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Minutes of Executive Board Meeting 86/11

10:00 a.m., January 24, 1986

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
A. Alfidja	Mawakani Samba
	L. K. Doe, Temporary
C. H. Dallara	M. K. Bush
	M. Lundsager, Temporary
	E. L. Walker, Temporary
J. de Groote	
B. de Maulde	S. de Forges
M. Finaish	T. Alhaimus
	M. B. Chatah, Temporary
H. Fujino	M. Sugita
	B. Goos
Huang F.	
	Jaafar A.
A. Kafka	
T. P. Lankester	M. Foot
H. Lundstrom	
	L. Leonard
E. I. M. Mtei	A. Abdallah
F. L. Nebbia	M. A. Weitz, Temporary
	J. E. Suraisry
P. Pérez	
J. J. Polak	J. de Beaufort Wijnholds
	A. V. Romuâldez
G. Salehkhou	O. Kabbaj
A. K. Sengupta	A. S. Jayawardena
S. Zecchini	N. Coumbis

L. Van Houtven, Secretary
S. J. Fennell, Assistant

Also Present

Liberian Representatives: E. Harmon, Ambassador-at-Large; R. Perry, Member, Liberian Senate; J. Rancy, President Pro Tempore, Liberian Senate. Administration Department: L. A. Wolfe. African Department: A. D. Ouattara, Director; R. J. Bhatia, Deputy Director; L. M. Goreux, Deputy Director; A. I. Abdi, A. Basu, E. L. Bornemann, E. A. Calamitsis, J. A. Clement, K. G. Dublin, C. Enweze, W. Huyser, A. Tahari, K. Thugge. Asian Department: S. Kohsaka. Central Banking Department: C.-J. Lindgren. European Department: L. A. Whittome, Counsellor and Director. Exchange and Trade Relations Department: C. D. Finch, Counsellor and Director; W. A. Beveridge, Deputy Director; M. Guitián, Deputy Director; J. T. Boorman, Y. Boutros-Ghali, G. Hacche, J. Hicklin, G. G. Johnson, P. Neuhaus, B. J. Nivollet, R. L. Sheehy, W. S. Tseng. External Relations Department: A. M. Abushadi, D. D. Driscoll, H. O. Hartmann, B. Nowzad, H. P. Puentes. Fiscal Affairs Department: V. Tanzi, Director; A. A. Tait, Deputy Director; E. S. Kreis, C. Schiller. IMF Institute: G. M. Teyssier, Director; O. B. Makalou. Legal Department: F. P. Gianviti, Director; H. Elizalde, W. E. Holder, Ph. Lachman, A. O. Liuksila, J. M. Ogoola, J. V. Surr. Middle Eastern Department: P. Chabrier, Deputy Director; S. H. Hitti, S. M. Thakur, S. Thayanithy. Research Department: W. C. Hood, Economic Counsellor and Director; R. R. Rhomberg, Deputy Director; D. J. Mathieson. Secretary's Department: J. W. Lang, Jr., Deputy Secretary; A. P. Bhagwat. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer; T. Leddy, Deputy Treasurer; D. Williams, Deputy Treasurer; J. E. Blalock, J. C. Corr, D. Gupta. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: A. A. Agah, P. E. Archibong, W.-R. Bengs, L. P. Ebrill, S. M. Hassan, H.-S. Lee, G. Nguyen, A. Ouanes, P. Péterfalvy, G. W. K. Pickering, I. Puro, Song G., D. C. Templeman, A. Vasudevan, K. Yao. Assistants to Executive Directors: H. Alaoui-Abdallaoui, J. R. N. Almeida, J. de la Harrán, F. Di Mauro, J. J. Dreizzen, G. Ercel, R. Fox, V. Govindarajan, N. Haque, G. D. Hodgson, O. Isleifsson, Z. b. Ismail, J. M. Jones, S. King, H. Kobayashi, S. Kolb, R. Msadek, K. Murakami, A. H. Mustafa, W. K. Parmena, J. Reddy, J. E. Rodríguez, V. Rousset, L. Tornetta, H. van der Burg.

1. AFGHANISTAN - 1985 ARTICLE IV CONSULTATION

The Executive Directors considered a staff report for the 1985 Article IV consultation with Afghanistan, together with a proposed decision concluding the Article XIV consultation with Afghanistan (SM/85/299, 11/6/85). They also had before them a staff report on recent economic developments in Afghanistan (SM/85/305, 11/14/85; and Cor. 1, 12/4/85).

The Deputy Director of the Middle Eastern Department stated that Afghanistan had repaid $590,000 to the World Bank on December 11, 1985 out of the total overdue obligations to the Bank on IDA credit of $610,000. However, a further installment amounting to $608,000 had become overdue on December 15, bringing the total overdue obligations to the World Bank to $628,000.

Mr. Salehkhou made the following statement:

> The Afghan economy is essentially based on agriculture, which provides two thirds of net material resources and 35 percent of exports. It also provides employment for the large majority of the population. Natural gas and coal mining provide a complementary source of revenue and exports. The events of recent years have led to movements of population and manpower that have undermined trade and the productive capacity of the country. To this must be added a decline of concessional aid by countries and international organizations as well as sharp reduction in workers' remittances and an increase in private capital outflows. Since 1978 a reorientation of trade has been taking place toward the council for Mutual Economic Assistance (CMEA) countries.
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> The creation of large public enterprises in the fields of agriculture and handicrafts has left only retail trade and transportation in the hands of the private sector. While statistics are difficult to obtain, official estimates indicate that net material product increased by 1.7 percent in 1984/85 and is expected to further increase by 3.3 percent for 1985/86.
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> Despite some improvement in the agricultural sector, food requirements for the population have to rely on imports, particularly of wheat, rice, and sugar. With the system of land reform introduced in 1978, a number of cooperatives have been organized, to provide for inputs and consumer goods. Better quality seeds and fertilizer are distributed and additional credit is being made available to farmers through the Agricultural Development Bank. Under the reorganized system, agricultural production increased by 4 percent in the three years ended 1983/84 while a decline was recorded in 1984/85.

The socioeconomic development plan for 1985/86 calls for a 1 percent increase in foodgrain and 47 percent and 100 percent increases in the production of cotton and sugar, respectively. Furthermore, livestock which contributes to about 30 percent of agricultural output and has increased only marginally in 1984/85 is to increase by about 1 percent in 1985/86.

Industry and mining, which together represent 15 percent of net material product (NMP), have progressed slightly in the last few years. With the exception of gas and coal, mineral deposits are yet to be exploited and the bulk of industry rests on the transformation of agricultural production including cotton, oil seeds, and sugar beets. The reform of the 1975 investment law is to give the private sector more encouragement in the participation of new projects through interest rate subsidization and tax incentives.

The growth of the industrial sector has been hampered by events of the recent years and a general shortage of skilled workers. While significant growth was registered in coal and mineral fertilizer, cement and electricity production was down in 1984/85, and gas output increased only slightly owing to the aging of existing fields. All in all the increase in industrial production for 1984/85 is estimated to be 4.7 percent.

The pressure on prices seems to have intensified in 1984/85 as the Kabul price index, the only one available, increased by 17 percent. The inflationary pressure was further exacerbated by production and transportation problems. The poor crop of 1984/85 put further pressure on prices, but government imports somewhat dampened the increase in the first part of 1985. A comprehensive subsidy program and food price control are in effect so as to limit the impact of inflation on the income of the population. Total budgetary subsidies amounted to 3.6 billion Afghanis in 1983/84 and 4.8 billion Afghanis in 1985/86, or \$71 million and \$95 million. A gradual increase in prices should reduce the budgetary pressures, thus no transfers are envisaged for petroleum products in 1985/86 as prices have been increased accordingly. Transportation, however, is still subsidized, particularly after the increase in the price of diesel fuel in 1985/86. The authorities continue to monitor the prices of industrial goods through the State Planning Committee and price increases are authorized on the basis of rising costs. Other forms of subsidies exist in the structure of interest and official exchange rates. The public wage policy corroborates with its pricing policy and some of the benefits of the subsidized prices are calculated as wage benefits for civil servants and public enterprise employees. Public wages have been increased in 1984 by about 18 percent.

Government revenues have in recent years been sluggish reflecting the slowdown in economic activity. As a consequence, resort to bank financing has been necessary in the period 1983/85 particularly with the increase in the Government's social and security expenditures. In contrast to the early 1980s when gas revenues and foreign transfers sufficiently covered the deficit, an approximately 42 percent increase in expenditures since 1983 resulted in a widening of the fiscal deficit by about one third of total expenditures. This was financed by borrowing from the banking system. As expenditures continued to rise in 1984 faster than revenues, government borrowing from the commercial banks expanded further. The fiscal situation in 1985 called for greater claim by the banking system on the Central Government equivalent to 75 percent of broad money at the beginning of the period. The preliminary budget for 1986 calls for a greater increase in revenues, more restraints on expenditures and lower borrowing from the banking system. Sales of natural gas should account for the major part of revenue increase along with import duties and increase from public enterprises, although the latter has been weak owing to lack of price adjustment.

Expenditures are scheduled to rise by 23 percent mainly to incorporate the salary increase of 1984/85 which was not taken into account in the 1985 budget and the rise in the cost of subsidies and transfers. An increase in development expenditures of 17 percent is scheduled for 1985/86 in view of the resumption of work on unfinished projects. The authorities are cognizant of the need to reduce the fiscal deficit, but room for maneuver remains limited.

The amount of currency in circulation is rather substantial in Afghanistan and merchants play an important role in the financing of domestic trade. They also deal freely in foreign exchange transactions. Da Afghanistan bank controls credit to the private and public sectors through annual credit plans. The growth of domestic liquidity has recently slowed down. It increased by 10.9 percent in 1984/85 compared to 18.5 percent in 1982/83. The bulk of the credit was due mainly to demands by the Central Government and the public enterprises. The authorities are determined to reduce liquidity through greater credit restraint.

Bilateral transactions represent an important part of the balance of payments. Balance of payments estimates exclude workers' remittances and tourist receipts which are financed by bazaar merchants. In the same manner, travel expenditures by residents and private capital transfers are also excluded.

The trade balance has persistently shown a deficit reflecting Afghanistan's narrow resource base, heavy dependence on imports as well as protectionism against its exports. The trade deficit widened further reaching $215 million compared to $70 million in 1982/83. A decline in gross official aid was behind the increase in the balance of payments deficit.

In 1984/85 an 8 percent increase in proceeds from gas and cotton exports in addition to the resumption of aid inflows reduced the deficit to $170 million. For the five-year period ended 1984/85 official reserves declined by $294 million of which $112 million was in convertible currencies. In an effort to promote exports, the authorities have adopted in recent years a more appropriate exchange rate. The rate of the Afghani has further depreciated in relation to the dollar since 1984. At the same time, receipts are experiencing a certain decline due to lower prices for wheat and sugar and transit delays through neighboring countries. Total foreign debt in mid-1985 amounted to $2.5 billion, most of which is owed to the CMEA countries. More project loans are on concessional terms bearing an interest rate of no more than 2 percent and maturities of 25 years. As a consequence, the debt service ratio remains moderate at about 15 percent of exports of goods and services. Total gross official reserves at the end of 1984/85 were equivalent to three months of projected imports for 1985/86.

The Afghani authorities welcome the consultation discussions. They worked closely with the staff in the preparation of its report. They generally concur with the staff appraisal and look forward to further cooperation with the Fund.

Mr. Jayawardena stated that he generally agreed with the thrust of the staff appraisal, which clearly identified the severe adverse impact of the continuing security problem on the economy and the inadequacy of data, which made any analysis difficult. However, the staff had proposed the standard prescriptions relating to containment of demand; price improvement, including a depreciation of the exchange rate; and a reduction of subsidies. Perhaps there were no other policy options available. The security situation had compounded the economic problems, and the only alternative was to prevent further dislocations in the hope that the economy could be rebuilt when the domestic situation returned to more normal conditions.

Preliminary data for 1984/85 indicated that national income or net material product (NMP) had grown by 1.7 percent, less than half the rate of the previous year, owing mainly to crop failure, Mr. Jayawardena noted. It was estimated that national income would grow by 3.3 percent in 1985/86, but recent unfavorable weather conditions threatened the achievement of that target. The authorities had adopted policies appropriately aimed at promoting agriculture, which employed 85 percent of the labor force and accounted for two thirds of national income. He welcomed their efforts to establish cooperatives and improve services and inputs, including irrigation. The land reform measures being implemented should also contribute to increased productivity. The staff's recommendation to levy an irrigation fee was appropriate, but it would have to be implemented in a gradual manner, as a sudden increase in the cost of cultivation might discourage the use of irrigation, particularly at the early stages of land reform, thereby adversely affecting production.

The authorities were formulating a five-year plan for 1986-1991, after several years of formulating only annual plans, Mr. Jayawardena commented. They appropriately viewed monetary, fiscal, exchange rate, and pricing policies as continuing to play a significant role as policy tools in the implementation of the plan. Their decision not to treat the plan as a directive plan, given the insufficiency of the statistical data, reflected the pragmatic manner in which they were approaching the issues confronting Afghanistan. The details of the plan were not yet known, but the need for external assistance was clear given the narrow resource base of the country.

