it an opportune moment to put together a clearly defined and structured program so as to accelerate the processes and achievement of objectives. The priorities to be attached to the different elements in this program and their phasing will determine its success, and the Polish authorities are well aware of this.

The pass-through effects of an outward-oriented adjustment program will have inevitable consequences on employment, income distribution, and living standards. The authorities' ability to withstand the forces that will emerge in opposition to reform will be greatly reinforced if economic growth is protected and sustained during the first years of a sustained adjustment effort.

In this context, due recognition should be given to the need to support the adjustment effort through adequate financing. The ground to be covered in changing economic structures, institutions, and mechanisms for economic management is considerable; the adjustment process will therefore extend over several years--underlining the need for sustained financing flows.

The external imbalance, debt service claims, and external financing constraints are reflected in the compression of imports during the last few years, and fixed investment has also declined. I therefore understand the authorities' concern about the need to reduce uncertainty about the inflow of medium- and long-term external finance. Improving the capacity utilization of efficient units, rationalizing investment priorities on the basis of structural adjustment, and enhancing the marginal efficiency of capital all provide a strong case for upgrading and modernizing the capital stock. Poland's economic potential--combined with appropriate policies--underscores its creditworthiness, and I am encouraged by the efforts made by the authorities to cooperate with commercial and official creditors in seeking solutions to its debt problem despite the existence of many obstacles. I welcome Mr. Samojlik's assertion of his authorities' readiness to discuss with the Fund a possible Fund-supported adjustment program. The present climate for international credit could be turned to Poland's advantage on the basis of comprehensive economic reforms, and the Fund can play an important role in restoring confidence in Poland on the part of the financial markets under the Fund's policies on use of Fund resources. This catalytic role can help to promote adjustment in a country willing to cooperate with the Fund, while improving the Fund's effectiveness in responding to the debt crisis. The Fund should therefore actively examine Poland's request.

Mr. Dallara said that in the year that had passed since the last Article IV consultation, there had been positive developments in several areas of the Polish economy, including economic growth, labor productivity, the improved use of energy, labor, and other inputs, and manufacturing exports.

Other developments had not been so positive, Mr. Dallara continued: inflation had accelerated somewhat; the current account deficit with the convertible currency area had grown slightly; and at times financial and wage policies had been rather lax, leading to worrisome trends in both areas. Perhaps most important, however, was the fact that since the last Article IV consultation, there had been only marginal progress in fundamental structural reforms to liberalize the economy; that marginal progress was perhaps the most disappointing aspect of the past 11 months' developments.

He welcomed the initial moves that had been made during the past year toward a second stage of economic reforms, Mr. Dallara commented. Nonetheless, there were clearly a large number of areas still in need of attention--in some areas, a rather urgent need. Those included credit and interest rates, the pricing system, financial discipline over enterprises, a new tax system for business, and closer linking of wages to productivity growth, inter alia.

It appeared that some time might be required to determine the scope, timing, and precise manner in which those reforms could be designed and implemented as part of a comprehensive and mutually supported program, Mr. Dallara remarked. The staff report suggested that the process was, in fact, still at a rather early stage. The technical challenge was formidable, but both the Fund and the World Bank might be able to provide support with advice and technical assistance. A principal objective of the Polish authorities and the Fund would be the attainment of sustainable real growth. Much would depend on reform in the enterprise sector, both to assure the modernization of industry and to create a source of export earnings necessary to strengthen the external position.

Business enterprises need an environment that reward success and penalized failure, Mr. Dallara said. The authorities acknowledged the need to move in that direction, and had taken some steps toward that end. But the staff report cited a number of policy changes that were still required for that goal to be realized, including greater management autonomy; a reduction in government subsidies and residual financial support, reduced access to credit, an end to negative interest rates, and liberalization of the trade and payments regime.

Although the authorities understood the need for movement in those areas, they had not yet produced concrete plans or policies, Mr. Dallara noted. The achievement of realistic and flexible pricing was at the heart of a more efficient Polish economy, but little progress appeared to have been made with respect to domestic price adjustment during the past year, despite some efforts. More would need to be done to dismantle more broad price controls generally, reduce the direct allocation of materials by administrative mechanisms, and constrain the rise in real wages, so that relative prices and wages could more consistently and automatically allocate goods, services, and labor to their most productive uses. A great deal remained to be done in that area.

The authorities had however made substantial progress on exchange rate policy during the past year, Mr. Dallara said, and he supported their efforts. The effectiveness of such a policy could, however, be undermined to the extent that corresponding shifts in the price level and in relative prices were thwarted by domestic price controls, and by such measures as equalization payments. In addition, the existing foreign exchange retention system tended to freeze Poland's foreign trade into existing patterns. That trend did not help to send signals to what were potentially the most productive sectors.

Poland's external position clearly needed considerable strengthening, both to re-establish more acceptable debtor-creditor relations and to remove current constraints on future economic growth, Mr. Dallara remarked. A prompt reduction in the current account deficit with the convertible currency area was needed. Despite the recognized difficulties involved in moving in that direction, he shared the staff's view that a target for current account equilibrium should be set sooner than the 1991 target fixed by the authorities, and that its achievement could be possible with the right policies without an unacceptable lowering of domestic absorption.

