

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/94

10:00 a.m., June 9, 1986

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

Executive Directors

J. de Groote

H. Fujino

J. E. Ismael

A. Kafka

F. L. Nebbia

Y. A. Nimatallah

P. Pérez

Alternate Executive Directors

Mawakani Samba

M. K. Bush

T. Alhaimus

M. Sugita

B. Goos

A. Bertuch-Samuels, Temporary

Yang W., Temporary

Jaafar A.

M. Foot

H. Fugmann

G. D. Hodgson, Temporary

W. K. Parmena, Temporary

L. P. Ebrill, Temporary

G. Ortiz

G. Nguyen, Temporary

J. de Beaufort Wijnholds

A. V. Romuáldez

O. Kabbaj

B. Tamami, Temporary

A. Vasudevan, Temporary

L. Tornetta, Temporary

L. Van Houtven, Secretary

K. S. Friedman, Assistant

L. Collier, Assistant

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Also Present

IBRD: M. R. Lav, East Asia and Pacific Regional Office. Asian Department: P. R. Narvekar, Deputy Director; B. B. Aghevli, L. H. de Wulf, S. M. Schadler, K. Yoshinari. Exchange and Trade Relations Department: J. T. Boorman, E. H. Brau. External Relations Department: A. F. Mohammed, Director; C. S. Gardner, Deputy Director. Fiscal Affairs Department: P. S. Heller, S. Richupan. IMF Institute: R. C. Barth; S. Kirakul, S. Swasdipanich, Participants. Legal Department: J. G. Evans, Jr., Deputy General Counsel; W. E. Holder, A. O. Liuksila, R. Munzberg. Middle Eastern Department: D. Hammann. Secretary's Department: A. Akanda, P. D. Péroz. Treasurer's Department. T. Leddy, Deputy Treasurer; D. Williams, Deputy Treasurer; D. Berthet, J. E. Blalock, J. Caskey, D. Gupta, D. V. Pritchett. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: P. E. Archibong, S. Ganjarerndee, J. Hospedales, K. Murakami, A. Ouanes, I. Puro, D. C. Templeman, R. Valladares. Assistants to Executive Directors: O. S.-M. Bethel, B. Bogdanovic, K. Celebican, J. J. Dreizzen, F. Di Mauro, R. Rox, V. Govindarajan, G. K. Hodges, O. Isleifsson, S. King, T. Morita, A. H. Mustafa, J. K. Orleans-Lindsay, J. Reddy, C. A. Salinas, P. Verly, E. L. Walker, Wang X.

1. OVERDUE FINANCIAL OBLIGATIONS - SIX-MONTHLY REPORT; AND
DECLARATION OF INELIGIBILITY - LEGAL ASPECTS OF SUBSEQUENT ACTION

The Executive Directors continued from the previous meeting (EBM/86/93, 6/6/86) their consideration of the six-monthly report on overdue financial obligations to the Fund (EBS/86/98, 4/28/86; Sup. 1, 5/16/86; and Sup. 2, 6/5/86) and a staff paper on legal aspects of ineligibility to use the Fund's general resources and subsequent actions by the Fund (SM/86/102, 5/14/86).

Mr. Nebbia said that the deterioration in the arrears situation was a cause for concern and should be addressed promptly in order to reverse the growing trend in arrears. The amount of overdue obligations to the Fund as well as the length of the arrears had continued to increase over the previous six months. However, the arrears still were not particularly significant in relation to the Fund's financial activities. The arrears amounted to 1.2 percent of total outstanding credit--an unimpressive figure in the light of the slow rate of growth of Fund credit over the previous two years. In addition, particular attention should be paid to the fact that only a small number of members accounted for 92 percent of the total arrears.