The country's budgetary position was under severe pressure, with an increase in the government deficit from Af 21 billion to Af 24.6 billion and in bank financing of the Government by an amount equal to about 23 percent of broad money between 1983/84 and 1984/85, Mr. Jayawardena observed. The reasons for those increases were difficult to determine given the insufficient data, although the authorities considered that they were due to the purchase of trucks and buildup of wheat stocks. The 1985/86 budget provided for an increase in revenue of 26 percent, largely from import duties, and in current expenditures of 23 percent, owing to an increase in employment of teachers and the establishment of new ministries. The projected increase in development expenditures of 17 percent was welcome. Those fiscal developments were expected to result in an overall fiscal deficit of Af 16.2 billion and use of bank credit of Af 7.4 billion, indicating a substantial improvement from previous years. However, the staff, while welcoming the authorities' intentions to reduce the fiscal deficit, considered that the projections of revenues were optimistic and that those of expenditures were underestimated. It considered that the overall deficit would be much higher and had therefore suggested that additional measures should be taken to improve the fiscal position. Such measures should include a slowing in the hiring of civil servants; a reduction of subsidies, especially on petroleum products; an across-the-board small increase in import duties and additional selective increases in nonessential import duties; and an improvement in pricing policy to increase the budgetary contribution of the public sector. Those suggestions were appropriate, but there was limited room for maneuver.

He welcomed the recent slowing in the growth of domestic credit and the authorities' commitment to restrain domestic credit in the future, Mr. Jayawardena stated. The staff had suggested that interest rates should be raised to positive levels. However, he recognized the authorities' difficulties in following a market-related interest rate policy given the country's circumstances.

The balance of payments position continued to be under pressure, Mr. Jayawardena noted. External reserves had declined sharply and external debt had risen. In view of the continuing security problems and consequent pressure on the budget, large current account deficits appeared to be unavoidable. Export promotion and an increase in concessional aid would be the only way to improve the situation in the immediate future. Borrowing on commercial terms should be kept to a minimum in view of the rising debt service burden, which had already reached 15 percent. It was encouraging to note that the authorities were considering simplifying and rationalizing the complex system of multiple exchange rates.

The authorities had been striving to adopt a pragmatic approach in an extremely difficult situation, Mr. Jayawardena observed. The technical assistance provided by the Fund in improving the country's statistical base was welcome. The completion of Article IV consultations with the Fund in the normal cycle under adverse circumstances indicated the importance attached by the authorities to Fund consultations.

Mrs. Walker noted that Afghanistan, one of the world's poorest countries, faced a variety of external and internal constraints on the growth and development of its economy. The lack of natural resources, including the very small percentage of fertile land on which the majority of the population worked, combined with a dependence on costly irrigation for an adequate water supply, further impeded development. The difficult internal security situation compounded the country's problems and had contributed to the imbalances in the fiscal and balance of payments positions. It appeared that those imbalances had increased further in 1984/85, and it was unlikely that the domestic and external economic constraints would ease in the near future.

However, the staff pointed out some areas where corrective action might be taken, Mrs. Walker observed. The 1985/86 budget estimates indicated an improvement in the deficit from that in 1984/85. The preliminary budget for 1986 called for a greater increase in revenues, restraint on expenditure, and a reduction in borrowing from the banking system. However, other financing needs might have been underestimated, possibly resulting in a 15 percent increase in the budget deficit for 1985/86. Expenditures would have to cover a large salary increase granted in 1985 and growing subsidies and transfers. In addition, no provisioning had been made for extrabudgetary outlays, which had been quite high in the past. Furthermore, revenues might have been underestimated, as part of the increase projected for 1986 was supposed to come from public sector enterprises whose profitability had been weak.

The authorities were operating under very difficult circumstances, but staff suggestions regarding measures to improve the fiscal situation should be considered, Mrs. Walker remarked. Subsidies to essential consumer goods could be reduced, the growth in the work force contained and a more stringent wage policy adopted, and measures introduced to increase the net financial contribution of public sector enterprises to the budget. More flexible pricing policies for those enterprises designed to, at a minimum, recover costs and provide an adequate return on investment, would help to increase their efficiency and self-financing ability, thereby reducing the fiscal deficit. A more flexible pricing policy in agriculture, involving an increase in procurement prices, could help to raise agricultural productivity and contribute toward achieving the authorities' goal of food self-sufficiency. She also welcomed the slowing of domestic credit expansion and the authorities' commitment to a more restrictive monetary policy.

Efforts to promote activity in the industrial sector were also needed, Mrs. Walker remarked. It was encouraging to know that the Government was aiming to strengthen private sector activity in industry and that the investment law was currently being revised to encourage the private sector to participate in new projects. However, the strict price control on industrial goods could distort the price of inputs and lead to inefficient production. It was discouraging that the authorities were making efforts to expand the system of price control beyond basic consumer goods and the manufacturing sector.

The export promotion measures taken by the authorities in recent years were welcome, but the most significant problem for export promotion and the overall balance of payments position was the complex exchange system, Mrs. Walker considered. While the exchange rate had depreciated in relation to the U.S. dollar since 1984, it was appropriate that the authorities were considering simplifying the exchange system. Finally, as the balance of payments position was likely to remain under pressure in the future, a more flexible exchange rate policy and a tighter fiscal policy should be pursued.

The Deputy Director from the Middle Eastern Department remarked that in a country such as Afghanistan, where the degree of monetization of the economy and the development of the banking sector was limited, the role of an active interest rate policy was somewhat reduced. For example, the average per capita liquid holdings in Afghanistan was $45, one third of that in neighboring countries. A number of factors should be considered when examining interest rate policy in Afghanistan. First, given the situation in the country, with high inflation and a rapidly depreciating exchange rate in the free market, there was an incentive to move away from domestic currency holdings into either goods or foreign currency. Consequently, an increase in interest rates might to some extent encourage the population to hold its money in financial assets, directly helping the balance of payments position. Second, an increase in the cost of credit could lead to some destocking and contain excessive imports. Third, in a country with many constraints on the kinds of policies that could be implemented, policies that would affect the broad economy were usually considered. It was in that respect that the staff had suggested that interest rate policy had a role, although a somewhat limited role, to play.

Mr. Salehkhou remarked that owing to the constraints on revenues and the budgetary position, the authorities had experienced difficulties in meeting their obligations, including their obligations to the World Bank. However, World Bank involvement in Afghanistan had declined and many of the projects that had been intended to generate revenue for the country had been interrupted. The authorities hoped that World Bank involvement would increase in the near future.

The Chairman made the following summing up:

Executive Directors were in broad agreement with the thrust of the views expressed in the staff appraisal of the report for the 1985 Article IV consultation with Afghanistan. It was noted that in recent years economic performance had been severely affected by the adverse security situation, external developments, relative price distortions, and a substantial weakening of the fiscal position. The efforts of the authorities to encourage production and contain the domestic and external imbalances had so far met with limited success. Those imbalances had become more pronounced in 1984/85, when cereal production had declined, the rate of inflation had accelerated, and the fiscal and external current account positions had weakened, Directors observed.

The prospects for the economy and the balance of payments depend upon the security situation and the constraints it places on economic policy formulation and implementation. Notwithstanding these constraints, the Afghan authorities were encouraged to adjust in a flexible fashion their policies in order to contain inflation and the deterioration of the balance of payments. Directors welcomed the emphasis placed by the authorities on increasing agricultural output as well as on increasing the role of the private sector in industry.

In the period ahead, the major emphasis in the adjustment efforts should be placed on strengthening the fiscal position, through containing the expansion in the government work force, limiting subsidization to essential consumer goods, and making a greater revenue effort, which could be achieved by the introduction of more flexible pricing policies for public sector enterprises and increased import duties. Pricing policies should take account of relative scarcities and rising costs and should aim at the generation of financial resources, while providing adequate incentives to producers. These measures should be supported by a cautious credit policy stance, and in this regard Executive Directors welcomed the restraint shown in credit policy.

The external position would benefit from a simplification of the complex multiple exchange rate system and a move toward a unified and flexible exchange rate. Directors welcomed the authorities' intention to move in that direction.

Directors noted the serious deficiencies that persisted in the statistical field and their impact on policy formulation and implementation. Intensified efforts to remedy this situation were urged.

It is recommended that the next Article IV consultation be held on the standard 12-month cycle.

The Executive Board then took the following decision:

1. The Fund takes this decision relating to Afghanistan's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1985 Article XIV consultation with Afghanistan in the light of the 1985 Article IV consultation with Afghanistan conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Afghanistan's present exchange regime involves exchange restrictions and multiple currency practices as described in SM/85/305. The Fund welcomes the transfer of most external transactions in convertible currencies to more depreciated rates, but notes that the present exchange rate structure is unduly complex. The Fund therefore recommends a simplification of the exchange rate system with a view toward the eventual establishment of a unified exchange rate at a more depreciated level. The Fund encourages Afghanistan to terminate the remaining bilateral payments agreement with a Fund member.

Decision No. 8188-(86/11), adopted
January 24, 1986

2. TANZANIA - OVERDUE FINANCIAL OBLIGATIONS - REVIEW OF DECISION ON COMPLAINTS UNDER RULE K-1 AND RULE S-1 AND NOTICE OF FAILURE TO SETTLE TRUST FUND OBLIGATIONS

The Executive Directors considered a staff paper further reviewing Decision No. 8056-(85/126) G/S/TR adopted on August 26, 1985 on complaints under Rule K-1 and Rule S-1 with respect to Tanzania's overdue obligations to the General Department and SDR Department and the notice of Tanzania's failure to settle Trust Fund obligations, together with a draft decision calling for a further review by March 24, 1986 (EBS/86/12, 1/21/86; and Cor. 1, 1/21/86).

The Deputy Director from the African Department made the following statement:

In the November 25, 1985 meeting of the Executive Board on Tanzania's overdue financial obligations to the Fund, the Executive Board decided on a further review for January 24, 1986 when it also wished the staff to report on Tanzania's policy stance and intentions to achieve domestic and external viability and to become current on its payments obligations to the Fund.

Since that meeting, two staff missions have visited Dar es Salaam--the first from December 3-14, 1985 to conduct the 1985 Article IV consultation discussions, and the second from January 7-17, 1986 to assist the authorities in the formulation of an adjustment program. The staff report on the consultation discussions would be issued soon, but the main findings of the mission have been stated on pages 2 and 3 of EBS/86/12 (1/21/86). In 1985, except for a modest growth in the agricultural sector attributable to favorable weather conditions, the deterioration in the economic and financial position of Tanzania has continued; the external current account deficit, excluding official grants, increased to over $500 million, or 8 percent of GDP, the external arrears increased further to about $980 million, and foreign reserves were virtually depleted. These developments notwithstanding, the authorities announced no further adjustment measures in conjunction with the 1985/86 budget.

At the conclusion of the first mission, the authorities indicated their desire to discuss in detail a possible adjustment policy package which could eventually be supported by a stand-by arrangement with the Fund and by other donor and creditor assistance. The second visit by the staff was in response to that request and was preceded by extensive discussions with the World Bank staff regarding the appropriate pace and content of the policy package, as well as the likely amount and duration of external assistance in support of such a package. A World Bank staff member was attached to the Fund mission.

Discussions with the authorities were wide ranging. It was commonly recognized that, in the present circumstances of Tanzania, adjustment toward viability would take, and also should not exceed, five to six years but that the policy package would have to be comprehensive and should include structural policies as well as restrained demand management. It was also recognized that, while external viability could not be realistically expected before the end of the present decade, all the major elements of the adjustment policies must be implemented at the earliest, with some crucial policies being in place at the very start of the adjustment program.

Based on this common approach to the adjustment principles, negotiations focused on the question of an adequate exchange rate policy. The staff noted that, as compared to end-1978, the real effective exchange rate of the Tanzanian shilling had appreciated by about 120 percent, and that the present and prospective balance of payments deficits were unsustainably large. In the staff's view, therefore, the Tanzanian currency is presently very greatly overvalued which, if not corrected substantially and immediately, would make it impossible to derive the needed improvement in the economy. The staff emphasized that the exchange rate of the Tanzanian shilling needs to be brought to a level where it would provide incentives for production, and exports, and discourage the present widespread diversion of activities into nonofficial channels. Given the crucial importance of this issue, the staff also recommended that the authorities be prepared to follow, after an initial large devaluation, a flexible exchange rate policy that would take into account, inter alia, developments in the balance of payments and the evolution of the exchange rate in the parallel market. On the basis of what the staff considered a minimum realistic starting rate, it proposed to the authorities a quantitative adjustment scenario and policy actions in other major areas.

Unlike in the past, the above recommendations of the mission were not rejected by the Tanzanian representatives, including the Minister of Finance, who, however, wished to start with a smaller depreciation in the initial part of the program with built-in flexibility that would move the exchange rate to about the level suggested by the mission within a period of a few months. They also emphasized the crucial importance of additional external assistance as, in their view, the production response depended more on the immediate provision of imported inputs and spare parts than on any paticular level of the starting exchange rate. The authorities provided the staff with a quantitative range of the exchange rate for the starting and intermediate points, as well as the timing for approaching the rate considered as the minimum for an acceptable adjustment program. The staff considers that if the authorities would move the exchange rate as recommended by the mission and keep the needed flexibility to attain a realistic and sustainable level, an adequate base would have been established for the authorities to formulate a comprehensive adjustment program that promises medium-term viability. The staff accordingly encouraged the Minister to begin implementing that policy on the exchange rate. The Minister of Finance informed the mission that he would have to submit these proposals to his Cabinet colleagues and to the leaders of the governing political party for discussion and agreement. He stated to the staff that the time interval between the conclusion of the staff mission and the Fund's Executive Boad discussions on Tanzania's overdue obligations, scheduled for January 24, was too short to expect a definitive response from the Government. The staff has now been informed that the Minister is still in the process of consultations within the Government and that no final decision has as yet been taken. The staff was also informed that this process would be completed within a few days and that, if approved by the authorities, an initial substantive move in the rate could be made in the first part of February. The staff intends to report further to the Executive Board on any developments in this regard at the time of the Board discussions on the 1985 Article IV consultation envisaged for early March.