He had listened with interest to an alternative view held by some other Directors, namely, that a slower pace of external adjustment with the convertible currency area was a more realistic prospect, Mr. Dallara said. He had also heard many of those same Directors indicate their support for an early stand-by arrangement with Poland. Accordingly, it was difficult to accept the idea that a move to a sustainable payments posi tion should not be recommended for the near future. At the same time, the possible use of Fund resources should be investigated in the near future, because Poland should not be put in the position of suggesting a program that did not provide realistic prospects for repayments to the Fund.

His authorities believed that the road ahead looked to be a rather difficult one, with challenges for both the Polish authorities and the Fund in developing their mutual relationship, Mr. Dallara noted. The staff report stated that obstacles were likely to arise to any fundamental economic reforms that might test the social tolerance of the society. The Government itself, as it faced political unrest and the short-term costs of reforms, might be tempted to adopt a piecemeal or stop-go approach to reform. His authorities, in contrast, encouraged a move to a more comprehensive and bold fashion.

The Fund had already faced a number of difficulties during the last decade in trying to support members with a history of widespread state planning, Mr. Dallara remarked. Those cases had sometimes been characterized by wage pressures--bottled up by inflation--and a lack of financial discipline over public enterprises. While he recognized the numerous differences between the Polish economy and other planned economies, he did see some similar problems, and in fact the Fund itself had more to learn about the optimum way to design programs in such economies.

The Polish authorities were at a rather early stage in formulating a program in a comprehensive medium-term framework, and in developing the concrete policy actions needed to implement such a program, Mr. Dallara considered. Both the Fund and the authorities would, before engaging in a formal program, need to have some confidence that the necessary program could be committed to, that what was committed to could be implemented, and that the implementation could in fact produce the intended positive result. Premature efforts to engage in a formal borrowing arrangement with the Fund could undermine the credibility of both the Fund and Poland, and could lead to a sense of mutual frustration and possibly to a repayment problem. It was in the interest of the Fund and of Poland to avoid such an eventuality. It would therefore be to the mutual advantage of both parties to work more closely together in the coming period within the context of a consultative relationship, developing and beginning to implement a clear plan for policy reform in the key areas. He encouraged the authorities to strengthen their reform efforts toward that end.

The staff representative from the European Department said that the fact that the current account deficit in convertible currencies was now equivalent to 1 percent of GDP should be taken not as an indication that adjustment would be easy, but as a counter to the excessively pessimistic view sometimes encountered concerning the problem. Even though technological and quality factors created difficulties for export growth, they should not be seen as insuperable. Appropriate demand management, exchange rate, and external incentive policies would allow the apparently dire problem of nonsubstitutability to be mitigated. The authorities intended to increase the share of foreign trade in the Polish economy, and the process of opening up the economy should ease the problems of substitutability. In addition, substitution possibilities should not be considered only at the level of finished goods; possibilities also existed at the level of intermediate and primary goods.

The dynamics of the reform process were complex, the staff representative considered, and there was a complicated and symbiotic relationship between systemic change and policy change. Policies would not be effective unless the system became more flexible, but the system itself could not be changed unless policies were also amended. As changes were necessary in institutions, in attitudes, and in the legal framework, change could realistically be expected only over time. The staff's suggestion was that a small number of key policy changes should be implemented simultaneously at the beginning of the process. The staff would emphasize, in particular, the need for changes in demand-management policy. From excess demand stemmed the need for price control and for comprehensive administrative intervention in the allocation of resources. There was some uncertainty concerning the extent of accumulated excess demand pressures. But, as the risk of there being a significant liquidity overhang was relatively large, it seemed prudent to take determined action on the demand-management front at the beginning of any program.

Price distortions were another area of difficulty for the authorities, the staff representative noted. Those distortions diminished the significance of financial magnitudes, making it difficult to rely on parametrically applied financial policies. That conclusion reinforced the need for early action to reduce price distortions, and thus to bring forward the time when discriminatory intervention in the financial affairs of enterprises--to offset the effects of distortions--would no longer be needed.

The staff had not intended to imply that there should be an indiscriminate pass-through of the effects of interest rate changes to prices, the staff representative said. Indeed, interest rate changes should themselves generate economies in the use of capital, at least over time and, therefore, a need for a less than full pass-through. The staff had simply sought to draw attention to the potentially crippling effects of increased interest rates on enterprises that had a heavy stock of debt to the banks. In a context of price controls, such enterprises could be put in a very difficult position.

The different indications of performance in the first half of 1987 that could be drawn from the trade and customs statistics, respectively, were not unknown in other countries, the staff representative remarked. Nonetheless, such differences did complicate the task of analysis. In Poland, the tradition since World War II had been to emphasize physical indicators and indicators of performance, neglecting financial magnitudes. That emphasis had changed and continued to change, and the authorities had been most cooperative in efforts to improve the quality of financial statistics.

Some possibilities did exist for commodity arbitrage by Poland between the convertible currency area and the ruble area, the staff representative noted. While there was no market between the two currencies and, therefore, no unambiguously correct way of expressing relative prices, there were--for certain commodities at certain times--differences in prices which, prima facie, might create possibilities for arbitrage. Trade with the ruble area did however take place under bilateral arrangements; accordingly, any arbitrage gain could be exploited only with the concurrence of a trading partner. That trading partner might also face similar possibilities. More generally, problems had been created by the need to integrate three price structures: a world trade price structure; a domestic Polish price structure; and a ruble area price structure.