In the staff's view it was premature to conclude that the arrears problem had been contained, but that statement seemed to be pessimistic, since the problem was confined to a relatively small number of members that had had serious imbalances even before they had become users of Fund resources, Mr. Nebbia continued. Arrears to the Fund were a symptom of the problems facing developing countries, especially low-income countries. Many of those countries had not yet benefited from the recovery of the industrial countries over the previous several years, and international trade and financial developments had undermined developing countries' adjustment efforts. Therefore, it was not surprising that a number of members had been unable to meet their obligations to their creditors, including the Fund. In searching for the solutions to the arrears problem, the Executive Board should remember that arrears to the Fund usually were not the result of a member's unwillingness to remain current; instead, in general they arose because external conditions made it impossible for a member to discharge its obligations on time despite the adjustment measures that the member had implemented.

The elimination of the arrears of Zambia and Somalia was welcome, and he agreed with the staff that positive solutions to arrears problems could be found with the active collaboration of all the parties concerned, Mr. Nebbia commented. Such efforts certainly had more positive results than the infliction of punishment on a member through a declaration of ineligibility to use the Fund's resources; that sanction had clearly not been very effective.

Members with arrears to the Fund should be encouraged to introduce feasible programs with appropriate financial support, Mr. Nebbia considered. Moreover, a reasonable time for the implementation of the programs and for the repayment of borrowed resources should be permitted.

The staff should comment further on the preventive step that it had mentioned, namely, an assessment of a member's ability to service its debt to the Fund, Mr. Nebbia said. The modalities of the mechanism of assessment should be described, particularly the mechanism that would be applied after a stand-by or extended arrangement with a member had expired. He wondered whether the mechanism would be different from the present practice of assessing medium-term scenarios.

The staff had raised a number of procedural issues, Mr. Nebbia noted. As to countries with continuous arrears and no individual obligations overdue for as long as two months, he agreed with the staff that the current review period of six months should be maintained. In addition, members with arrears should receive the benefit of the investment income on supplementary financing facility subsidies that had been withheld pending the settlement of charges on supplementary financing facility purchases. He agreed with the staff that those earnings should be used first as an offset against any other outstanding overdue obligations to the Fund at the time of the subsidy payment.

In SM/86/102 the staff had clearly described the possible actions that were legally available to the Fund in dealing with members that had been declared ineligible to use the Fund's general resources, Mr. Nebbia remarked. Section II dealt with actions that the Fund could take either before or after a declaration of ineligibility. In that connection, the underlying principle should continue to be to promote the prompt normalization of relations between the member concerned and the Fund. Accordingly, the Fund should carefully weigh the impact of possible actions on the difficulty that the member concerned might have in becoming current in the Fund as well as on confidence in the Fund's financial position. Of the various optional courses of action that the staff had described, the Executive Board had already undertaken reviews of individual members' situation even after a declaration of ineligibility, and it had given some publicity to declarations of ineligibility through press releases--a fairly active form of publicity--and in the Annual Report and certain other Fund publications. Additional publicity concerning members that remained in arrears after a declaration of ineligibility would not be an appropriate way in which to encourage those members to become current in the Fund. In fact, such publicity could cause a further deterioration in the relations between the member and the Fund and could discourage other financial institutions from assisting the member.

Positive publicity of partial payments by a member with arrears and of the adoption of appropriate corrective measures by the country would be a helpful contribution by the Fund to the member's efforts to obtain assistance from non-Fund sources that would enable the country to settle its arrears to the Fund, Mr. Nebbia said. A case-by-case approach to such positive publicity would be appropriate; it should facilitate coordinated actions involving the Fund, the member with arrears, and potential donors and creditors. Such concerted efforts would be helpful in formulating the adjustment policies and in catalyzing the external assistance that would enable a member to normalize its relations with the Fund.

Technical assistance provided to a member with arrears at the member's request would be in the best interest of both the Fund and the members concerned, Mr. Nebbia considered. Indeed, members should be encouraged to request such assistance, which could contribute directly to the adoption of needed adjustment measures and thereby indirectly to early payment to the Fund. The introduction of a mechanism that would require a member with arrears to pay for technical assistance in their local currency would send a clear signal that the Fund was disappointed with the member's arrears situation, something that obviously should be avoided.