Regarding Tanzania's overdue obligations to the Fund, Tanzania paid SDR 1.1 million on January 21, and the arrears now amount to SDR 17.9 million. The authorities have reiterated that they would make every effort to become current with the Fund but, in light of the balance of payments situation and lack of any external reserves, they were unable to indicate how and when this could be done.

Mr. Mtei stated that his authorities deeply regretted their inability to clear their overdue obligations to the Fund and to other creditors owing to continuing economic problems. However, the authorities were determined to adopt a strong, comprehensive adjustment program to overcome those problems. The Government, under the newly elected president, was giving the highest priority to achieving economic recovery and growth. The authorities had welcomed the detailed technical discussions between the authorities and the staff earlier in January and were considering carefully the elements of the proposed adjustment program. In the past few months, Tanzania's economic situation had become severely strained despite the measures introduced in 1985 with respect to producer prices, public enterprises, and the budget deficit. Nevertheless, the authorities had demonstrated their commitment to clearing their arrears to the Fund by paying SDR 1.1 million to the Fund even though they were experiencing difficulties in financing various essential imports. He noticed that a number of countries with overdue obligations had been given three months between the second and third reviews and suggested that Tanzania should be given the same amount of time. He therefore proposed that the draft decision be amended to indicate that the next review should be held not later than April 24, 1986, rather than March 24, 1986.

The Deputy Director of the African Department, responding to a number of questions from Executive Directors, stated that the recent discussions between the staff and the authorities had been more encouraging than in the past, when the authorities had clearly rejected the staff's policy advice. There was a common understanding that exchange rate action would have to take a central role in any adjustment program and that given the overvaluation of the currency, a substantial exchange rate change would be called for at the beginning of the program. The authorities also recognized that they could not expect an indefinite inflow of exceptional balance of payments assistance and that they must, therefore, provide a clear indication of the maximum timeframe within which external viability would be achieved.

The Minister of Finance had discussed a possible exchange rate policy action but had felt the need to consult with his authorities on the particular measures required, the Deputy Director indicated. The previous President of Tanzania had been opposed to any substantial move in the exchange rate, and as he remained president of the governing party, the

Minister of Finance felt it necessary to reach a general consensus on general policy measures within the Government and the party. The Minister of Finance also recognized that it would be difficult to implement any measures before mid-June, when the new budget would be introduced.

World Bank staff had been involved in all the discussions with the authorities, as it could have a useful role to play with respect to structural policies relating to producer prices, marketing arrangements, import programs, and possible reform of the state enterprises, the Deputy Director commented. The World Bank and Fund staff had a common approach and were working toward a common view regarding the details of an adjustment program. He hoped that before the Executive Board discussion of the Article IV consultation with Tanzania, the World Bank and Fund would have reached clear agreement on a number of issues.

Responding to a question from Mr. Foot, the Deputy Director stated that at the beginning of the recent discussions, the authorities and the staff had held widely divergent views. However, by the end of the visit, there had been a convergence of views in terms of the timing of the exchange rate adjustments and of the target level of the exchange rate. The difference of view relating to the intermediate exchange rate was not large and could probably be overcome.

Responding to a question from Ms. Lundsager on the likelihood that Tanzania would clear its arrears to the Fund, the Deputy Director from the African Department indictated that the central bank, the official holder of reserves, had virtually no available reserves and was unlikely to be in a position to meet Tanzania's overdue obligations by April. The staff and the authorities were hoping that further progress could be made on the formulation of an adjustment program, a consultative group meeting could be held in the near future, and financing arranged with donor countries. In addition, the authorities intended to discuss possibilities of obtaining bridge financing from the commercial banks.

The staff representative from the Treasurer's Department, in response to a question on the timing of the reviews, remarked that at the time of the first review of the decision limiting Tanzania's use of the Fund's resources, the staff had drafted a decision that had allowed for a three-month period before the second review. However, Directors had been concerned that Tanzania had made only a small payment four days before the meeting and that the arrears had risen rapidly since the complaint had been issued. The Executive Board had decided that as Tanzania's progress should be monitored closely, the second review should be held in two months.

The staff proposed that the next review should be held in two months based on Tanzania's overall situation and Directors' views that reviews should be set flexibly in light of the member's performance, the staff representative from the Treasurer's Department indicated. A two-month review period was not out of line with previous cases of overdue obligations. The staff had prepared the paper before the recent payment by Tanzania on January 21, which had been expected by end-December based on the authorities' indications at the previous Board discussion.

Mr. Polak suggested that the proposed decision should be amended so that it did not imply that the Executive Board expected that Tanzania would automatically be declared ineligible if it did not become current with the Fund. In the case of Liberia, the Executive Board had not declared the country ineligible to use the Fund's resources despite that expectation, as expressed in the decision at the previous review.

The staff representative from the Treasurer's Department stated that as Liberia had made substantial payments to the Fund, the Executive Board had decided not to declare the country ineligible to use the Fund's resources as expected. However, in Tanzania's case, it still seemed appropriate to state in the decision that it was expected that a decision to declare the member ineligible to use the Fund's general resources would be taken at the next review in the absence of full settlement of the country's overdue financial obligations.

Mr. Goos commented that he welcomed the authorities' indication that they would consider correcting the grossly overvalued exchange rate and other price distortions to pave the way for the formulation of a comprehensive adjustment program. Given the country's difficult economic situation, a comprehensive approach to adjustment offered the only prospect for improvement. The authorities' recent payment to the Fund, while small compared with the country's total overdue obligations, was welcome. He hoped that the authorities' efforts would lead to the early resolution of the existing difficulties, including an early and full repayment of arrears to the Fund. He agreed with the decision as proposed in the staff report but could go along with Mr. Mtei's request for a review after three months if that option were favored by a majority of Directors.

Mr. Doe noted that Tanzania's economic and financial situation had deteriorated further. Decisive actions were needed to strengthen the economy, and he urged the authorities to take appropriate measures to pave the way for an early economic recovery and a restoration of internal and external balance. The authorities should move resolutely to correct the overvalued exchange rate and make further progress toward implementing a comprehensive and coherent adjustment program. He supported Mr. Mtei's request that the matter of Tanzania's overdue obligations be reviewed in three months rather than two months as proposed by the staff.

Mr. Jayawardena commented that he welcomed the progress made by the authorities in discussing policy options with the staff. Tanzania had made a small payment to the Fund at the expense of essential imports. Given those factors, he agreed with the proposed decision as amended by Mr. Mtei.

Mr. Leonard remarked that as a new government had recently taken over, and as the authorities had shown a readiness to tackle the country's problems and to pay off their arrears, he could go along with Mr. Mtei's request to hold the next review in three months.

Mr. Foot stated that he was pleased that the authorities had recognized the need for adjustment and had made a small payment to the Fund. However, further action was needed and the problems would only mount if the authorities delayed taking action. He urged them to implement appropriate measures as soon as possible, particularly with respect to the exchange rate, in order to convince creditors and donors that they were serious about adjustment. He supported the decision as proposed but could agree to Mr. Mtei's request that the next review be held in three months. However, he would expect a great deal of action to have been taken by that time.

He shared Mr. Polak's concern about the wording of the decision, Mr. Foot indicated. The proposed decision should be somewhat tougher to indicate a further step toward a declaration of ineligibility, but the declaration of ineligibility should perhaps be made on a date subsequent to the next review, rather than with effect from the date of the review.

Mr. Suraisry noted that Tanzania continued to face difficult economic problems. In the absence of a comprehensive adjustment program supported by Fund resources, those problems would become even more acute, as was evident from the country's recent experience. Despite the adjustment measures taken by the authorities in 1984/85, the situation had continued to deteriorate. He urged the authorities to work closely with the Fund and to take appropriate adjustment measures along the lines outlined in the Chairman's summing up of the previous Article IV consultation with Tanzania (EBM/84/179, 12/7/84). Such measures were critical for mobilizing external resources, which were urgently needed to put the economy back on track. He welcomed the recent developments discussed by the staff at the present meeting. The proposed decision was in line with the understandings reached by the Executive Board at the previous discussion on Tanzania and with the case-by-case approach for dealing with overdue obligations. Nevertheless, he could agree to change the decision so that Tanzania could be treated in the same way as Liberia.

Mr. Polak remarked that in view of the staff's comments, he could go along with the proposed wording of the decision. However, it did not seem appropriate to state that a country would be declared ineligible to use the Fund's resources unless it became current with the Fund by a certain date and then to refrain from declaring the member ineligible if it paid only one half of the arrears to the Fund, as had been the case in Liberia.

As for the timing of the next review, two months was the longest time that the Executive Board should wait before reviewing further the situation in Tanzania, Mr. Polak considered. The authorities would not necessarily have to have solved all their problems by that time, but the Executive Board should be provided an opportunity to review the situation then.

Mr. Salehkhou commented that he was encouraged by the recent positive developments in Tanzania. He supported Mr. Mtei's request to hold the review in three months and urged donors to help Tanzania to clear its arrears to the Fund.

Ms. Lundsager welcomed the recent payment from Tanzania to the Fund, an indication that the authorities were committed to addressing their problems. However, it was disappointing that the payment had not been made in December, as the authorities had originally indicated. The progress on discussions between the staff and the authorities on an appropriate policy package was encouraging.

She supported the proposed decision as drafted by the staff, with a review in two months, Ms. Lundsager said. A number of developments were expected in the near future, and the Executive Board should be kept informed of Tanzania's progress. She was inclined to favor the wording of the decision as drafted by the staff regarding an expectation of a declaration of ineligibility, but she understood other Directors' concerns on the matter. The Executive Board would have the opportunity to review Tanzania's progress before declaring the country ineligible to use the Fund's resources.

Mr. Coumbis stated that recent developments in Tanzania were encouraging. He could support Mr. Mtei's request to hold the next review in three months and could go with the language in the proposed decision.

Mr. Chatah remarked that it was encouraging that the discussions between the staff and the authorities had been more positive than in the past and that there was a possibility for a normalization of relations between the Fund and Tanzania in a reasonable time frame. In the light of those developments, he could support the proposed decision as amended by Mr. Mtei. The Fund should show some responsiveness to the more positive attitude on the part of the authorities. He hoped that the authorities would make considerable progress in adopting and implementing a comprehensive policy program in coming weeks. He understood Mr. Polak's concern about the wording of the decision and wondered whether it could be reworded to delete the reference to the expectation of a declaration of ineligibility.

Mr. Weitz welcomed the progress made in discussions between the staff and the authorities and the recent payment made by Tanzania to the Fund. He urged the authorities to take the necessary measures as soon as possible to improve the difficult economic situation. He supported Mr. Mtei's request to hold the review in three months.

Mr. Lundstrom stated that he was encouraged by the recent discussions between the staff and the authorities. He was in favor of giving the authorities additional time to take action and agreed that the next review should be held on April 24. He had no strong feelings about the wording of the decision.

Mr. Huang indicated his support for Mr. Mtei's request.

The Chairman noted that the majority of the Board was in favor of holding the next review after three months. However, the authorities should use that additional time to make the necessary payments to the Fund and to obtain the support of the international community by implementing a strong adjustment program.

The Executive Board then took the following decision:

1. The Fund has reviewed further Decision No. 8056-(85/126) G/S/TR, adopted August 26, 1985, in light of the facts described in EBS/86/12 (1/21/86) pertaining to Tanzania's overdue financial obligations to the Fund.

2. The Fund regrets the continuing nonobservance by Tanzania of its financial obligations to the Fund and notes that further substantial obligations will fall due in the near future. The Fund again urges the Tanzanian authorities to make full and prompt settlement of the overdue financial obligations to the Fund.

3. The Fund reiterates the need for Tanzania to adopt urgently a strong and comprehensive program that would result in necessary economic adjustment.

4. The Fund shall review further Decision No. 8056-(85/126) G/S/TR not later than April 24, 1986, taking into account any further developments. It is expected that a decision to declare Tanzania ineligible to use the Fund's general resources, pursuant to Article XXVI, Section 2(a), will be taken, with effect on the date of the review, in the absence of full settlement of Tanzania's overdue financial obligations to the Fund in the General Department by that date. It is further expected that a decision to suspend, pursuant to Article XXIII, Section 2(b), Tanzania's right to use SDRs it acquires after the date of the review will be taken with effect on that date, in the absence of full settlement of Tanzania's overdue financial obligations to the Fund in the SDR Department by that date.

Decision No. 8189-(86/11) G/S/TR, adopted
January 24, 1986

3. LIBERIA - OVERDUE FINANCIAL OBLIGATIONS - REQUEST FOR RECONSIDERATION OF DECISION NO. 8134-(85/169) G/S/TR

At the request of Mr. Mtei, the Executive Board agreed to take up the matter of the decision adopted on November 25, 1985 (Decision No. 8134-(85/169) G/S/TR) to declare Liberia ineligible to use the Fund's resources if it was not current in its obligations to the Fund on January 24, 1986, the date of the present meeting.

Mr. Mtei stated that the Liberian authorities hoped that due consideration would be given to the difficult circumstances facing the country, particularly the lack of offshore receipts that would make it impossible for Liberia to make payments to the Fund before end-March 1986. In considering Liberia's situation, Directors should keep in mind that the Government had begun to put in place a comprehensive adjustment program and had agreed with the staff on a mini-budget for the last six months of the current fiscal year. If the authorities could keep within that budget, it would represent a considerable adjustment and should contribute to restoring the confidence of the international community in the Government's management of the economy.