The scenarios described in the appendix to the staff report were not models of the economy, the staff representative noted, a point that could not be overemphasized. The changes that had taken place in the Polish economy during the past ten to fifteen years had been so dramatic that there was little to be gained from an econometric approach. Thus, the illustrative numbers and coefficients used in devising the scenarios were only approximations; though broadly consistent with the results of available empirical work, their scientific basis should not be overemphasized.

Mr. Samojlik said that the reform package was very complex, but at its core was the reform of economic instruments, especially the price system. Reforms would revolve around the relations between prices and costs, the level of subsidies, the level of the exchange rate in relation to the cost of acquiring foreign reserves, and the level of interest rates in comparison to the rate of inflation. Without those deep and complex changes, it was difficult to control the economy through financial and economic instruments. Such changes should create the basis for improved economic decisions by enterprises; they should also create the possibility of abandoning the direct allocation of resources.

The problem of the submarginal exchange rate raised the issue of export subsidies, Mr. Samojlik continued. The existence of a submarginal rate of exchange meant that the authorities did not wish to apply the marginal rate of exchange to the whole economy, thus subsidizing part of Poland's exports. In order to diminish the cost influence of the exchange rate on the whole economy, the authorities sought to maintain a submarginal rate. Beyond the submarginal rate, a portion of total exports were, for various reasons, subsidized.

In 1987, the authorities had assumed that an equilibrium budget would be attainable, balancing income and expenditure, Mr. Samojlik said. After eight months, it had become clear that such an equilibrium would not be easily attainable without additional measures. As usual, while it was too early to know exactly what was going on in the economy in 1987, it was also already too late to act properly and effectively to alter the outcome for the year. However, budgetary expenditure had already been reduced. Part of the problem stemmed from the existence of strong export incentives. Tax receipts had been reduced because substantial tax relief was available for exports. While export growth had been about 12 percent after eight months, some government income had been given up. In 1988 the system would be changed, emphasizing the level of the exchange rate rather than tax relief for exporters.

While no final results had yet come from Poland's discussions with the Paris Club concerning the accumulation of arrears, a fairly precise program of restructuring had been developed, Mr. Samojlik noted. He hoped that a realistic and acceptable solution for both sides would be attainable in 1987.

The control of domestic demand remained a problem in Poland, Mr. Samojlik commented. While controls were no looser than they had been in the past two years, they had not been strengthened. Effective control of demand would in any event depend upon the changes that would come during the second stage of the reform program.

The Chairman made the following summing up:

> Directors welcomed the progress made by the Polish authorities in recent years toward restoring satisfactory economic growth and reducing external imbalances. In 1986, the buoyant performance of output had continued, but the increment to output had been largely absorbed by domestic expenditure. Real wages had increased despite the authorities' intention to hold them stable;

financial policies had been less tight than expected; as a result, the rate of inflation had continued to rise and the reduction in the external current account deficit had been limited to the nonconvertible area.

Directors welcomed the indications in the statement of Minister Samojlik that the Polish authorities intend to introduce broad systemic economic reforms in 1988 that should lead to a reduction in the resources centrally allocated and the liberalization of the price system, including an active exchange rate policy to promote the role of market forces and competitiveness in the economy. The systemic changes would have to go hand in hand with stronger monetary and fiscal policies to tackle continuing excess demand.

Directors agreed that the crucial need was to strengthen Poland's external finanical situation, so as to provide a more secure basis for adequate growth in domestic output. Directors stressed the difficulties confronting Poland's debt and debt-servicing situations and said that decisive and sustained action would be necessary to improve perceptions of the country's creditworthiness. The external debt in convertible currencies continued to increase; there was continuing heavy reliance on exceptional financing; and a substantial and growing volume of arrears to official creditors had emerged. While the Polish authorities' latest medium-term balance of payments scenarios were seen as constituting an adjustment path preferable to that previously envisaged by them, most Directors--noting the differences of view between the Polish authorities and the staff regarding the pace of further external adjustment-stressed that considerably more rapid adjustment was both desirable and possible. In addition, some Directors questioned the relatively rapid growth in consumption foreseen by the authorities, especially in view of the strong recovery in consumption in recent years.

Directors generally supported the staff's policy recommendations. A determined and sustained tightening of demand-management policies was seen as essential for the strengthening of external performance, reducing inflation, and permitting the authorities to proceed with their program of systemic reform--a program judged to be crucial by the entire membership of the Fund. Directors noted that in formulating demand-management policies, comprehensive tax reform and the reduction of budget subsidies should have a high priority, and it was also most important to address the problems created by the accumulation of excess liquidity in the economy. Directors urged the authorities to proceed rapidly and decisively with their plans to introduce positive real interest rates.

Directors also stressed the need to reduce other price distortions and to reform the exchange and trade system. Directors welcomed the more active exchange rate policy pursued in the last year but felt that the level of the real exchange rate would need to be kept under close review in light of evolving trade performance and of the requirements of the debt-servicing situation. I understand that this is the intention of the authorities. More generally, Directors saw a need to simplify the exchange and trade system, in particular by reducing the role of administrative controls.

Directors considered that complementary measures in several areas were necessary if economic agents were to have the freedom and incentive to respond to altered price signals. In particular, that would involve a reduction in the central allocation of resources, a strengthening of financial discipline in enterprises, measures to boost the mobility of factors of production, and action to improve the quality and efficiency of investment.

While many of the above policy objectives formed part of the authorities' planned second stage of economic reform, Directors observed that important decisions remained to be taken concerning implementation of the latter. The urged the authorities to proceed as rapidly as possible with the finalization of a policy package that would be strongly front loaded, and to avoid a piecemeal approach that was unlikely to be effective and might perhaps be counterproductive.