The recent introduction of special charges was a sufficient--if not an excessive--step to safeguard the Fund's interests as well as to induce members to eliminate their arrears to the Fund, Mr. Nebbia said. Most members with arrears were genuinely unable to honor their obligations to the Fund because of either reduced export proceeds and insufficient reserves, or increased social and political unrest. Each case must be examined carefully in order to determine whether or not a certain degree of hardship existed and, on the basis of that assessment, which course of action would be appropriate. The Fund should not impose measures across the board that might not be helpful in achieving the main objective of eliminating all the arrears to the Fund.

The ultimate sanction of compulsory withdrawal for nonpayment of arrears or other infractions of the Fund's Articles should be avoided to the extent possible, Mr. Nebbia commented. It would not be in the Fund's interest to cancel the membership of any country, and all possible avenues should be explored together with the member in order to provide opportunities for the country to settle its obligations. In the period after a declaration of ineligibility even a rescheduling of a member's arrears to the Fund would have much more merit than a decision requiring the member to withdraw from the Fund. The rescheduling alternative would at least maintain the possibility that the member could regain full membership and that the Fund could be paid.

If compulsory withdrawal were finally thought to be the only available option, he doubted whether the procedures that the staff had mentioned were fully appropriate, Mr. Nebbia said. For example, the staff had mentioned that the meaning of "reasonable periods" had not been formally interpreted. He agreed with Mr. Kafka that, given the many factors involved, the appropriate interpretation of "reasonable period" could not be defined in general terms and must be determined on a case-by-case basis. Finally, the procedures for early withdrawal should not be initiated in the cases of Guyana and Viet Nam.

Mr. Romuáldez commented that he shared other Executive Directors' concern about the continued deterioration in the arrears situation. He took little comfort from the fact that almost all overdue obligations were concentrated among relatively few members with protracted arrears; after all, total forthcoming obligations due to the Fund from those members in the remainder of 1986 and in 1987 amounted to nearly SDR 1 billion. In addition, it was particularly worrying that almost half the

members that were due to make payments to the Fund over the previous year had been late in making those payments. The six-monthly report clearly showed that there was a growing core of prolonged arrears and a significant incidence of payments that had been overdue for shorter periods, which suggested that members had not strictly adhered to the principle of prompt payment to the Fund.

On page 7 of the six-monthly report, the staff had made the important point that a member's ability to service its financial obligations depended most fundamentally upon the country's pursuit of appropriate adjustment policies both over the period of an arrangement and during the entire period in which a member had outstanding obligations to the Fund, Mr. Romuáldez noted. The validity of that statement was borne out by the experience with Zambia and Somalia. That experience had clearly demonstrated that even very difficult arrears problems could be solved with sufficient determination by the member concerned and with the assistance of the Fund and other members.

He generally supported the proposals in the six-monthly report, Mr. Romuáldez said. The staff had correctly stressed that closer attention should be paid to the role of preventive measures in the early identification and treatment of potential arrears problems. It would be appropriate to include the staff's assessment of a member's ability to meet its obligations to the Fund in papers relating to the use of Fund resources and in Article IV consultation reports.

While the regular reviews provided an opportunity for staff assessments of a member's repayment capability during a program period, there might be a need in some cases involving net use of Fund credit for a more timely review of members' performance following the expiration of a program than was possible under the normal Article IV consultation cycle, Mr. Romuáldez remarked. If Executive Directors considered, on the basis of the staff's assessment, that there was a risk that the member might not be in a position to meet its obligations fully to the Fund at some future time, the staff could perhaps be asked to report again after reviewing the situation after six months. He wondered whether alternatively, or in addition, it would be practicable to schedule members' Article IV consultations about six months after the expiration of a program to enable the Fund to conduct an early review of the postprogram policy performance.