Liberia's economic problems were serious, and it would take considerable time to effect structural changes, Mr. Mtei pointed out. Substantial help from the international community, including the United States, was called for. A declaration of ineligibility at present would only harm the credibility of the Government in financial circles. More important, it might be difficult to reverse that decision. Liberia owed about SDR 45 million to the Fund, and it would have to pay an additional SDR 70 million in 1986. Without massive external assistance, the country could remain ineligible to use the resources of the Fund for an extended period. He urged the Executive Board to reconsider the matter of Liberia's overdue obligations to the Fund in two months, giving the authorities time to raise some foreign exchange and to begin making payments, while making a major restructuring effort to set the economy on a path of sustained growth. The Minister of Finance had informed him immediately before the meeting that even some of Liberia's missions abroad had not been paid owing to the difficulties in raising finances. Therefore, it would be virtually impossible for Liberia to make even a token payment to demonstrate its commitment to the Fund. However, the Minister of Finance had indicated that it was the authorities' intention to clear the arrears to the Fund as soon as possible.

The staff representative from the African Department commented that the recent Fund mission to Liberia had reviewed economic developments and prospects and had discussed with the authorities adjustment measures that could be implemented to improve Liberia's overall performance and to help it to discharge its overdue obligations to the Fund. The Minister of Finance had indicated at the outset that Liberia would be unable to make any payments to the Fund before end-March, as all of the Government's offshore revenues in the first quarter of 1986 had been pledged to repay loans received from foreign concessions operating in Liberia. Following the repayment of those loans, the Government would make small regular payments to the Fund.

Budgetary performance in the first half of fiscal year 1985/86 had been disappointing, the staff representative noted. Revenue receipts had fallen short of estimates included in the August pro forma budget, mainly as a result of a decline in the collection of customs duty and the continued practice by the Government of financing expenditures by giving up its right to collect tax obligations. Owing to a lack of enforcement of budgetary controls and large extrabudgetary expenditures incurred in relation to recent political events, total expenditures had far exceeded the original projections. The resulting deficit, on a commitment basis--

$78 million, or 13 percent of GDP on an annual basis compared with a projected deficit of 1 percent of GDP--had been largely financed by a further accumulation of domestic and external arrears, as well as by borrowing from the domestic banking system. The pro forma budget for the second half of the current fiscal year currently being discussed by the authorities projected a deficit on a commitment basis of $5 million, less than 1 percent of GDP on an annual basis. The staff considered that the budget, if approved and fully implemented, would represent a serious effort to redress the financial situation by improving revenue collection, limiting duty free exemptions, reducing the size of the wage bill, and freezing new nonessential construction projects. However, the budgetary target might prove difficult to achieve, given the optimistic assumptions on which the projections were based. Furthermore, the budget failed to provide adequate resources to cover all scheduled debt service payments.

Mr. Suraisry stated that the letter to the Managing Director from the Minister of Finance did not indicate any serious commitment on the part of the authorities that would convince him to go back on the decision that the Board had taken to declare Liberia ineligible to use the Fund's resources.

Mr. Foot stated that he agreed with Mr. Suraisry. The Board had decided in November (EBM/85/169, 11/25/85) to give Liberia additional time to take further measures to become current with the Fund. The Managing Director had clearly indicated to the authorities that only if Liberia had made major payments to the Fund and indicated in the clearest terms, including through the implementation of strong adjustment measures, that prompt and full settlement was likely could ineligibility be avoided. The authorities had taken no significant action in the intervening period. While their present intentions were praiseworthy and he encouraged them to implement the proposed measures immediately, the authorities' track record was not encouraging. A decision to declare a country ineligible to use the Fund's resources did not preclude a continuing dialogue with the Fund. The forthcoming Article IV consultation discussions could provide a good opportunity for the authorities to discuss further elements of a comprehensive adjustment program. In the meantime, he urged the authorities to demonstrate their commitment to adjustment by implementing the measures that they had outlined.

Mr. Polak commented that he agreed with the previous speakers. The earlier decision taken by the Executive Board on November 25, 1985 could have been reversed if there had been strong indications that Liberia had made major payments and was in the process of adopting a strong program. However, in view of the need to maintain the Fund's credibility and to ensure consistency in Fund policy, the decision to declare Liberia ineligible on the present date should not be changed. It would be very easy for the Executive Board to reverse that decision when the authorities became current in their obligations to the Fund.

Mr. Fujino, Mr. Coumbis, Mr. de Forges, Mr. Goos, and Mr. Leonard stated that they supported previous speakers.

Ms. Bush remarked that the authorities had taken no actions since the previous Board meeting on Liberia that would warrant reconsideration of the decision taken on November 25, 1985 to declare Liberia ineligible to use the Fund's resources. However, the declaration of ineligibility should not be seen as an indication that the Fund viewed Liberia's problems in a less serious light. She hoped that the authorities would continue to work with the staff in formulating an adjustment program that would address the country's economic problems and would enable the authorities to repay the Fund. It would not be difficult for the Executive Board to reverse its decision on ineligibility as soon as the arrears were paid in full. Her authorities were willing to work with other donors in the months ahead to help the Liberian authorities address their problems. It would be interesting to learn from the staff whether Liberia was making any payments to other external creditors.

The staff representative from the African Department remarked that very few external debt payments had been made since July, and there had been a substantial increase in external arrears to all of Liberia's external creditors. However, the authorities had made a substantial payment to the Fund in September and to the World Bank. Liberia was not current with the World Bank at present, although the World Bank was currently disbursing resources as Liberia's payments were not overdue beyond the 60-day limit.

Mr. Mtei reiterated that a declaration of ineligibility would only damage the Government's credibility, which was necessary to obtain additional financial resources from the international community.

The Chairman noted that the Executive Board agreed that the authorities had not taken any actions that would warrant reconsideration of Decision No. 8134-(85/169) G/S/TR, adopted on November 25, 1985, to declare Liberia ineligible to use the Fund's resources on the date of the present meeting. Several Executive Directors had stressed the importance of cooperation with the Fund and noted in that connection the forthcoming Article IV consultation with Liberia.

4. CONDITIONALITY - REVIEW; ISSUES RELATING TO PROGRAM DESIGN AND PROLONGED USE OF FUND RESOURCES

The Executive Directors considered a staff paper reviewing the guidelines on conditionality and assessing related issues in the areas of program design and prolonged use of Fund resources (EBS/85/265, 12/5/85). They also had before them as background information a paper on aspects of program design--a review of the experience in the 1980s of countries with upper credit tranche arrangements approved in 1982 (EBS/85/277, 12/17/85; and Cor. 1, 1/22/86).

Mr. Dallara made the following statement:

The material provided as background for our Board discussion on conditionality provides substantial empirical evidence, as well as useful analysis, on many issues related to the implementation of Fund conditionality. I would like to take as a point of departure for my statement the comment on page 1 of the staff document (EBS/85/265) that the "Fund's support for members' adjustment efforts has played a critical role for promoting a coordinated approach to problems of adjustment and financing, an approach that in the large has been remarkably succesful in preserving the fabric of international cooperation."

This success should be attributed in part to the Fund's policies and procedures relating to the use of its resources, policies known collectively as "conditionality." These policies, built up through case-by-case experience over a period of more than three decades, and codified in two Board reviews in the late 1960s and 1970s, respectively, have generally served the Fund and its membership well. They have enabled the Fund to support, as Mr. Guitián indicates in his pamphlet on Fund conditionality, members' adjustment efforts in a manner consistent with that member's economic interests and objectives, as well as the broader interests of the Fund as a whole.

This has, in some respects, been reinforced by the experience of the early 1980s, when the Fund has been called upon to provide temporary balance of payments financing and policy advice, in the context of stand-by or extended arrangements, on an unprecedented scale. The credibility of the Fund in providing policy advice and encouraging needed policy changes has been critical to the Fund's ability to catalyze additional resource flows and, more generally, to its ability to foster progress in dealing with the serious economic problems which many debtor countries experienced during the early 1980s.

Fund conditionality has evolved over time, adapted gradually to the changing economic circumstances and needs of its members. Further changes should also be made in a cautious and evolutionary fashion. But we should not shy away from the need for further adaptations in Fund conditionality, particularly at a time when the staff paper makes clear, "in spite of the adaptations that have been made in Fund conditionality, questions remain about its effectiveness." It is, therefore, important, as the paper suggests, to consider "whether improvements can be made in the design of adjustment programs to bring about stronger assurances of both balance of payments adjustment and sustained growth."

It is a fact that a substantial number of members entering into Fund arrangements over the last five years have not been as successful in their adjustment efforts as would have been desirable (EBS/85/265, page 1). This has been due substantially in many cases to problems of implementation. But adverse developments in the external environment have also been a factor, the world economic expansion and lower interest rates of recent years notwithstanding. Additionally, we must recognize that the design of Fund programs may also have been a factor and is incumbent on us to use the present review 1/ of conditionality to assess the extent to which this has been the case, and to consider appropriate corrections as needed.

It was in recognition of the problems that have developed, particularly in connection with a number of major debtors, that Secretary Baker proposed a "Program for Sustained Growth" in his speech at the Annual Meetings in Seoul. My colleagues are familiar with this program to strengthen the international debt strategy, which has received broad support in the international financial community, including from this Board during our discussion of international capital markets this past November. As they will recall, this Program is centered on three elements. First, the adoption by principal debtors of comprehensive macroeconomic and structural policies, supported by the international financial institutions, to promote growth and balance of payments adjustment, and to reduce inflation. Second, a continued central role for the Fund, in conjunction with increased and more effective structural adjustment lending by the multilateral development banks (MDBs), both in support of the adoption by principal debtors of marketoriented policies for growth. Third, increased lending by the private banks in support of comprehensive economic adjustment programs. The emphasis in this strategy to promote both growth and balance of payments adjustment, as well as the continued central role for the Fund, underscore the importance of an introspective look at this time of our policies relating to the use of Fund resources.

Many of my comments and observations relating to this review will be of a general nature, as are many of the points brought out in the staff material. Let me make clear at the outset, therefore, our recognition that Fund conditionality must be framed on a case-by-case basis in light of the particular circumstances of a member. This does not preclude us, however,

1/ I would be remiss if I did not mention the important role the Fund can play in promoting a more favorable external environment, particularly through surveillance of the policies of member countries not using Fund resources. In this connection, we will have the occasion to discuss methods of strengthening Fund surveillance during our upcoming Board meeting on this issue.

from drawing certain generalizations from the empirical evidence provided us in this review. I would also like to stress our view that Fund conditionality is not a process of forcing policy change on a member country. Without the willingness and capacity of national authorities to support and implement policy changes, external efforts to encourage such change are unlikely to succeed regardless of the "techniques of conditionality."

In this vein, one of the lessons which can be drawn from the recent experience with Fund-supported programs is that at the heart of economic programs to promote both balance of payments adjustment and growth must be sound macroeconomic policies that have strong support at home. The review of recent experience, in fact, reinforces the need for persistent and early action in these policy areas if imbalances are to be corrected at an early stage and the adverse effect of such imbalances on growth minimized. This point was underscored by Secretary Baker in his Seoul speech when he stated that:

> Macroeconomic policies have been central to efforts to date and must be strengthened to achieve greater progress. These policies should consist of: market-oriented exchange rate, interest rate, wage and pricing policies to promote greater economic efficiency and responsiveness to growth and employment opportunities; and sound monetary and fiscal policies focused on reducing domestic imbalances and inflation and on freeing up resources for the private sector.

The theoretical basis for an emphasis on monetary and fiscal policy is founded not only in the monetary approach to the balance of payments, which has been central to the Fund's efforts for many years, but also in the absorption approach, which emphasizes the need to reduce absorption in the short run in order to promote adjustment and growth in the medium term. Fund programs are often implemented in circumstances characterized by excess credit creation, large and/or growing fiscal imbalances, excess demand and high, if not accelerating, rates of inflation. The background paper for today's Board meeting (EBS/85/277) documents the extend to which fiscal and monetary imbalances prevailed in many of the countries under study. Fiscal imbalances, for example, were a major source of difficulties in most of the countries in the sample, while related monetary imbalances also prevailed in many countries. Furthermore, such conditions often contributed to the imposition of controls, both domestic and external, which reduced economic efficiency.

In such circumstances, the need to restore financial stability, to reduce the overall level of absorption in the short run, and the need to reduce government dissavings in order to help increase savings and investment in the economy as a whole, can be critical to re-establishing sustainable growth with a viable payments position in the medium term. Not only can sound fiscal and monetary policies directly help foster the economic climate for such a resumption of growth, but they can strengthen confidence among both domestic and foreign investors, contributing to a general restoration of creditworthiness which can have further positive effects on growth.

Since Fund policies have generally been centered on disciplined monetary and fiscal policies, we have developed techniques for encouraging policy change in these areas, particularly the use of performance criteria placing ceilings and sub-ceilings on the net expansion of domestic credit, as well as the priority given in many programs to the need to establish and maintain real positive interest rates. Recent experience might suggest, however, more frequent use of performance criteria directly related to fiscal imbalances, as well as the greater use of subceilings in areas additional to credit to the public sector.

A troublesome aspect of fiscal and monetary performance in recent years has been the extent to which progress in reducing initial imbalances has in some cases been eroded or reversed through inadequate implementation over time, adverse exogenous developments, or a combination of these and other factors. This is not, of course, a phenomenon limited to developments in the fiscal and monetary areas, but it has been particularly evident in these areas.

When a Fund-supported program is no longer in effect, Article IV consultations can provide a framework for a continuous dialogue between the Fund and the member to help maintain policy momentum. Use can also be made, as the staff paper suggests, of the provision in all upper credit tranche arrangements for consultations during the period a member has outstanding purchases in the upper credit tranches. We believe this would be a useful approach, and support its use in selected cases and instances--not necessarily limited to cases of prolonged use or to consultations around the time of the completion of a program.