Many Directors stressed the critical role that the Fund could play in collaborating with the authorities toward the elaboration and implementation of a coherent and comprehensive set of mutually reinforcing policies and of a specific timetable for their implementation. While the hope was expressed by a number of Directors that such a program could be supported by the use of Fund resources, Directors also stressed that it should be assessed carefully, to ensure that all reasonable conditions for the success of such an important operation would be met.

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

The Executive Board then took the following decision:

1. The Fund takes this decision in concluding the 1987 Article XIV consultation with the Polish People's Republic, in the light of the 1987 Article IV consultation with Poland conducted under Decision No. 5392-(77/63), adopted April 19, 1977, as amended (Surveillance over Exchange Rate Policies).

2. The restrictions on the making of payments and transfers for current international transactions, and the multiple currency practices which are described in detail in SM/87/224, are maintained by Poland in accordance with Article XIV. The

Fund notes the complexity of Poland's exchange system and urges the authorities to take early steps to relax exchange restrictions evidenced by payments arrears and bilateral payments arrangements, and encourages the authorities to eliminate the restrictive multiple currency practices in the near future.

Decision No. 8695-(87/139), adopted
September 16, 1987

2. THE ROLE OF THE FUND - ISSUES RAISED IN THE GROUP OF TEN AND GROUP OF TWENTY-FOUR REPORTS

The Executive Directors gave preliminary consideration to proposals regarding the role of the Fund, as presented in report of the Deputies of the Group of Ten (EBD/85/154, Sup. 1, 6/21/85) and reports of the Deputies of the Group of Twenty-four (EBD/85/228, 8/30 /85; and EBD/87/196, 7/22/87), and as summarized in a staff paper on issues raised in those reports (SM/87/189, 7/31/87; and Cor. 1, 9/14/87).

Mr. Pineau made the following statement on behalf of Mrs. Ploix:

The staff document on the G-24 and G-10 reports seems to be preliminary in nature, as it details all the main proposals and for each of them refers to previous decisions or to forthcoming discussions, for which new papers are being prepared. This is understandable, if one considers the scope and variety of questions to be addressed. Therefore, today's debate must be seen only as the opening session of a general review of the principles which must guide Fund operations. My authorities want to take this opportunity to outline their position on all the relevant points raised in both reports.

The G-24 report focuses on Fund financial assistance and the conditionality embodied in corresponding Fund-supported programs. The G-10 report, while dwelling on the functioning of the international monetary system, does so in chapters distinct from the one entitled "The Role of the Fund." It must be made clear that, for my authorities, the Fund has a prominent role to play in the surveillance and improvement of the international monetary system, a role which goes beyond the issues we are examining now.

Generally speaking, one of the major roles of the Fund is to contribute to the stability and consolidation of the world economy by extending financial support to those countries experiencing balance of payments difficulties and undertaking adjustment efforts. Such support is necessary, since the adjustment takes time. The assistance must be provided under adequate procedures and in return for a contractual program which takes into account the specific situation of the country and which is conducive to economic recovery. The increasing magnitude of world economic imbalances requires that the Fund be equipped with adequate means of financing, both in terms of volume and conditions, so that it can be in a position to maintain its role as an international financial institution, acting as a catalyst for additional financing, along with its own programs.

These basic principles lead me now to touch upon the design and implementation of Fund programs, the financial conditions of Fund operations, Fund credit facilities, and relations between the Fund and the World Bank.

On the design of Fund programs, we think that it is important to look beyond the need for restrictive demand-management policies and the revolving nature of Fund resources. Instead, we should adopt a pragmatic, case-by-case approach of the sort referred to by the Managing Director, who declared--shortly after taking office--that there was no standard adjustment program applicable to all the member countries. We must adhere to this principle; in that connection, we particularly share the concern expressed in the G-24 report that programs should be formulated in as close cooperation as possible with national authorities. However, it is not possible to grant the authorities the final say on the basic parameters of a program, since a contract intrinsically concerns and commits both parties.

One G-24 proposal entails carrying out a "growth analysis" for every program, which would incorporate a growth target set by the country itself. Then a "financial analysis" would be derived from this "growth analysis," determining the financing requirements to be covered by creditor countries on the basis of the actual growth rate. We do not feel that this proposal is workable. Indeed, as I have already mentioned, a program is a contract which is binding on the country and on the Fund. It cannot include numerous other intervening parties, whose very number would make the conclusion of the contract almost impossible. Thus, the desire to achieve symmetry between debtor and creditor countries should not lead to deterring creditors from extending new financing beforehand.

Nevertheless, my authorities remain supportive of the Fund's decision to take better account of growth objectives in the adjustment programs and to put emphasis on structural measures. They also consider it useful for the Fund to continue its efforts to clarify and improve its "image."

On the implementation of adjustment programs, my authorities view favorably the G-24 stand against a proliferation of performance criteria. Without endorsing overly mechanistic proposals on domestic credit ceilings and public investment limits, they consider that the assessment of results must continue to be made in a flexible manner. In fact, it is more meaningful to comply with an objective than to hit a precise quantitative target. My authorities have no objection to the use of "prior actions," which make it possible to sound out the strength of commitments and to consolidate the credibility of programs. In contrast, I must recall that we are not, as a rule, supportive of "approvals in principle."