He agreed with the staff that the present policy on continuous arrears should be maintained for the time being, but that it should be kept under review by the staff and should be reviewed by the Executive Board as necessary, Mr. Romuáldez continued. In addition, a complaint under Rule S-1 should be treated in the same way as a declaration of ineligibility; accordingly, the lifting of the suspension under Rule S-1 should require a separate Executive Board decision and should be reviewed on the occasion of the six-monthly review after a declaration of ineligibility. He also agreed that no allowance should be made for the interest earned on supplementary financing facility subsidies withheld by the Fund whether in assessing special charges or in determining the subsidy that was

eventually payable to members. As the staff had concluded, paying interest to members that were late in paying charges would be inconsistent with the Fund's treatment of other members that had paid their supplementary financing facility charges on time. If the Executive Board decided that a benefit was to be paid to members that had not paid their charges on time, the benefit should be used first as an offset against any overdue obligations of the member to the Fund.

The staff paper on legal issues did not clarify some of the legal aspects of the actions available to the Fund in dealing with members' persistent failure to fulfill their obligations to the Fund following a declaration of ineligibility, Mr. Romuáldez commented. He was not surprised that the staff's presentation left a few Executive Directors feeling uneasy and dissatisfied. The staff paper had given him the clear impression that, short of compulsory withdrawal, there was little that the Fund could do to compel payment after a member in arrears had been declared ineligible to use the Fund's general resources.

The legal actions that were mentioned in SM/86/102 could be classified in two ways, Mr. Romuáldez went on. The first category consisted of actions that relied on the cooperation of the member concerned that had already been found not to be cooperating with the Fund. That category included the most constructive actions that were available to the Executive Board, namely, concerted actions, technical assistance, and advice during regular reviews. The second classification included actions that did not necessarily require the cooperation of the member concerned. Those actions were perhaps less constructive, except as a means of persuasion, and included publicity, financial penalties, and compulsory withdrawal.

Before applying the compulsory withdrawal procedures the Executive Board must be convinced that the actions in the first category were not working and were unlikely to work without some further inducement, or that the actions in the first category would discourage other members from maintaining prolonged arrears or would encourage members that had prolonged arrears to discharge them, Mr. Romuáldez commented. He was not convinced that further actions along the lines of those in the second category of actions were warranted. A number of members with substantial arrears had made payments to the Fund, but payments had not been made by countries that had been declared ineligible, with the exception of a small payment by Guyana. It was also worth noting that recent developments in the world economy had strengthened the outlook for many non-oil exporting developing countries.

He shared Mr. Nimatallah's concern about the arrears problem and he fully agreed with Mr. Nimatallah that greater emphasis should be placed on preventive measures in the design of Fund-supported programs, Mr. Romuáldez said. He also agreed with Mr. Nimatallah that it would be useful to examine whether a further step such as suspension--with all its implications with respect to the provision of technical assistance and quota increases--could be introduced after a declaration of ineligibility and before compulsory withdrawal. Some of Mr. Polak's suggestions should be explored, possibly in the context of the suspension proposal.

It would not be appropriate for the Fund's Executive Board to ask the World Bank to suspend access to new resources by countries that had been declared ineligible to use the Fund's general resources, Mr. Romuáldez considered. In addition, it would be premature for the Fund to introduce a new ad hoc financial penalty prior to the analysis of the system of special charges and overdue financial obligations to the Fund that was due to be completed by November 1986.

It had been suggested that in the absence of immediate and substantial progress in the cases of Guyana and Viet Nam the Executive Board should initiate steps that would lead to their compulsory withdrawal, Mr. Romuáldez noted. While he was willing to discuss that matter further following the coming Article IV consultations with those countries, he preferred to defer such an action a while longer.