Another approach which could help promote greater continuity in economic policies, and perhaps encourage correction of policy deficiencies at an early stage, would be to bring more efficiency and effectiveness to the review process. One way to do this might be to bring reviews of existing programs to the Board within an agreed time frame, regardless of whether the review has been successfully completed. Such an approach would allow for a discussion of issues relative to access and phasing and could have a number of advantages. It could provide for a clear and thoughtful discussion of a member's policies by the Board, the staff, and the member which would maximize the potential to reduce slippages in policies or performance that might otherwise accumulate; reduce chances for a reversal of hard-won progress in the first half of the program; and provide a setting that could assist the member and staff in formulating new policies and criteria in order to build upon an existing Fund program, or negotiate a new program.

We believe that this approach merits consideration and would be interested in having the staff investigate ways to accomplish it.

Techniques have also been developed to encourage needed policy change in another traditionally important area of Fund-supported adjustment programs, referred to by Secretary Baker in his Seoul speech--exchange rate policy. With its theoretical foundation in both the elasticities and absorption approaches to the balance of payments, exchange rate policy has appropriately been a central part of most Fund-supported economic programs.

In many developing countries, the capacity of the exchange rate to affect both domestic absorption and supply is unmatched by any other single variable or policy instrument. In the context of the current economic problems faced by many debtor countries, an effective exchange rate policy can be particularly useful in promoting competitiveness and reducing absorption. This would occur in a much more efficient manner than through controls or restrictions. As the background staff paper points out on page 23, "exchange rate misalignments were seen as an important factor in the balance of payments difficulties of many of the sample countries."

As appropriate exchange rate policy can have important positive benefits not only on adjustment of external imbalances, but on the prospects for medium-term growth, particularly the potential for exchange rate change to stimulate aggregate supply. Not only can such a policy increase the overall level of economic activity, but it can have important positive effects on the expansion and diversification of exports and, consequently, on external creditworthiness--which in turn can have further positive effects on growth.

The Fund's techniques used to encourage policy changes in these areas have often involved prior actions. While prior actions have proved useful in bringing about needed immediate exchange rate changes, this is sometimes a once-and-for-all measure, whereas the real need is for a more automatic procedure that ensures continous exchange rate flexibility. As the staff paper points out on page 23, "mechanisms that provide for more continuous flexibility in exchange rate policy are preferable." In particular, market-determined pricing of the exchange rate might be the most effective approach in many countries and in many instances has been. In this regard, we look forward to the discussion of the staff paper on "Experience with Exchange Rate Flexibility in Developing Countries" during which we will be able to review past experience. That discussion could provide us with an opportunity to review the success associated with flexible exchange rate regimes and to consider how flexible market-oriented exchange rate policies might be incorporated in Fund programs.

I believe that we should make further efforts to incorporate into our programs mechanisms to help ensure not only that an appropriate exchange rate policy is in place at the onset of a program, but that it is implemented throughout the course of the program. Alternatively, a formal commitment in letters of intent to a flexible exchange rate policy, bolstered by the inclusion of consideration of exchange rate policy as a part of the program review, can be a useful approach for securing continuity in exchange rate adjustment.

Before leaving the subject of exchange rate policy, let me stress the continuing importance of the Fund's role in liberalizing exchange regimes. A realistic exchange rate cannot play its proper role if access to the exchange market is severely restricted, with the result that the resource allocation effects of exchange rate movement are minimized or thwarted. Investment that takes place in a restrictive environment is often misplaced, therefore limiting its positive effect on growth. Efforts to reduce exchange restrictions often need to be approached in a broad context, not only relating to exchange rate policy but also to tariff reform and import liberalization, areas to which I will turn later. The standard performance criterion in the area of exchange restrictions has focused on the need to avoid further intensification of existing, or imposition of new, exchange restrictions. However, some programs do go beyond this and take a more active approach in encouraging the reduction or elimination of existing restrictions. We see more scope for increased use of specific understandings to this effect incorporated into review clauses.

Although the exchange rate may be the most important price, the need for a comprehensive approach to prices in order to promote balance of payments adjustment and growth is also stressed in the staff paper. We believe that consideration needs to be given to ways in which appropriate pricing policy can be more effectively encouraged through Fund programs. Pricing which is more closely related to the relative scarcity of goods and services in an economy can have important benefits in promoting adjustment and growth. Among them are: the reduction of imbalance in government fiscal positions; the provision of appropriate pricing signals to producers and consumers, thus encouraging a shift of resources into more productive sectors and limiting excess demand; and the reduction or elimination of black markets, in some cases leading to a reduced "effective price" on various subsidized goods. In fact, appropriate pricing policy is an essential adjunct to exchange rate changes, because without a pass-through of these changes to the domestic pricing system, exchange rate changes are not likely to have a significant positive effect.

As with the exchange rate, techniques are needed which help provide for more continuous adjustment of other prices to changing economic circumstances. A correction of a few particularly important prices at the beginning of a program can help give the Fund a sufficient basis for approval of the use of Fund resources in a program, and can give important impetus to the movement of relative prices toward a more competitive and more efficient structure. But such gains will be short-lived, and their impact limited, if they are not extended more generally, and more continuously, throughout the economy. This is particularly important in an environment of high inflation. Thus, it is important that Fund programs incorporate more consistently techniques for encouraging continous and broadly based pricing changes. The incorporation into review clauses of appropriate agreements on such mechanisms could be helpful in avoiding situations where the prices of a few key goods and services, often politically sensitive, become the focal point of discussions between the Fund and a member country. Market-oriented strategies may be particularly effective in this regard, although, as the staff paper points out, other techniques can also be envisioned.

A review of our recent experience under Fund-supported programs also underscores the importance of other aspects of structural adjustment, particularly those that can expand the aggregate potential supply of output. The evidence suggests that programs which are heavily oriented toward demand restraint, without supportive pricing and structural policy changes, are less likely to promote an adjustment of the balance of payments in the context of a renewal of growth than are programs which incorporate at an early stage measures in these areas. As the background paper points out on page 36, "the prevailing pattern in general was for countries to initiate the adjustment process with emphasis on demand restraint, and to turn only gradually to a greater emphasis" on policies more oriented toward improving the supply capacity of the economy.

As the background paper continues on page 40, some of this may be due to "the realization of the limits of what could be accomplished solely with demand policies, as well as an increased awareness of the size of imbalances." It may also, however, be partly a function of the design of Fund programs, with our well-developed staff expertise and institutional techniques to guide demand-oriented policies, relative to other supply-oriented policies. Among the cases reviewed, in those in which a broadly based adjustment strategy, including structural measures, was implemented at an early stage, the performance both in terms of balance of payments adjustment and growth generally exceeded the performance of cases where the economic strategy was more heavily focused on demand restraint.

The staff paper makes the point on page 10 that some types of structural measures are difficult to implement quickly and economic responses to them are often less predictable and have longer lags than the responses elicited by more immediate demand-management policies. While it is true that certain types of structural policies are difficult to implement quickly, and it may also be true that there are longer lags involved in certain structural policy changes, I have some difficulty with the concept that economic responses to them are less predictable. Furthermore, I would interpret the existence of long lags, and the difficulties in implementation as evidence of the need for additional and earlier emphasis in these areas, if growth and adjustment are to be realized. As Occasional Paper No. 41 on "Fund-supported Adjustment Programs and Economic Growth" makes clear on page 4, "notwithstanding the difficulties of implementing supply-side policies as part of an adjustment program, the Fund has stressed their importance in improving efficiency and the long-term rate of growth."

As Directors are aware, in his Seoul speech, Secretary Baker stressed the importance of programs designed to promote both adjustment and growth, and underscored the role which could be played in facilitating the achievement of these objectives by structural policies, supporting and enhancing the effectiveness of needed macroeconomic policy changes. This emphasis on growth was warmly received in the Executive Board discussion referred to earlier. As the Managing Director's summing up of that discussion notes, "the growth-oriented strategy of adjustment was welcomed."

It is from that premise, which I believe we all share, that I approach questions related to other structural policies and Fund-supported programs. My comments will focus on the way in which the Fund can play an important role in promoting these objectives, but I would like to preface these comments by a few general points. First, as in other policy areas, the key question is not the role of the Fund, nor for that matter the roles of other multilateral institutions, in promoting structural policy changes, but rather the importance of appropriate policies being developed and implemented by the debtor countries.

Second, it is important that the multilateral development banks play an increasing role in supporting needed structural policy changes in debtor countries. In many areas of structural change, the Bank can and should take the lead, but the Fund's role can be supportive. In other areas, the Fund will need to play a leading role. This may be particularly important in areas, and in countries, where World Bank efforts to support policy changes may take some time to become fully developed. The exact division of labor in individual cases will, of course, need to be worked out on a case-by-case basis in light of the economic problems and prospects of individual members, as well as the relative strength of the two institutions.

Third, enhanced attention by the Fund to certain areas of structural adjustment may have staffing implications for the Fund, and it may therefore only be feasible to see this enhanced attention develop over time. The comparative advantages of the two institutions are generally well known and accepted, as is the need for them to work together closely and effectively. The Fund's experience and expertise in macroeconomic, exchange rate and financial policies and reforms, and the Bank's experience and expertise in microeconomic, sectoral and development policies, suggest a natural pattern of specialization and collaboration between the two institutions in supporting sound policies in member countries.

Fourth, increased emphasis by my authorities on early and broadly based efforts on structural reform should not be misinterpreted as a view that structural adjustment can occur in a relatively brief period of time. As the following discussion of individual policy areas demonstrates, structural adjustment can often require a significant period of time for full implementation.

In his Seoul speech, Secretary Baker touched on a number of areas in which additional emphasis in Fund programs is being given, or is warranted. He noted, in particular, that increasing attention is being paid to areas such as trade liberalization, pricing policies, and the efficiency of government-owned enterprises. Furthermore, he stated that "the Fund should give higher priority to tax reform, market-oriented pricing, the reduction of labor market rigidities, and to opening economies to foreign trade and investment. This will help assure that Fund-supported programs are growth oriented."

Indeed, the Fund has increasingly stressed the importance of supply-side policies as demonstrated by the following data: of 93 programs approved between 1980 and 1984, public enterprise pricing was covered in 51 of these programs; 26 included agreements partially or fully to privatize public enterprises; 24 included efforts to reform and modernize the financial system; 45 promoted liberalization of the trade system; 36 included comitments to adopt a more flexible pricing system, with 28 committed to reviewing the price control system; and 20 incorporated measures to simplify the income tax rate structure.

As the background staff paper points out on page 63, however, "despite the widespread attention paid to structural issues, the reforms achieved were often of a stepwise, piecemeal character, and there continued to be a large degree of reliance on administrative controls in resource allocation."

Therefore, we must consider ways in which we can help promote more consistent and more effective structural policy action if we are to enable the Fund to fulfill more effectively its role in promoting growth and adjustment. This involves the development of tools and techniques which the Fund can use, on a case-by-case basis, in supporting, guiding, and nurturing policy changes in these areas.

As a guide to our future efforts, we have found past experience helpful. Below, I outline a number of policy areas in which we see a need for the Fund to give greater attention and to develop greater consistency in its approach, keeping in mind that the degree and nature of the attention given in any particular Fund program will inevitably be a function of the economic problems and circumstances of the country, and that efforts in these areas must be closely coordinated with the World Bank.

Fund work in this area has often been conducted in the context of technical assistance. In this way the Fund has played, and should continue to play, a useful and constructive role in facilitating policy change in member countries. But greater integration into Fund programs of Fund efforts to promote tax reform, and the strengthening of tax systems, may well be warranted in some cases. As the background staff paper notes on page 21, "in most sample countries the pattern of evolution of government revenue largely reflected structural weaknesses in the tax system," with "narrow tax bases heavily concentrated on taxes on external transactions and deficiencies in tax administration" representing important aspects of fiscal imbalances. Furthermore, there has been growing awareness that high tax rates and tax policies in many countries not only encourage tax evasion, smuggling, and other nonproductive activities, but they may even lead to reduced government revenue over time. They can also involve significant distortions and disincentives to investment and job creation.

It is important that judgments be made at the outset of Fund-supported programs regarding the importance of basic changes in tax systems, including tax rates and the tax base, and that, where these judgments point toward a priority need for changes in these areas to achieve program objectives, tax reforms be part of program design. Efforts to reduce fiscal imbalances in the context of inadequate and inefficient tax systems are likely to focus excessively on immediate revenue-increasing measures which can have an adverse medium-term effect on exports and/or growth, and lead to overemphasis on reductions in investment expenditure. Furthermore, the effect on deficits of expenditure cuts, if carried out, is more predictable than the effect of revenue measures.

These comments should not be misinterpreted to suggest that efforts to reduce fiscal imbalances should be pursued at a slower pace. Quite the contrary. Efforts to reduce such imbalances can often be enhanced, both by expenditure cuts and, particularly in the medium term, by a broadening of the tax base, which may also allow for cuts in marginal tax rates.

There are, of course, a range of cases where tax reform has been a part of a Fund-supported program. The 1981 Korean stand-by arrangement with the Fund provides one example. Mauritius is a case where tax reform has been pursued with Fund technical assistance. Although commitments were not incorporated in the 1983-84 Fund program, action was taken which was then reported in the subsequent letter of intent. What is important is not so much that tax reform be incorporated routinely into Fund programs, but that tax reform be given appropriate consideration and priority in the range of policy instruments needed to achieve agreed objectives. This cannot always be done in the context of technical assistance. In some cases, it may require precise understandings incorporated into review clauses if we are to be faithful to Article V, Section 3(a), the provision in the Articles of Agreement from which conditionality springs. In some cases, quantitative targets may be appropriate, or at least firm understandings regarding the timing of procedural steps needed to accomplish changes in tax sytems--for example, submission of a tax reform plan to a legislature.