With respect to facilities designed to address temporary developments, my authorities consider that their proposal, made to improve the access to the compensatory financing facility, will have to be reviewed during our forthcoming discussion in October. Again, on this point, the suggestions of the G-24 report aimed at establishing facilities linked to growth or commodity prices appear too mechanistic. Likewise, relating debt servicing to external parameters does not seem workable and would render meaningless the notion of contract. However, we can still envisage a case-by-case approach to assist countries which face exceptional circumstances, such as that of Mexico.

On the financial conditions of Fund operations, I must first reiterate my authorities' support for a substantial increase in quotas, which remains the main financial resource of the Fund. This will allow an increase in Fund credits, an objective which will have to be preserved even if access limits are reduced. In fact, however, we are opposed to such a reduction, since potential access to Fund resources must parallel developments in the world economy and overall imbalances. This is a precondition for the Fund to retain its credibility and play its pivotal role in the current debt strategy, which we still endorse while calling for some improvements. I would also like to make it clear that my authorities are in favor of a nonrestrictive interpretation of the provision on "the existence of an exceptional situation...that would threaten the stability of the international monetary system," a provision which enables activation of the GAB when Fund resources are insufficient.

As for the poorest countries, I just want to restate my authorities' intention to participate in the enhancement of the structural adjustment facility, and their desire to see a prompt completion of this initiative, along the lines of the Venice comuniqué. Similarly, although it seems desirable to soften the terms of other facilities such as the compensatory financing facility, which is now practically inaccessible to sub-Saharan African countries, it is necessary to avoid a withdrawal of Fund credits financed through its ordinary resources. Thus, the G-24 proposal aimed at generalizing concessional terms for all Fund facilities appears both unrealistic and potentially dangerous. Finally, I would like to recall our favorable stance on a resumption of SDR allocations.

The G-24 proposal to reactivate the extended Fund facility as the main tool for medium-term structural adjustment programs, in particular for middle-income countries, is an attractive one.

However, an option would be to use this facility as a subsequent and final stage for countries having recorded good results under a structural adjustment facility program. At this stage, my authorities are not ready to commit themselves to any specific option, but would welcome a thorough review of this matter. At the very least, the extended Fund facility should not be abandoned. Apart from the issue of reactivating the extended Fund facility, the Group of Twenty-Four has proposed structural adjustment facility and extended Fund facility growth-oriented adjustment programs which could be designed practically without conditionality. These programs are clearly not acceptable, since they would be incompatible with the basic principles which my authorities consider as still valid.

On the relationship between the Fund and the World Bank, we should economize on theoretical debates on the respective role of each institution and on cross conditionality, which is of course to be avoided. Instead, a constructive and pragmatic approach must be followed, as exemplified by the structural adjustment facility.

Mr. Sengupta made the following statement:

The Interim Committee at its 1987 spring meeting asked us to deliberate on the role of the Fund and the various suggestions regarding that role as contained in the reports of the Group of Ten and the Group of Twenty-Four. This was largely in response to the request of the G-9 Ministers, supported by others, that the Interim Committee should have an occasion to discuss the issues relating to the role of the Fund which were touched upon in the G-10 and G-24 reports of 1985 and which were elaborated further in the second report of the Group of Twenty-Four, finalized in the first half of this year. The communiqué referred to the second report as the "forthcoming report of the Group of Twenty-Four" because, formally, the report was not adopted until June. There was a great expectation among the developing countries that the suggestions regarding the role of the Fund would be discussed at the September Interim Committee meeting. It is unfortunate that this will not be possible, as the Board did not have a chance to discuss the suggestions in the Report fully until now. The Managing Director explained to us recently that he wanted to study these reports thoroughly before bringing the matter to the Board, and we accept fully his genuine desire to do justice to these reports. I would therefore like to make some constructive suggestions about how to go about examining the reports so that they can be brought forward for discussion at the next Interim Committee meeting.

The paper that has been prepared by the staff is excellent in summarizing the main points and proposals contained in these two reports. A careful study of the staff paper makes it clear that most of these proposals are quite far-reaching, with significant implications for the operation of the international monetary system. However, the paper does not evaluate these proposals; nor does it bring out the methods by which these proposals can be implemented or determine whether all the proposals are feasible and desirable. It is, therefore, not possible--nor would it be fair to the staff--for us to comment on the substance of these proposals today.

I would therefore limit myself to the modalities of discussing these reports in the Board after the Annual Meetings so that they can be taken up for comprehensive discussion at the Interim Committee meeting in the spring of 1988.

My first suggestion is that the Chairman may wish to report to the Interim Committee in September that the staff has started examination of the proposals and that the Board will have an opportunity to deliberate on them between now and the spring of 1988, as much as possible. But in light of this, the Chairman may also consider suggesting to the Committee that the matter of role of the Fund as examined in the reports of the Group of Ten and Group of Twenty-Four be placed on the Committee's agenda for the spring 1988 meeting.

In order to do justice to these reports, it is necessary to discuss all the proposals together, in an integrated manner. The report of the Group of Twenty-Four in particular examines the different aspects on the basis of a framework under which the totality of the approach leads to something more than sum of the different proposals addressed individually in an ad hoc manner. I submit that the report of the Group of Ten also lends itself to such an approach. We therefore regard it necessary to consider the two reports as a whole as a separate agenda item at the next Interim Committee meeting.