It was essential for the Fund to maintain its present stance of being always alert to the needs of members, including those that, in the spirit of international cooperation that was characteristic of the Fund's membership, sought to adjust their economies, meet their obligations, and normalize their standing in the Fund, Mr. Romuáldez remarked. Nevertheless, there was a need for mechanisms or levers that would provide stronger and more effective incentives for members with arrears--especially those that had already been declared ineligible to use the Fund's general resources--to become current in the Fund.

Mr. Pérez said that the six-monthly report clearly showed that the arrears situation had deteriorated over the previous six months: the total amount of overdue obligations had increased sharply; and the obligations that had been overdue for longer than six months had more than doubled. Several other indicators also suggested that the arrears situation had worsened. Furthermore, recent information showed that some countries in which the Fund's exposure was high had fallen into arrears, thereby casting a larger shadow on efforts to solve the problem. The recent developments and prospects were clearly a cause for deep concern.

Although some payments had been made in recent months and, in some cases, the prospects for payment had improved, there was still considerable uncertainty on how and when the present trend in arrears could be reversed, Mr. Pérez continued. Still, the arrears problems seemed to be temporary in nature. In analyzing that problem Executive Directors should bear in mind the circumstances in which the problem had emerged: the growing incidence of overdue payments to the Fund had been a consequence of the difficulties faced by most countries in the wake of the prolonged world recession and the unfavorable terms of trade movements that had caused the accumulation of external debt. The arrears problem had not been due to a change in the basic perception of members of the importance of remaining current in the Fund.

As the staff had noted, the improvement in the world economy in recent years together with a recent decline in oil prices might significantly contribute, first, to alleviating the overwhelming economic

problems and external payments difficulties facing many countries and, second, to enhancing the possibility of reducing the economic imbalances that had been accumulated over the previous decade, Mr. Pérez remarked. However, the effects of the more positive external environment on the economic situation of highly indebted countries would not be felt immediately. Of course, the attitude of the countries concerned toward the timely adoption of appropriate domestic and external policies was crucial to their taking full advantage of the more positive international economic environment, thereby placing themselves in a position to restore external payments viability. In any event, the transmission of the positive effects of international economic developments would take time, and the Fund--while encouraging members to adopt adequate policies--should not add to the burden of the members concerned. Instead, the Fund, together with other multilateral institutions and individual members, should make every effort to help members with arrears to deal with their external payments problems by adopting appropriate measures and mobilizing external financing, thereby establishing the foundation for the settlement of the overdue obligations to the Fund.

There were two particularly significant conclusions to be drawn from recent developments, Mr. Pérez considered. First, the arrears problem was concentrated in a relatively small number of members: only two countries--Sudan and Peru--accounted for 55 percent of total arrears. Second, a declaration of ineligibility had proved to be ineffective: little progress in handling a case of overdue obligations was made after a declaration was announced. The problem of arrears to the Fund was a recent one, and the Executive Board should explore all possible avenues for solving the problem within the framework of the Articles and in so doing should be pragmatic and should draw on the lessons learned from experience. Hitherto, the Executive Board's consideration of appropriate action by the Fund had been limited mainly to deciding on the period between each step in a process that had in effect been predetermined. The trend had been to shorten the time required to apply the process up to a declaration of ineligibility. Few initiatives had been fully developed in the area of cooperation, and the results of the process had not been encouraging. That outcome was unsurprising; by its nature the arrears problem could not be solved merely by adding obstacles to members that were already in a difficult position.