Financial sector reform is another area where attention has been given in a number of recent Fund programs. In the program recently agreed between Fund management and Guinea, for example, a prior action has been the closing of state banks and their replacement with new banks which allow foreign participation. Measures involving the financial public enterprises in the Philippines have been an important part of the current Philippine program, including plans for a broad rehabilitation and reorganization of a number of financial public enterprises.

Financial sector reform is often designed to mobilize savings. Measures to stimulate domestic savings can be critical to the growth and adjustment prospects of a debtor country. Fund efforts to foster the expansion of savings have generally focused on increasing the rate of such savings through interest rate policies that help to assure a positive rate of return. This is appropriate, particularly since in almost half of the cases reviewed, the level of interest rates has been judged to be a contributing factor in the development of imbalances.

In some cases, however, the adjustment of interest rates is not sufficient to encourage savings adequately and to promote an efficient allocation of resources. Further efforts may be needed to allow for the development of private market and public financial instruments, financial institutions, and financial markets in order that the mobilization of savings can be fostered not only by positive real rates of interest, but by an efficient, convenient and diverse array of liquid financial instruments and modern financial institutions.

While the Fund has, to some extent, encouraged the development of financial markets, we should in some cases be more active in helping to design and develop financial instruments that will broaden and deepen financial markets, thereby enhancing the ability of a member's economy to generate savings and investment. The Central Banking Department's work in establishing and reforming central banks and in designing instruments that bring about more efficient implementation of monetary policy may provide a useful base for further development of our activities in the above areas.

The most appropriate manner in which needed financial market reforms can be incorporated into Fund programs is an issue which requires further attention. Our review of programs which have included measures in these areas suggests that we have not advanced very far in developing methods which can be effective and have broad applicability. In some cases, more explicit language incorporated into review clauses may be appropriate.

Trade liberalization has been an increasingly important part of Fund programs in recent years. In many instances, it is closely linked to the implementation of appropriate exchange rate policy, as well as to the liberalization of domestic prices and the exposure of domestic industries to competitive forces aimed at promoting greater efficiency and growth. Trade liberalization played an important part, for example, in Mexico's extended arrangement, but it has also been incorporated into some recent stand-by arrangements, such as those of Korea and Morocco.

As with certain other areas of structural adjustment, however, action in this area has often been delayed. This has occurred in spite of the fact that developments leading up to the initiation of Fund-supported programs in many countries in recent years have led to the intensification of restrictions on trade, heightening the need for early liberalization in this area, if the output and employment losses which can temporarily be associated with reductions in absorption are to be minimized. Delays in action in such areas are particularly unfortunate. In cases where trade and payments liberalization are judged to be important to a growth-oriented adjustment process, specific commitments regarding, for example, the shift of imports from quantitative restrictions to tariffs perhaps could be incorporated into programs as performance criteria, or as part of a review clause.

Let me reiterate here that the extent to which measures in this area, as well as a number of other structural areas, will need to be utilized in Fund programs will depend not only on the circumstances of the member, but on the extent to which the World Bank and other multilateral development institutions are actively involved in encouraging needed policy changes in these areas for a particular country.

Fund programs have generally contained relatively little in the way of targets or commitments in the labor market field. In fact, background information and data on labor markets, such as wage rates, employment shifts, legislative developments, and labor practices, have been rather scarce in staff documents. In fact, important data may not be available even to the authorities of some member countries. Yet the staff background paper cites a few interesting examples where labor rigidities have evidently impeded economic adjustment and sustainable growth. For example, the staff refers to a problem of internal mobility of labor in connection with programs in Hungary and Guinea, to guaranteed public employment commitments in Mali, Senegal, and Somalia, and to labor tenure laws in Mali and Senegal. Also, wage indexation difficulties have been identified in Brazil, Barbados, Peru, and elsewhere.

It is not clear how far the Fund can or should go toward addressing these problems, or exactly what priority to give to them. But the existence of these rigidities and their adverse effects on adjustment and growth argue for some attention by the Fund to this area. We might begin by looking into the adequacy of labor market data, and linkages between labor market rigidities and impediments to growth. This could, in particular cases, lead to the possible inclusion in Fund programs of some structural measures to deal with problems which may be identified. This is yet another area where Fund/Bank collaboration is likely to be important.

Fund-supported programs have given increasing attention to the need to improve the efficiency of the public enterprises and reduce their drain on government budgets. Public enterprise pricing policies have been key in this respect, with pricing more closely related to the scarcity of goods and services not only strengthening the fiscal position, but promoting a more efficient allocation of resources and providing appropriate incentives to producers and consumers.

Various techniques have been used by the Fund to encourage such changes. Often, specific changes in particularly important commodities or public services have been secured as prior actions. In other cases--for example, recent stand-by arrangements with Yugoslavia--public sector price liberalization has been part of a generalized reduction in the degree of price control.

Many of the comments made in the staff paper, and earlier in my statement concerning automatic pricing policies more generally, are applicable to public sector pricing in particular. The 1985 stand-by arrangement with Uruguay embodies an approach which we believe could be more broadly applied, and could assist member countries in their efforts to avoid a situation where inadequate pricing changes during an earlier stage increase the need for large pricing changes in sensitive commodities or public services at a later stage. In Uruguay's program, there is a commitment to automatic adjustments of public enterprise pricing at intervals of no more than four months in order to assure a targeted surplus for the enterprises. This commitment is embodied in the memorandum of understanding, and is specifically cited as a policy to be reviewed.

Parastatal pricing is only one aspect of efforts by member countries to improve the efficiency of these entities. Various additional efforts are called for in many cases to improve their operational performance. The measures can include steps to strengthen managerial capabilities directly, by case-by-case study and implementation of measures to streamline management and improve operating procedures. The Fund probably should not be expected to develop detailed proposals in this regard, since the World Bank has developed considerable expertise in this area. Nonetheless, the Fund can play a role in encouraging managerial reform of some public enterprises, especially in the financial sector. Furthermore, managerial studies and reforms that are best carried out by the World Bank, in the area of public utilities for instance, can be supported by the Fund by the inclusion in a review clause of an expectation that a given study will be completed or a program of reform begun by a specified date. An example is the present arrangement with Mali, which requires the first review to include understandings on measures pertaining to public enterprises. The letter of intent lists actions to be taken in individual entities and provides indications that discussions are to continue with the World Bank on a sectoral reform program, with implementation expected around the time of the first review.

In cases where urgent reduction of parastatal losses is required, a more general approach can be to subject these firms to market tests, thus increasing the responsiveness of management to market signals. By working with a member to indicate to public entities that their profitability is a key factor in determining managerial remuneration, or even their continued existence as public entities, the Fund can promote rapidly improved performance. Related to this is the incentive effect of limiting access to fiscal transfers or banking sector credit. By reducing the capability of inefficient public enterprises to receive outside funding, incentives are created to contain costs by more efficient management or even reduced payrolls. Such an approach can serve the dual purpose mentioned earlier of limiting fiscal deficits or credit expansion, while increasing the efficiency of resource utilization in the economy.

The stand-by arrangement with Argentina provides such an example, wherein mention was made in the letter of intent of limits on government transfers to, and the monitoring of, expenditures of the enterprises. While in this case these measures were not specifically cited in the review clause, the review was to focus on fiscal policy, thus encompassing transfers to the enterprise sector. In other arrangements, such as the present one with Jamaica, the performance criteria included specific limits on net domestic credit to some selected public entities.

A supplementary approach that has been utilized in a number of Fund programs addresses the issue of parastatal efficiency by suggesting or requiring some degree of privatization. This is an area where, perhaps, the World Bank can provide the needed expertise in identifying those firms that appropriately could be privately run, especially those that do not produce true public or strategic goods or services. This is, naturally, a sensitive subject, and some may view it as too microeconomic in character for the Fund to become involved. Nonetheless, there have been several instances in which Fund programs have included as prior actions, or in review clauses, measures on future commitments to divest or even close specific public enterprises. This approach appears to be taken in those cases where substantial losses can be attributed directly to individual firms, and where the services provided by them could be provided by a private enterprise. In several cases, a national airline has been identified as a major drain on public resources, and a clear case has been made for private sector provision of the service.

These various examples serve to illustrate that, in fact, the Fund already utilizes a variety of pragmatic methods to encourage improved performance of public enterprises. While the World Bank can, perhaps, take the lead on micro-oriented reforms, the Fund does have available the means of enhancing Fund/Bank collaboration in this area and of supporting structural reforms that the Bank may formulate. Finally, the Fund can take a number of steps to increase the financial viability of these firms, thus contributing to increased efficiency of resource utilization.

The reductions in net new international bank lending which have occurrred in recent years have increased the need for more nondebt creating capital flows to debtor countries. This is a widely held view, but policies in many debtor countries regarding foreign direct investment remain highly restrictive, discouraging equity flows. Secretary Baker highlighted in his Seoul speech the need for "market-opening" measures to encourage foreign direct investment and capital inflows. As indicated above, he further stated that "the Fund should give higher priority to... opening economies to foreign trade and investment."

The Fund has historically not played a significant role in this area, for reasons related in part to the mandate of the Fund. The World Bank has also not played a particularly active role in this field, although its involvement has often been greater than that of the Fund, and the impending establishment of the Multilateral Investment Guarantee Agency (MIGA) should strengthen its capacity to promote policy change in this area. It may be that the 1980 report prepared by the Development Committee's Task Force on Private Foreign Investment, and the subsequent 1983 IFC Study of Investment Incentives and Performance Requirements, as well as the Fund's own study of June 1984 (SM/84/145), could be re-examined to provide some guidance in this field.

In any case, the need for comprehensive Fund programs, and the increasing importance which the international financial community has placed on changes in this area, all suggest that the Fund would be remiss if it did not consider developing--in support of and in conjunction with the World Bank as appropriate--some role in this area.

In a few recent cases, Fund programs have, in some way, embodied some references to liberalization of foreign direct investment. For example, in Ecuador's program, progress in this field is mentioned in the staff report, but not in the letter of intent or memorandum of economic policies. In the case of Korea, liberalization objectives and plans are actually included in the authorities' memorandum of understanding and progress was to be examined as part of a program review. More generally, some of the aspects of foreign direct investment policies which may be worthy of review and possible modifications include restrictions on incoming direct investment, limits on profit remittances, local content and export performance requirements, and the potential for an increase in equity participation limits. Whatever may prove to be the best procedure for Fund involvement in this complex field, there is a case for a more active role in the context of the Fund's increased emphasis on economic growth with a sustainable external position.

Prolonged users of Fund resources continue to be a serious problem which threatens the revolving character of Fund resources, and which has been a factor in the arrears problems which have developed in the Fund in recent years. I have not focused my statement on this issue, not because it is unimportant, but because the lessons learned from our review of programs in connection with this Board meeting--drawn to a significant extent from the countries that are prolonged users of Fund resources--are lessons with broad applicability for the Fund's policies regarding the use of its resources, and not just for "prolonged users."

A particular point that emerges from the cases of prolonged use which does perhaps merit special mention is the lack of early and comprehensive corrective policy steps on the part of many member countries. This has posed problems regarding the achievement of the countries' economic objectives of adjustment and growth. It also poses major questions about whether programs which are too heavily based on demand restraint, and are inadequately designed to support both adjustment and growth in a medium-term horizon, are consistent with our mandate--to adopt policies on the use of the Fund's general resources that will assist members to solve their balance of payments problems in a manner consistent with the Articles of Agreement, and which will establish adequate safeguards for the temporary use of the general resources of the Fund. Our experience with some cases relating to prolonged use, in fact, reminds us that all programs should meet a dual set of tests in order to be acceptable: that they are adequate to help solve a member's payments problem over the medium term in a manner conducive to growth; and that they provide an adequate assurance to the Fund that the policies can, if implemented, provide a framework for the repayment of the purchases from the Fund on schedule.

On the particular options put forward in the staff paper for possible use in cases of prolonged use, I would make the following brief comments: shadow programs could have a limited role to play in special circumstances, although it must not be seen as an adequate substitute for a fully acceptable set of policies. While I would agree that strict rules on access by prolonged users are not appropriate, I continue to stress the importance of taking into account, inter alia, a member's past record, the strength of the proposed program, and a member's outstanding use of Fund credit in determining the appropriate access level. Backloading of purchases can be an effective and appropriate device to help safeguard the revolving character of

Fund resources in cases of prolonged use. On preconditions and performance criteria, early action is obviously critical in such cases, but may be equally important in other cases.

The above examples and suggestions are not put forward as immediate, definitive proposals for change which involve amendment to our guidelines for conditionality. As I indicated earlier, I believe that the changes which need to be made in Fund conditionality are more evolutionary than revolutionary, and I would agree with the staff that needed changes can be accomplished within the context of the current guidelines for conditionality. In reviewing those guidelines, one can only have admiration for the farsightedness of our predecessors who developed them in 1968, and amended them in 1979. I see no need to amend them further at this stage. But within the context of those guidelines, we must remain alert to the need to adapt our practices and procedures while remaining committed to the basic purposes and objectives of the Fund.

Our political leaders are virtually unanimously stressing the importance of growth. The Program for Sustained Growth, put forward by Secretary Baker, will require the active participation and cooperation of all parties if it is to succeed. The external financing which is clearly essential to the restoration of sustainable growth and balance of payments adjustment cannot be expected to materialize without clear, broad-based policy change. And even if it did, the economic benefits would be short-lived, absent needed policy changes.

The Baker initiative has helped focus the attention of the international community on the need for growth. But the awareness of the need for policies to encourage growth in many countries preceded the Baker Initiative. As Chairman Volker has recently stated, a new temper of opinion has been emerging in many debtor countries, forged out of recent adversity, in support of growth-oriented outward looking, liberal economic policies, along with a renewed effort to reduce inflation and fiscal deficits.