My second suggestion is that the staff should now be asked to evaluate and appraise these proposals, to examine their feasibility as well as their desirability, to point out where and why some of the proposals cannot work or cannot be accepted, and to suggest, if possible, amendments to the proposals in line with the spirit behind them. It is only on the basis of such a thorough staff examination of these proposals that the Board can discuss them in full knowledge of their implications and can indicate in what form they should be discussed in the next Interim Committee meeting.

My third suggestion is about the specific papers that the staff should prepare on this subject. As I see it, most of the proposals are interrelated, and it will be optimal if the staff examines them all together in the form of, say, two comprehensive papers. The first paper should deal with the design of Fund-supported programs and their implementation, covering the interrelationship between the growth exercises and financial exercises in growth-oriented adjustment programs as well as conditionality, performance criteria, contingency mechanisms, and repayment provisions. The second paper should focus on the financial aspects of implementing Fund-supported programs, including the catalytic role of the Fund, debt reconstruction, the Fund's financial resources and their use, and the reorientation of existing Fund facilities. We understand that several of these topics have already been discussed in different papers prepared by the staff at different points in time, although a careful reading of the present paper indicates that our reports have made many new suggestions, which have still not been properly examined. In the interest of promoting an integrated treatment of the proposals contained in the reports, we would like to see all the proposals examined together, in the context of two logically distinct, although interrelated aspects of the role of the Fund, namely, one on the design and implementation of Fund-supported programs and the other on financing and reorientation of the existing Fund facilities. If some of the proposals have already been discussed elsewhere, or in different papers, all comments on them should be culled and brought under one umbrella. Consider, for example, the question of debt, which will be discussed after the Annual Meetings in a staff paper on issues in managing the debt situation. We would like some of the aspects of this paper to be brought up again in the staff paper prepared for the agenda item on the role of the Fund in order to elaborate on the debt reconstruction approach that has been spelled out in the G-24 report. This will not imply any additional work. On the other hand, when these issues are re-examined in the framework of the overall role of the Fund, the considerable merit of the approach that has been proposed in our report will become evident.

My suggestion about preparing two comprehensive papers is only to illustrate the point that the proposal should be discussed in an integrated manner. If the staff considers that there should be more than two papers or that there should be a different classification of the issues into more convenient groups for facilitating discussion, I would be perfectly willing to go along. But the issues are interrelated and, therefore, they should be discussed together. And once we have done that in the Board, it should be possible for our Ministers to discuss them meaningfully at the spring 1988 Interim Committee meeting.

Mr. Ortiz made the following statement:

My authorities were initially disappointed at the failure to include the examination of the role of the Fund--and the analysis that has been done of the various aspects comprising this broad topic in the G-10 and G-24 reports--in the agenda of the forthcoming Interim Committee meeting. They acknowledge, however, the problem of timing and the difficulties that the Board and the staff would have faced if a substantive consideration of these reports had been attempted in the short time available since the issuance of the latest G-24 report. They expect that the Executive Board will give full consideration to the various proposals included in these reports in the coming months and that the more important aspects of the role of the Fund in the context of growth-oriented adjustment will be placed on the agenda of the Interim Committee next spring. As Mr. Sengupta has mentioned, it would be useful if the Managing Director would report to the Interim Committee that the Board has taken a first look at the various proposals and that it intends to pursue substantive discussions before the meetings next spring.

The paper before us contains a description of the issues pertaining to the role of the Fund in adjustment. It is organized following the format of the G-24 report, and its purpose is to help orient and organize future work and establish priorities. There is no substantive discussion of the issues in the paper, and I will not attempt to begin such discussion at this point. Thus, I will not comment on Mrs. Ploix's interesting preview of her authorities' views on the more substantive points. Rather, I will focus my brief remarks on the way in which I think work should be organized and the different issues which should be considered over the coming months.

A case could be made for considering the G-10 and G-24 reports as a whole, since obviously all the issues are related. This, however, would not be practical. Thus, the question arises whether we should consider the different issues separately and expect the staff to prepare separate papers, or, alternatively, whether we should consider, in the "normal" course of our discussions on the different subjects, the views expressed in the reports. It would perhaps be impractical to consider all issues separately, since this may lead to the proliferation of Board meetings. I would then identify two primary subjects that should be the focus of our main discussion; the views in the reports on some of the remaining issues can be taken into account in forthcoming discussions already contemplated in the work program.

The two main topics for consideration that I would suggest are: the design and implementation of Fund programs; and the financing of Fund programs. Regarding the first topic, the staff informs us that there are several papers in preparation for our consideration after the Annual Meetings. These papers will, according to the report, "examine issues relating to the design and monitoring of structural adjustment and to the G-24 proposal on integrating growth exercises into the design of adjustment programs. Further work in this area will be developed in the forthcoming review of conditionality." My main observation in this area is that we should attempt to focus in an integrated fashion on the questions of design and implementation. By this I do not mean that we should attempt to cover everything in a single Board session but that we should discuss together as part of the same general topic the issues of design, such as the growth exercises and the impact of the debt overhang in adjustment, conditionality, performance criteria, contingency mechanisms, and so on. In particular, I would not like to see the discussion on monitoring procedures left until we take up the regular review of conditionality.

On the subject of financing of Fund-supported programs, the various proposals in the reports regarding Fund resources, access limits, financial terms, overdue obligations of the Fund, and the reorientation of existing facilities should also be taken up together. I remain open-minded on the catalytic role of the Fund, which includes the Fund's role in the debt strategy and the G-24 proposals for a debt reconstruction scheme, since I understand that this matter will be taken up in our forthcoming discussion on the debt situation.