The way in which the Executive Board addressed the issue of uniform treatment in the area of arrears to the Fund was crucial for the overall treatment of the arrears cases, Mr. Pérez commented. It was not helpful to try to find a common denominator for the various different arrears cases. The Executive Board should avoid changing the prevailing pattern of actions for dealing with arrears cases unless new cases were clearly different from old cases. Any modification of the pattern of accepted actions should be considered only at the time of the six-monthly reviews of the arrears situation or on other occasions when the Executive Board discussed its overall policy stance with respect to arrears. The case-by-case approach to handling arrears must be continued; it would not be possible to standardize fully the approach to handling arrears. The Fund

should avoid any discriminatory practices, which could undermine a member's willingness to eliminate its overdue obligations to the Fund. Equal treatment of members that were basically in the same situation and had essentially the same performance record would not be sufficient. The Fund's analysis should not be limited to a group of economic indicators; the Fund should examine the factors that had caused the arrears to be accumulated and the options that were available to the authorities concerned. In its examination, the staff should pay due regard to the influence of external factors; it should not concentrate solely on policy errors that the authorities might have made.

Commenting on the issues raised in SM/86/102, Mr. Pérez said that the shortening of the period between reviews had apparently contributed to the deterioration in the arrears situation. The possibility of solving an arrears problem was significantly reduced after a declaration of ineligibility. It was inefficient to have more than two reviews per year of each case involving a country that had been declared ineligible to use the Fund's general resources. Members with arrears should not consider review periods as something akin to grace periods; on the contrary, the authorities should remain active in their search for solutions to the arrears problems while the Fund should keep open all means of communication and should advise and encourage the country to adopt the necessary measures that would contribute to concerted action to eliminate the country's arrears.

No change in the present policy concerning publicity was warranted, Mr. Pérez continued. Publicity was a delicate matter. Additional publicity could exert further pressure on some countries to pay the Fund, but it might hamper other members' ability to acquire financing from non-Fund sources, thereby impairing the countries' ability to pay the Fund. Additional publicity steps would be inconsistent with the Fund's own interest.

Maintaining an open attitude toward requests for technical assistance by members with arrears was consistent with the Fund's cooperative character, Mr. Pérez said. Technical assistance would help a member with arrears to adopt the necessary measures, thereby paving the way for an early solution to the arrears problem. Instead of either limiting technical assistance to members with arrears or making those members bear the cost of technical assistance, the Fund should facilitate and encourage the use of such assistance by the members concerned.

He had supported the establishment of a system of special charges aimed at recouping the financial costs to the Fund of the arrears to the institution, but charges should not be imposed as a sanction against members with overdue obligations to the Fund, Mr. Pérez commented. The possibility of setting off claims should be fully explored. The room in which to use that option seemed to be narrow, but, as a matter of principle, it should be applied in appropriate circumstances. The suggestion to make a quota increase conditional upon the settlement of arrears by a member with arrears should be examined.

Concerted action was the most promising avenue for dealing with individual cases of arrears to the Fund, Mr. Pérez considered. He fully agreed with the staff that the success of a member with arrears in its efforts to restore normal relations with the Fund depended in many cases not only on the member's readiness to adopt corrective measures, but also on the resumption of adequate financing from other sources in support of strengthened policies. The Fund's efforts to coordinate concerted action should not be limited to cases of arrears prior to a declaration of ineligibility; it should be maintained in the period after such a declaration. The staff's suggestion that efforts at concerted action should be intensified after a declaration of ineligibility should be approached with caution to avoid misconceptions by the country concerned or the financial community.

He had no difficulty with the staff's complete and clear analysis of the option of compulsory withdrawal, Mr. Pérez said. It would be difficult to initiate the compulsory withdrawal procedure, because an 85 percent majority was required. The drafters of the Articles had gone to great lengths to prevent any precipitous consideration of compulsory withdrawal. Before considering the possibility of initiating the compulsory withdrawal procedures the Executive Board should make a report on the arrears problem to a meeting of the Board of Governors if it were clear to the Executive Board that the arrears problem threatened the stability of the Fund. That report should include not only a presentation of the arrears situation and prospects, but also an exhaustive explanation of the origins of the problem, the Fund's overall strategy for dealing with the problem, and the conclusion that the Executive Board had used all possible options before considering the ultimate step of compulsory withdrawal. A proposal to initiate the compulsory withdrawal procedure that was not approved by the Board of Governors would clearly be unsatisfactory.