It is our challenge to help policymakers translate these objectives into reality. Growth for most economies must come primarily from within--from domestic savings, domestic investment, and domestic policies--but it is clear that the international community must support those efforts, both with financing and with policy advice.

This institution has a role to play in both areas, although the financing we can and should provide is temporary and modest in amount. It is the Fund's ability and mandate to provide policy advice that gives it a special place in the international financial system. The question is how best we can go fulfill this role. It is not sufficient to express verbal support for the concept of growth, and then avoid the effort to develop mechanisms within this institution which can help our member countries achieve this important objective. We must continuously develop the tools of our trade to strengthen the effectiveness of the Fund in promoting sustained world economic growth. It is with that spirit in mind that I put forward the views and ideas in this statement and hopefully within that same spirit that they will be received.

Mr. Goos remarked that a review of the Fund's conditionality was particularly appropriate at the present time, when a number of questions were being raised about the effectiveness of the Fund's policy restrictions and the respective roles of the Fund and multilateral development agencies in helping to overcome the debt problem and promoting adjustment and growth. In that context, it had been proposed that the role of those agencies should be strengthened, while reducing the extent of Fund conditionality. By contrast, he felt that in the present and foreseeable circumstances the Fund's conditionality would, if anything, increase in importance. Experience demonstrated that without Fund support many countries in balance of payments difficulties had been unable to tackle their problems in a decisive and sustainable manner. In addition, the increasing incidence of overdue payments to the Fund, as well as the growing number of prolonged users, suggested that the Fund's conditionality was becoming increasingly important.

The recent intensive debate regarding growth-oriented strategies to resolve the debt problem had been prompted in the first instance by the unsatisfactory growth performance of many countries in recent years, Mr. Goos recognized. While such a reaction was understandable, it should not be forgotten that the high growth rates of the 1970s had been achieved often at the cost of excessive foreign borrowing. Accordingly, those growth rates were an inappropriate standard upon which to base current and prospective growth scenarios. By the same token, and even more important, he cautioned against overoptimistic projections of short-term growth prospects for many highly indebted countries, which were in continued need of Fund support.

While there was no realistic alternative to applying Fund conditionality to promote adjustment and create the basis for sustainable growth, it was unfortunate to note from the staff paper the limited success of recent Fund-supported programs, Mr. Goos stated. He was particularly concerned that recent experience could undermine the Fund's credibility and its central role in the adjustment process. That concern was heightened by the fact that some members had chosen to turn their backs on the Fund in an attempt to solve their economic problems without Fund support. It was most disquieting that a few of those members were publicly denouncing the Fund and its conditionality as ineffective and detrimental to economic prosperity and that they explicitly invited other countries to follow suit in bypassing the Fund's assistance. While the

Fund in certain conditions could play a useful role as a scapegoat in overcoming domestic political resistance to adjustment, in some recent incidences such public statements threatened to damage the image of the Fund. He recommended that the Fund in its public relations work should try to clarify its role and the rationale for its conditionality. He greatly appreciated the Managing Director's enormous contribution in that respect, particularly through his numerous speeches and public statements. It might be worth exploring the possibility of having bilateral contacts with high ranking officials of the countries in question. He hoped that the review of the Fund's conditionality would go a long way toward correcting misconceptions about the purpose of Fund-supported adjustment programs.

He was in broad agreement with the specific conclusions and recommendations presented by the staff in the paper before the Board, Mr. Goos indicated. The proposed improvements in program design were necessary and realistic to enhance the effectiveness of Fund arrangements. Nevertheless, in many cases, improvements in program design would not automatically guarantee a higher ratio of successful Fund programs unless those improvements were accompanied by a strong commitment on the part of the authorities to ensure effective and sustained policy implementation. Other important prerequisites were an appropriate degree of flexibility in program design to provide for unexpected changes in the external environment and a willingness by the authorities to adapt the adjustment path as necessary.

Regarding the time frame for adjustment, the present and prospective environment in which adjustment had to take place suggested the need for an early implementation of corrective measures and for the adoption of strategies that attach increased emphasis to direct action in addressing domestic and external imbalances, Mr. Goos considered. Such an intensification of the adjustment effort not only would be consistent with the reduced availability of external resources as suggested by the staff but would also address the problem of weaker commodity prices and excessive debt service obligations in many countries. Furthermore, an intensified adjustment effort would also be called for in those countries where successful external adjustment had not been matched by a corresponding reduction in the underlying imbalances. It therefore followed that a more gradual adjustment course would be appropriate only in countries with basically sound economic structures and a manageable level of external indebtedness. In any event, Fund programs should continue to aim at achieving a viable balance of payments position before the repurchases to the Fund began to fall due. Nevertheless, it was probably realistic to assume that the time frame for adjustment would have to be longer in the less developed countries, particularly in Africa. In those cases, the Fund should focus primarily on the task of designing an appropriate adjustment path supported by Fund resources available from Trust Fund reflows and in close collaboration with the World Bank.

Medium-term scenarios had a useful role to play, particularly in determining the appropriate amount of Fund financing based on the prospective debt servicing capacity of a member undergoing adjustment, Mr. Goos stated. Regarding policy formulation in structural adjustment programs, he reiterated the need of many countries to adopt early and more direct adjustment measures. The extent to which structural adjustment measures had to be adopted in support of fiscal and monetary policy should be assessed against the specific causes of the imbalances in each case. Such an ad hoc approach was also necessary in implementing mechanisms for adjusting relative prices and for institutional reform, which could contribute significantly to structural adjustment, particularly in the longer term. Nevertheless, he cautioned against placing too much emphasis on such measures in the framework of the shorter-term Fund programs. In contrast, there was more scope for enhanced institutional reform under adjustment programs supported by Trust Fund reflows. As institutional reform fell clearly in the Bank's area of competence, the Fund should rely largely, if not exclusively, on the Bank's advice. If the Bank were unable to provide the necessary information on particular institutional reform measures, the capability of the Bank should be expanded: the Fund staff should not become involved actively in advising an institutional reform or other microeconomic adjustment matters.

He recalled that in the case of a number of recent requests for Fund-supported adjustment programs, the Executive Board had criticized the vague declarations of intent on the part of the authorities and the corresponding lack of precise understandings on concrete adjustment measures, Mr. Goos commented. He therefore fully supported the staff's suggestion to specify as clearly as possible the policy measures to be implemented. Furthermore, important measures should be implemented at the beginning of the program, and, in cases of an unsatisfactory track record, the authorities should be required to take prior actions.

The staff's comments regarding structural issues in fiscal adjustment and the problem of capital flight were appropriate, Mr. Goos considered. It was a matter of particular concern that even countries implementing Fund-supported adjustment programs had had only limited success in fighting capital flight. The catalytic role of the Fund was bound to be undermined when private and official resources mobilized through Fund-assisted programs were only partially used in support of those programs. Realistic interest rate and exchange rate policies could help to resolve that problem. Nevertheless, it might be worth exploring the extent to which structural and institutional factors in some countries were giving rise to significant capital flight even when sound interest rates and exchange rate policies were in place.

The staff's proposal regarding the targeting of gross foreign exchange reserves was appealing, Mr. Goos commented, but he had doubts about the feasibility and practical relevance of such an approach. Even if a particular reserve level could be achieved by the end of the program period, it would still be extremely difficult to project with any degree of precision the likely development of reserves in the following years when repurchase obligations would fall due.

On the techniques for addressing the prolonged use of Fund resources, it seemed that the staff had changed its definition of prolonged users from the one used in a previous staff paper on the issue (SM/84/91, 4/27/84), Mr. Goos noted. The list of prolonged users based on the definition in the current staff paper would be distinctly longer than if the earlier definition had been applied. The staff had apparently changed its definition owing to its view that the global environment had significantly worsened and that that worsening was being matched by a need for stronger adjustment and tighter Fund conditionality. The extent to which the Fund should remain financially involved with prolonged users had also to be decided on a case-by-case basis. In any event, the Fund should refrain from extending credit to countries if there were no assurances that those credits would be repurchased in the medium term.

The measures contemplated to improve program design should help to reduce the incidence of prolonged use, Mr. Goos considered. He fully supported the specific proposals on pages 31-35 in the staff report, particularly the proposals regarding shadow programs, phasing, and more extensive use of preconditions--measures which would help to safeguard the temporary character of Fund resources. The recommendation for more continuity in the dialogue between the Fund and members in the period following an adjustment program by specifying and quantifying further policy intentions was also appropriate.

The present guidelines on conditionality and the provisions relating to the extended fund facility remained adequate, Mr. Goos remarked. In particular, the various proposals suggested by the staff were consistent with those guidelines and provisions which continued to provide sufficient scope for the design of country-specific programs in accordance with the particular circumstances of individual cases.

In sum, it was important to strengthen the underlying conditions for more satisfactory and sustainable growth in developing countries as a prerequisite to the resolution of the debt problem, Mr. Goos commented. To that extent, he believed that the staff's proposals were fully consistent with the objectives of the Baker initiative. However, there was no room for renewed excessive financing. A resumption of growth had to be accompanied by increased mobilization and more effective use of domestic savings, by halting capital flight, strengthening international competitiveness, and achieving a more sustainable balance between indebtedness and debt servicing capacity. The Fund must continue to play a central role in that strategy, while taking into account the particular circumstances of each case, as outlined in the guidelines on conditionality. It should be flexible in designing and presenting adjustment programs, without compromising their substance. In addition, the rather limited success of recent Fund arrangements clearly indicated the need to explore all possibilities to increase the rate of success. In particular, the authorities' commitment to implement effectively the agreed adjustment measures and the extent of domestic political support for such measures should be examined in view of the staff's finding that in many instances a lack of commitment or ability to adjust had been the major underlying cause of program failure.

Mr. Leonard noted that the staff had examined the effectiveness of the Fund's economic prescriptions, questioning whether Fund-prescribed policies provided a key for a return to sustainable growth at more or less optimum levels for countries in economic difficulties. The record of adjustment of the countries covered in the background paper, though not without bright spots, gave cause for concern. The improvement in the external balance of those countries had been uneven and incomplete. In particular, the reduction in their current account deficits had been achieved through economic contraction rather than through better and more balanced economic performance. Furthermore, there had been little or no increase in per capita GDP. Inflation had been eased in most countries but had not been brought under control. Unfortunately, also, the future prospects for those countries were not bright. Their shortfalls in adjustment stemmed from three sources; the difficulties of the world economic environment, the manner in which the countries had pursued their adjustment programs, and the content and ambit of the programs themselves.

The quantification in the staff paper of the effects of exogenous developments on external current account balances was particularly helpful, Mr. Leonard indicated. Table 6 of the background paper indicated that countries with both large and small payments deficits had been adversely affected by exogenous developments in 1981-84. Indeed, the small deficit countries had been more successful in adjusting despite the fact that exogenous development had affected them more severely. The most remarkable feature of the Table was that it indicated how much better all the countries would have performed in a more favorable economic environment.

The extent and pace of the change from a favorable to an adverse external, financial, and economic environment at the beginning of the decade had also been a factor militating against adjustment, as it had left many countries with higher external debt and debt service ratios than would have prevailed without such a marked swing in economic developments, Mr. Leonard commented. That situation highlighted the need for considerable concessional aid if some countries were to overcome their external imbalances and debt problems. It also highlighted the need for major industrial countries to have particular regard to the impact of their policies on other countries. The serious fiscal and large payments imbalances among the industrial countries should be corrected so as to reduce their adverse effects on interest rates, exchange rates, and, ultimately, growth. Protectionist pressures must also be resisted by all member countries and support given to a more open trading system. It would have been useful if the staff had focused more on Fund surveillance, which had an obvious and increasingly necessary role to play in that area.

The degree of commitment to adjustment of the authorities of countries in difficulty depended on many factors, Mr. Leonard pointed out. Commitment depended on the design of adjustment programs and the closeness of relations between the individual country and the Fund. Effective implementation was enhanced if the authorities saw the adjustment program as their own and accepted it as a means for overcoming their difficulties rather than as a disagreeable pill that had to be swallowed in order to gain access to Fund resources. Considerable importance should therefore be placed on close contacts between the Fund and the authorities in the formulation of adjustment programs, which should be based on research and empirical evidence reflecting the country's particular circumstances as well as on economic theory. It would be advisable if the authorities were to use the results of the staff and other research as part of their efforts to persuade the population of the need for, and appropriateness of, adjustment policies.

A sequential implementation of adjustment policies might also provide the authorities with some room for maneuver in cases where simultaneous implementation of a wide range of actions might cause difficulties, Mr. Leonard noted. Could the staff comment on that idea and on whether there might be a desirable order of priorities in implementing policy measures in such circumstances?

Close monitoring of progress had a part to play in successful program implementation and would depend on an adequate base of data and information, Mr. Leonard considered. Where effective monitoring was jeopardized by a lack of information or monitoring capability, Fund or Bank technical assistance might be called for, perhaps even before a program was put in place. Alternatively, where monitoring deficiencies existed, countries might want to conserve scarce administrative resources by relying more on market forces as a means of adjustment. It might also be worthwhile for members to adopt monitoring practices that were independent of, and more frequent than, the program reviews, in order to increase the likelihood of success.

His chair agreed that the design of adjustment programs should be set in a medium-term context and that the scope of adjustment might have to be extended to encompass structural change and might require consideration of detailed policy matters, Mr. Leonard commented. The Fund should be pragmatic in its approach to those issues. In deciding on the extent of Fund involvement, consideration must be taken of the Fund's expertise and competence, the limited extent of its resources in terms of staff, and the inescapable fact that responsibility for policymaking in any country was the right and responsibility of the authorities concerned. The Fund's role was that of counsellor, a capacity in which it should outline and enumerate as fully as possible the potential benefits of different adjustment measures, while leaving the choice of measures to the authorities.