On the manner in which we would expect the paper to be approached, I have two final comments. First, the papers should be given an operational context; the different proposals should not only be discussed at an abstract level, but the staff should also discuss the question of implementation of such proposals. Second, as Mr. Sengupta has pointed out, the staff should appraise the feasibility and desirability of implementing these proposals, or should look at possible amendments that could make them operationally feasible.

Mr. Reddy made the following statement:

I view today's discussions as preliminary, to be followed by more comprehensive and detailed discussions on the various issues raised in the G-10 and G-24 reports. For today's discussion, I will organize my comments under the same headings which are used in the staff paper.

On the design of Fund-supported adjustment programs, let me state, at the outset, that this chair accepts conditionality as a useful and necessary instrument for adjustment. At the same time, we believe that Fund-supported programs must be well designed to tackle growth and adjustment problems simultaneously, and they must also take into account the social and political circumstances of each country. Program designing is a very complex matter, since numerous, and sometimes conflicting, objectives may have to be accommodated. It is, therefore, important that an adjustment program for each country be "tailor made" and based on a careful examination of the sources of external imbalances and an assessment of the growth and external prospects for the country.

One of the criticisms of Fund-supported programs is that they rely too heavily on demand-management policies, thereby resulting in a loss of output. To avoid this difficulty, the G-24 report has suggested an alternative approach under which a positive rate of growth, which is close to the country's potential, could be achieved. Under this approach, "growth exercises" would provide estimates of the external finance needed to achieve a positive rate of growth, and these estimates would then enter into the Fund's "financial exercises" as the external counterpart of the domestic stabilization efforts. We believe that this is an interesting idea that should be studied by the Fund staff, and the Board should return to this matter for a more detailed and comprehensive discussion after the Annual Meetings.

It is theoretically possible for high growth and external equilibrium to co-exist with high inflation. However, experience shows that sustained growth and external equilibrium are seldom, if ever, present in a country with a high inflation rate. Therefore, the program objective of reducing inflation--which often requires demand restraint--is not necessarily inconsistent with the objective of promoting sustainable growth. In the circumstances, priority must be given to reducing inflation in those countries which have a history of high inflation so that the economy can be put on a path of sustained growth.

On the implementation of Fund-supported adjustment programs, I agree with the observation in the G-24 report that there has been a proliferation of prior actions and performance criteria, as well as supplementary monitoring techniques, reviews, and consultations; and that these have led to a tightening of conditionality and excessive rigidity. The report is suggesting a reversal of this trend and, to this end, a number of interesting suggestions have been made. I see considerable merit in the G-24 suggestion that the Fund should assess the compliance with the performance criteria regarding policy instruments only if program targets are not met. This would give greater flexibility to the authorities in the mix of policies that can be used to achieve program targets. The need for accommodating growth in the performance criteria is emphasized in the G-24 report. It is a matter which should be examined carefully so that an appropriate balance can be struck between the need for growth and the need for stabilization.

As far as the question of prior action is concerned, there are differences of view between those who argue that a strong dose of adjustment is required at the beginning of the program in order to enhance its credibility, and those who argue that because many adjustments require time, policy actions should be phased over a longer period. There is merit in both these positions. I believe that the likely social and political shocks resulting from prior actions must be evaluated and taken into account in every case before determining the extent to which the Fund should go in front-loading adjustment.

An important aspect of Fund-supported programs is their implication for income distribution. While I can readily agree that some of the policy prescriptions of these programs have a positive impact on income distribution, there are also cases where the implications are not so clear. For example, it has been reported that in some countries, excessive diversion of resources to the external sector has led to the neglect of domestic food production, with the result that shortages of food supply have developed. This type of development tends to have graver consequences for the poorer sections of the community than for the well-to-do groups. The Fund must also reconsider its attitude toward subsidies, especially those which have a direct bearing on the poorer sections of the community. Therefore, we welcome the proposed staff paper that will examine the impact of Fund-supported programs on income distribution.

I have found the G-24 ideas on contingency mechanisms both innovative and interesting, and I feel that these ideas should be pursued by the staff. The proposals for a contingency mechanism to provide additional financing when performance criteria are on track but actual economic growth is short of target should be investigated further, as should the idea of contingency mechanisms relating to exogenous developments during program periods. We do have some reservations on the third type of proposed contingency mechanism, where repayment obligations to the Fund would be related to members' capacity to pay, but I would not like to take a firm position on this matter until the staff has studied the idea fully.

On the use of the Fund's financial resources, I agree with the Group of Twenty-Four that the Fund can only play an effective role in promoting adjustment with growth if it has adequate resources at its disposal. In this respect, I look forward to discussions on the Ninth General Review of Quotas and the review of the decision on the General Arrangements to Borrow (GAB). I also agree with the observation that the policy on access has become very restrictive, that actual access should be increased, and that the enlarged access policy should be maintained.

The Fund will have to play an important role in resolving the debt problem, and I do not believe that it can play an effective catalytic role at a time when the institution itself is cutting back, or is seen to be cutting back, on actual access. Negative net lending by the Fund could be seen by the markets as a retrenchment at a time when the Fund is calling for commercial lenders to increase their exposure to the developing countries. As far as the low-income countries are concerned, this chair welcomes the proposed enhancement of the structural adjustment facility. We hope that the enlarged resources of the facility can be made available to the Fund for disbursement by the beginning of 1988.