Apparently the Executive Board was losing another good opportunity--namely, the present discussion--to assess the provisions of Article V, Sections 7(g) and 8(e), Mr. Pérez said. A number of Executive Directors had asked the staff to analyze those provisions, and that analysis could have appropriately been included in SM/86/102.

Mr. Kabbaj said that during the six-month period covered by the staff report the problem of overdue financial obligations to the Fund had continued to be a cause for concern. Despite the full settlement by Zambia and Somalia, which had reduced the growth rate of arrears, the total amount of overdue obligations, the amount of arrears outstanding for more than six months, and the daily average number of members with arrears had grown.

The staff paper on legal issues presented possible legal actions that the Fund could take in the period after a declaration of ineligibility, Mr. Kabbaj noted. He agreed with the Managing Director that consideration of action by the Fund in a particular case would need to take into account the totality of the member's circumstances. While the principle of uniformity of treatment was broadly accepted, different remedies could be

applied to individual countries facing financial problems, including those related to making repurchases from the Fund; the remedies could be based on the particular circumstances of each of the members concerned.

The experience with arrears had shown that the introduction of punitive measures and the tightening of existing measures did not help to solve the problem and did not encourage members to make payments to the Fund when in fact those members were not in a position to do so, Mr. Kabbaj remarked. During the discussion on the previous six-monthly report, the Executive Board had agreed to tighten the procedures for dealing with cases of arrears. The Executive Board had decided *inter alia* to shorten the maximum period between the emergence of arrears and the substantive consideration of the arrears by the Executive Board. In December 1985, the Executive Board had imposed special charges on overdue repurchases and overdue charges. Nevertheless, during the period under review two additional members had been declared ineligible to use the Fund's general resources, and total overdue obligations as a percentage of Fund credit and of obligations due to the Fund had increased. Moreover, despite the tightening of the procedures, total overdue obligations had increased from about \$52 million to about \$718 million in the period covered by the present report. Hence, he did not agree with the staff's conclusion on page 8 of SM/86/102 that special charges might deter members from falling into arrears or induce members in arrears to discharge their obligations sooner than they would have otherwise. However, he fully agreed with the staff that the special charges had no effect on members that were unable or unwilling to discharge their obligations.

It was clear that almost all the members with arrears were willing to settle their arrears even though they faced serious hardship that had led to the delay in making payments to the Fund, Mr. Kabbaj continued. A declaration of ineligibility and other penalties should be considered only as a last resort, when a member with arrears was unwilling to discharge its overdue obligations. In that connection, the flexibility that the Executive Board had recently shown in handling some cases of arrears was welcome and seemed to be an indication of a more cooperative attitude toward members that were actively trying to pay the Fund. The present circumstances of members with arrears called for a more careful and comprehensive look at the roots of the arrears problem than for a further tightening of the current procedures for dealing with cases of arrears.

The overall economic performance of the members with arrears clearly indicated that their economies had been adversely affected by external factors, Mr. Kabbaj went on. Apart from occasional weak financial discipline as well as political and social constraints, most members with arrears had suffered from the steady decline in primary commodity prices, high real interest rates, increased protectionism in most industrial countries, and unfavorable weather conditions. Those factors had increased existing imbalances, including balance of payments deficits, thereby causing the members to fall into arrears to their various creditors, including the Fund.

Other causes of arrears to the Fund included the virtual interruption of private lending to developing countries as well as policies on the use of Fund resources, Mr. Kabbaj went on. Over the previous several years, those policies had extended and tightened conditionality, severely curtailing potential and actual access while increasing the cost of Fund resources toward market-interest rates and generally resulting in a deliberate reduction in members' outstanding debt to the Fund. Despite members' real balance of payments needs and deteriorating overall financial conditions, the Fund's policies had resulted in insignificant or negative levels of access, thereby discouraging members from seeking the Fund's cooperation in correcting their imbalances. That outcome was reflected in the sharp reduction in the number of arrangements with members and in the fact that many existing arrangements were inoperative. The Fund's policies had not encouraged members to give the Fund priority in settling their overdue external obligations. Even more important, the policies appeared to be undermining international efforts to deal with debt problems and seemed to give members with depleted international reserves no alternative but to fall into arrears, including on their obligations to the Fund.