On the question of advising on structural change, it might prove difficult in practice to establish the dividing line between World Bank and Fund competence, Mr. Leonard remarked. The Bank's contribution in assessing the size and nature of investment programs would be important in ensuring that adjustment did not fall too heavily on public sector investment or maintenance expenditures. Bank staff might also have views on which current expenditures were essential for the promotion of growth and on issues such as the reform of parastatal bodies. However, the Fund should give advice on structural change in taxation and monetary systems and in related institutions. Ideally, the two institutions should coordinate their involvement in a country. If the Bank's appraisals of a country's investment strategy and of other aspects of structural adjustment were not available when Fund programs were under discussion, the Fund staff might have to give advice on those matters.

The extension of the adjustment process in the medium term might be seen as a gradualist approach to adjustment, Mr. Leonard noted. As against this, he had been impressed by the staff's arguments in support of an acceleration of the adjustment efforts and the implementation of important measures at the outset of the program to ensure their effectiveness and prevent the authorities' commitment from weakening. Only if there were sufficient resources available over a number of years to bridge external financing gaps would there be time for structural measures, particularly on the supply side, to have effect. Those considerations suggested that short-term costs of adjustment, in the form of lower growth and living standards, might be unavoidable and were a necessary prelude to healthy progress.

Implementing adjustment in a medium-term framework had advantages, as it allowed time for the economy to be shaped by structural action, Mr. Leonard considered. Furthermore, medium-term scenarios allowed for an assessment of the direction and adequacy of the measures being employed. Flexibility was indispensable in a medium-term approach in order to take account of changes in economic circumstances and in assumptions on the part of the Fund or the authorities. In that regard, further development of sensitivity analyses and alternative medium-term scenarios would help in formulating contingent policy measures. The use of adjustment mechanisms that were flexible, automatic, and of a continuing nature, such as those based on market principles, were also appropriate. He suggested that paragraph 9 of the guidelines on conditionality should be amended. The present wording was restrictive, as it allowed performance criteria to be established for structural matters only in exceptional cases where they were essential for the effectiveness of the member's program. That formulation ruled out setting structural performance criteria in the generality of cases.

He was in broad agreement with the staff's proposal regarding the problem of prolonged use of Fund resources, Mr. Leonard indicated. In particular, special consultations with members with outstanding purchases in the upper tranches was a valuable means of sustaining adjustment efforts. Moreover, the reasons for a lack of progress during an earlier program should be considered when formulating a new program and should lead to more sound agreements between the Fund and the member country on the elements of the new program. A greater use of prior actions was desirable in certain circumstances, especially where a specific action or reform was essential for the success of the program as a whole.

The provision of the extended fund facility remained appropriate for dealing with payments problems of a more structural nature, Mr. Leonard remarked. However, the Fund should not depart from the current practice of utilizing stand-by arrangements extensively, given the associated flexibility they provided. A country's past record of policy implementation and cooperation with the Fund remained an important consideration in deciding on the commitment of Fund resources over an extended period.

Mr. Salehkhou made the following statement:

> There has been in recent months a long overdue, yet welcome emphasis on the issue of growth in public statements about the problems of developing countries' foreign debt and economic and financial adjustment. While these countries and some multilateral development agencies had all along insisted that the problems of foreign debt and adjustment could be dealt with effectively and in sustainable fashion only through economic growth, it was not until recently that an apparent consensus on this issue did emerge. Our discussion today of the experience with Fund conditionality and ways to improve the design of Fund programs appears to be an appropriate opportunity to address also the issue of growth and how it is affected by Fund programs.
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> The main conclusions of the background paper on the experience with Fund programs adopted in 1982 indicate that only limited progress was obtained in achieving a viable balance of payments position by 1984 and that the overall performance of concerned economies was generally below expectations. Significant improvements in the external current account deficits of sample countries have continued to rely heavily on containment of imports and, in spite of a series of Fund-supported adjustment programs, their performance with respect to real GDP growth was less satisfactory than that of the group of developing countries at large. In analyzing the causes of sample countries' low performance, the two staff reports stress the impact of a number of exogenous factors and the underestimation of both the magnitude of the required adjustment and the severity of the international environment. However by emphasizing the programs of implementation, the reports refrain from addressing specifically the issue of program design and its implications not only for the overall performance of sample countries but also for their ability to adjust to exogenous developments and to sustain over the medium term demand management policies.

Exogenous developments have no doubt been the most critical factors affecting sample countries. These have included not only the steepest international economic recession since World War II, a considerable deterioration in the terms of trade of primary commodity producers, unprecedently high international interest rates, unstable exchange relationships among the major currencies, and intensification of protectionist practices, but also the abrupt interruption of private, as well as official capital flows, and in the case of African countries, harsh and prolonged drought. It is clear that some of the sample countries have sustained better than others the impact of such developments, and the staff usefully compares the experience of so-called small payments deficit countries and large payments deficit countries. In spite of the severity of the international environment, small payments deficit countries seem to have performed better in moving closer to a viable balance of payments position, in correcting domestic imbalances and improving real economic growth. Comparison between the two groups, however, needs to be qualified. The individual circumstances of members being different, it should be noted that some of the small deficit countries entered into Fund programs with significantly less severe imbalances, and in the case of at least two members, the programs could be considered largely precautionary. Larger deficit countries also appear to have been considerably more affected by exogenous factors and benefited little from the 1984 "international recovery."

There will always be doubts about an evaluation of Fund programs which is performed by the Fund's own staff and by those same departments responsible for important parts of the design and harmonizing of such programs. May I recall that, along with other Executive Directors, I supported the idea of establishing an independent evaluation unit similar to the World Bank's. I am convinced that such a decision would go a long way in improving the Fund's image in the international community and could result in a considerable strengthening of program design.

Furthermore, evaluation of the performance under Fund programs would be incomplete if its concern is mostly directed at observance of performance criteria and achievement of program objectives. A number of critical issues need also to be addressed, including among others: what the impact of Fund programs on employment and income distribution has been; to what extent have positive real interest rates encouraged savings and investment; the costs of demand contraction policies, whether they were inevitable, or if there were alternative solutions; to what extent the so-called catalytic role has indeed worked. Was the adoption of Fund programs accompanied by meaningful increases in capital inflows or by a reduction of capital flight?

In assessing the performance under 1982 Fund programs, it is also necessary to note that the abrupt interruption in international lending and initial underestimation of the impact of world recession on international trade masked, to a large extent, the magnitude of the adjustment actually realized. While it also necessitated the adoption of even stronger adjustment measures, only a few of the sample countries had sufficient room left to maneuver to promptly address the new imbalances. The staff's main report underlines the failure of many sample countries to adequately react to exogenous developments and to effectively and fully implement some of the corrective policies provided for under the programs. It would have been useful if the report also addressed the feasibility and realism of the Fund attitude in this regard which mostly consist of requiring a higher degree of adjustment from user countries to offset the effects of factors for which they are not in the least responsible. The Fund, whose responsibility is obviously much broader than balance of payments financing, should equally address the issue of adjustment in large surplus countries.

It is in this context that the problems of implementation reported by the staff should be considered. The lack of public and political support for sustained adjustment reforms and the lengthy legislative processes needed for the implementation of key measures are evidently major constraints. However, these may only be the manifestation of Fund programs' failure to match relative improvements in the external accounts with progress in dealing with the domestic aspects of the crisis. Reduced trade and current account deficits have generally translated into low or negative real economic growth, high levels of unemployment, reduced social expenditures, and acceleration of inflation. The lack of public support should be no surprise considering the little progress recorded in addressing domestic imbalances as well as the sweeping nature of the reforms required by Fund conditionality. These types of reforms proved very difficult to implement even in the context of major industrial economies with seasoned legislatures and with significantly lower domestic costs. Unlike the staff who considers that the problems of implementation should be dealt with to a large extent through closer monitoring of adjustment policies and performance, through an increase in the number of resident representative positions, through more preconditions and strong backloading of disbursements, I believe that what is really needed is a more comprehensive and balanced adjustment program. Such a program should aim at reducing external imbalances without jeopardizing domestic activity, and should be realistic in both its objectives and the instruments used. Domestic considerations should not be subordinated to external objectives, including debt obligations, as these objectives generally determine not only the authorities' ability to implement adjustment programs but also the sustainability over the medium term of the external balance. Thus, the objective of improving program design needs to be much broader than just strengthening of conditionality as proposed by the staff. Considering that the outcome of Fund-supported programs has so far been inconclusive and that a study of the theoretical aspects of program design is being prepared by the staff, we could not logically adopt further tightening of conditionality before the outcome of such a study. The more so since there seems to be now a concensus over the need to allow for more economic growth under Fund programs.

In considering possible improvements in program design, in addition to the adoption of new priorities and emphases, it is necessary to review some aspects of the Fund's adjustment strategy which has in the past constrained achievement of economic viability.

First, there is the case for addressing all imbalances simultaneously to avoid delays in implementation of the adjustment program, and to eliminate at once the source of economic imbalance. Caution in this regard is certainly called for, in spite of the need to adopt comprehensive strategies. Some of the required reforms are necessarily less equal than others, and when implemented early in the adjustment process, they could exacerbate existing imbalances and unnecessarily complicate the authorities' endeavor. This, for example, is the case with the introduction of trade liberalization while adjustment policies are aimed at reducing domestic absorption and the need for external financing. Trade liberalization has forced even greater reliance on demand management policies, including greater restraint of credit to the private sector, and thus stronger impact on economic growth than might be warranted.

Second, it is clear that improved competitiveness in the developing economies is not linked only to adequate relative prices and exchange rates. There is obviously the problem of defining adequate indicators in the light of inexplicable imperfections in international exchange and commodity markets. Moreover, the need for competitiveness through exchange rates should also consider issues such as the acquisition and development of required technologies and, most importantly, protectionism against developing countries' exports and the low elasticities of supply and demand in their foreign trade. Finally, it is necessary to take into account the effects of large swings in exchange rates and increases in domestic prices on investment, growth, and capital flight.

Third, institutional reforms could be instrumental in laying the ground for the resumption of strong and balanced growth, and the World Bank should play a major role in this regard. However, World Bank's assessment of the required reforms should not be allowed to delay adoption of Fund adjustment programs. Futhermore, in view of the increasing emphasis over the need for developing the private sector and for the privatization of public enterprises to improve efficiency, the Fund should be careful not to be perceived as dogmatist on this issue. One the one hand, efficiency is not necessarily synonymous with privatization. On the other hand, in many instances, public ownership is hardly a matter of choice and could merely reflect the failure of private investors to develop particular sectors of economic activity.

Fourth, although medium-term scenarios could be helpful in assessing the magnitude and pace of the required adjustment, they should not be considered more than broad indicators. Because they entail considerable uncertainties, they should be kept in perspective and not become a justification for an excessive or unsustainable pace of adjustment. The outcome of these scenarios and resulting financing gaps are to a large extent sensitive to assumptions with respect to the world economy which in recent years have been marked by unusually high uncertainties.

Fifth, clear understandings about the scope and elements of adjustment policies between the Fund and the authorities are obviously essential to the effective implementation of Fund-supported programs. Intervention by the Fund at the microeconomic level, however, appears to be rarely warranted. It might not only unecessarily complicate negotiations and delay establishment of adjustment programs, but could also undermine political support for their implementation. As to the continuity of policy dialogue between the Fund and members after the expiration of adjustment programs, I believe that the regular Article IV consultations remain the appropriate framework for this exercise.

Sixth, while the daunting magnitude of the required adjustment has been a major factor in the shortfalls between program objectives and performance, countries that had kept their imbalances from rising have had generally greater success with adjustment. Thus, the importance of early adjustment could not be overemphasized, and I fully share the staff's concern in this regard. I do have, however, some doubts as to whether Fund policies have recently been encouraging members to seek Fund assistance at an early stage of their difficulties, considering the trend with respect to access and conditionality as well as the unusual increase in Fund charges at a time when nominal market interest rates have been declining significantly. Access and conditionality are further tightened by the staff's restrictive interpretation of the guidelines which in most instances seems to be in line with the views of only part of the Executive Board.

I wish to conclude these remarks by referring briefly to the question of prolonged use of Fund resources. A major conclusion from our consideration of this issue last year was that the magnitude of prolonged use is in no way unprecedented or indeed surprising considering the nature of the difficulties encountered in the last few years. It should be noted, however, that while prolonged users in the 1960s and early 1970s eventually recovered and corrected their external imbalances, there remain considerable uncertainties about the ability of many of the countries' currently prolonged users to achieve viable balance of payments over the medium term. Essential differences in this regard reflect for the prolonged users of the former period largely favorable external environment, including rapid growth in world trade, improved terms of trade, and sharp increases in both concessional assistance in private flows and lending. The Fund also contributed to this with SDR allocations. By contrast, the early 1980s have been marked by a general deterioration of world economic conditions, interruption of official and private international lending, and phasing down of the Fund's enlarged access policy.

The Executive Directors agreed to continue their discussion on conditionality and issues relating to program design and the prolonged use of Fund resources in the afternoon.

5. EXECUTIVE DIRECTOR

The Chairman bade farewell to Mr. de Maulde on the completion of his term of service as Executive Director for France.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/86/10 (1/23/86) and EBM/86/11 (1/24/86).

6. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to Executive Director as set forth in EBAP/86/16 (1/17/86).

Adopted January 23, 1986

7. EXECUTIVE BOARD TRAVEL

Travel by Executive Director and by Advisor to Executive Director as set forth in EBAP/86/19 (1/22/86) is approved.

APPROVED: September 10, 1986

LEO VAN HOUTVEN
Secretary