With respect to Fund facilities, I welcome the proposed comprehensive review of conditionality. Following more detailed discussion of the issues raised in the G-10 and G-24 reports, I would hope that greater attention could be given to economic growth in adjustment programs. I would also like to endorse the view that the compensatory financing facility should be free of conditionality in all those cases where the export shortfall is temporary and reversible and where macroeconomic policies are broadly appropriate.

Finally, this chair supports Fund/Bank collaboration in order to help members design appropriate growth-oriented adjustment programs to coordinate the financing of such programs. The Bank must concentrate on development issues and structural policy reforms, whereas the Fund should concentrate on macroeconomic and exchange rate problems. As we have indicated in the past, collaboration between the Fund and the Bank must not lead to cross-conditionality.

Mr. Song made the following statement:

The role of the Fund generally is a broad and multifaceted one, although judging from the content of the staff paper, I assume that today's discussion will focus mainly on the role of the Fund in adjustment, the primary subject of the recent important report put out by the Deputies of the Group of Twenty-Four.

Everyone knows we are facing a changing and uncertain world economy with many protracted and difficult problems that need to be resolved. Right now, the most pressing matter for the Fund to resolve is how to adapt its policies, facilities, and practices to the current situation. In order to tackle these problems successfully, this adaptation needs to be effective and in line with the purposes expressed in the Articles of Agreement. As demonstrated at many junctures in the Fund's history, innovations are essential in any process of adaptation. The thrust of the G-24 Deputies' report is innovative, as shown in the underlying principles on which the report is based, as well as in its analyses and recommendations. The report therefore merits serious consideration by the Board.

Three areas in the G-24 report deserve special attention in my view. The first concerns "growth exercises." As the report suggests, prior to agreement on the design of Fund-supported adjustment programs, a set of growth exercises should be performed. Second, the principle of symmetrical obligations needs to be followed by debtor and creditor countries in the process of adjustment with growth. Third, flexibility needs to be a fundamental principle in establishing and applying conditionality requirements in the use of Fund resources and related recommendations.

Equally important are the ideas expressed in the Managing Director's remarks before the seventh session of UNCTAD, especially his listing the seven features of growth. These features should be kept in mind when designing growth-oriented adjustment policies. It seems to me that the essence of these two important documents reflect the same viewpoint, namely, that it is important to achieve adjustment with growth. However, there remains a need to narrow the gap between some of the differences in order to come to an overall understanding. As I understand it, today's discussion is not expected to focus exclusively on an examination of substantive issues and, therefore, I make no further comment in this respect.

The specific issues raised in the G-10 and G-24 reports, if I calculate accurately, total at least 24 items, which--irrespective of how thoroughly each item may be discussed--represents a heavy load for the Board.

I believe three principles may be useful in guiding the priority of the main discussion: (1) to work on those aspects which are urgently needed for reform of adjustment program design; (2) to help improve the Fund's facilities and strengthen the Fund's resources; and (3) to highlight those issues where a consensus view has already been reached.

Based on the above, I think the following matters should be examined in an orderly way by the Board: (1) the design and monitoring of structural adjustment and the design of Fund-supported programs, a comprehensive review of conditionality, the G-24 proposal for integrating growth exercises into the design of adjustment programs, and contingency mechanisms; (2) G-24 recommendations on Fund facility improvement and related issues, such as the establishment of a separate facility to provide subsidies, as well as a further review of existing facilities like the compensatory financing facility; (3) management of the debt situation and the enlargement of structural adjustment facility resources, as well as Fund-Bank relations in these respects; and (4) a review of quotas, the General Arrangements to Borrow, and SDRs, and a comprehensive review of the size of the Fund with a view to restoring its mandated role in providing financial support to its member countries.

The Executive Directors agreed to continue their discussion at 3:00 p.m.

## DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/87/138 (9/15/87) and EBM/87/139 (9/16/87).

### 3. MOROCCO - STAND-BY ARRANGEMENT - WAIVER OF PERFORMANCE CRITERION

1. Morocco has consulted with the Fund in accordance with paragraph 4 of the stand-by arrangement for Morocco (EBS/86/262, Sup. 3, 12/17/86), concerning the nonobservance of the performance criterion on outstanding external payments arrears referred to in paragraph 4(a)(vii) of the stand-by arrangement and paragraph 7 and Table 1 of the technical memorandum of understanding annexed to the memorandum of economic and financial policies and to the letter of November 12, 1986.

2. The Fund finds that, in view of the circumstances pertaining to the nonobservance of the performance criterion on outstanding external payments arrears as at June 30, 1987, as described in EBS/87/195 (9/10/87), no additional understandings are necessary and Morocco may resume purchases under the stand-by arrangement.

Decision No. 8696-(87/139), adopted
September 15, 1987

### 4. SOMALIA - OVERDUE FINANCIAL OBLIGATIONS - REPORT AND COMPLAINT UNDER RULE K-1

1. The complaint of the Managing Director dated September 8, 1987 on Somalia in EBS/87/194 (9/8/87) is noted. It shall be placed on the agenda of the Executive Board for October 7, 1987.

2. The Fund urges Somalia to become current in its financial obligations to the Fund promptly and to avoid thereby the need for the Fund to take remedial action.

Decision No. 8697-(87/139), adopted
September 15, 1987

5. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 87/25 and 87/26 are approved. (EBD/87/228, 9/9/87)

Adopted September 15, 1987

APPROVED: May 3, 1988

JOSEPH W. LANG, JR.
Acting Secretary