It was clear that the so-called catalytic role of the Fund's financial assistance could be effective only if the assistance were meaningful and were commensurate with the adjustment efforts required from members, the balance of payments need of members, and the additional capital that members expected to receive from other creditors, Mr. Kabbaj said. It was common knowledge that commercial banks and even the World Bank were balking at proposed financing packages for countries whose financing gaps were accounted for largely by payments due to the Fund, particularly at a time when the Fund's liquidity was strong and comfortable. That attitude was a crucial factor in the delay in the taking off of the Baker initiative and seemed to be inconsistent with the initiative's objectives. Furthermore, it was important to consider whether the loans under the initiative would be sufficient to generate economic growth and to solve the debt problem if those loans were used to a large extent to pay the Fund, leaving little or no resources for development and growth in the borrowing countries. The projected substantial net inflows to the Fund over the coming two years were a major obstacle in the effort to deal with debt problems, including obligations to the Fund.

He agreed with the staff that positive solutions to arrears problems could be found with the active collaboration of the member concerned, the Fund, and other members, Mr. Kabbaj commented. However, importance should be attached to the role and responsibility of the Fund in leading the required concerted efforts. The Fund should carefully consider the circumstances in which arrears problems had emerged. In that connection, the Fund should take into account the adverse effects of exogenous factors on the countries concerned, which had resulted in a scarcity of foreign resources. The effectiveness of Fund-supported adjustment programs should be carefully reviewed. The Fund should welcome the intention of authorities to undertake adjustment programs that would result in the elimination of arrears. In tailoring individual programs the Fund should

be aware of the gravity of the present economic and social situation in each country. Moreover, donor countries should provide concessional assistance. The most positive contribution to the arrears problem that the Fund could make at the present stage was to provide the debtor countries in arrears with technical assistance and to give their economies sufficient time in which to recover, thereby enabling the countries to pay the Fund. He agreed with Mr. Kafka's suggestion to apply the provisions of Article V, Section 7(g) and Section 8(e) in difficult cases of serious hardship.

He opposed any tightening of the relevant rules as a part of the effort to deal with the problem of overdue financial obligations to the Fund, Mr. Kabbaj stated. Instead of using administrative measures to deal with arrears problems, the Fund should try to prevent the emergence of arrears by implementing a comprehensive policy aimed at promoting realistic adjustment together with reasonable economic growth. That policy should be sustained by adequate flows of resources that reflected all the relevant factors, including the heavy debt service burden of debtor countries.

Mr. Fugmann said that he generally agreed with the staff's analysis in the six-monthly report and shared previous speakers' concern about the growing arrears to the Fund. If any encouragement was to be found from the report, it was that the number of members with protracted arrears appeared to have stabilized, but he agreed with the staff that it was premature to conclude that the general arrears problem had been contained.

He also agreed with the staff that, despite recent setbacks, the cases of Zambia and Somalia demonstrated that, even where the arrears problems were deep and protracted, positive solutions could be found with the active collaboration of the member with arrears, the Fund, and other members, Mr. Fugmann continued. It was therefore disappointing that at least one of those members had fallen back into arrears to the Fund.

He welcomed the increased emphasis that the staff had given to preventive measures, particularly assessments of a member's ability to service its debt to the Fund, Mr. Fugmann remarked. He agreed with the useful clarifications that the staff had given with respect to certain aspects of the procedures for handling cases of arrears, including the approach to complaints under Rule S-1 following a declaration of ineligibility. He too was interested in examining the possibility of making future quota increases conditional upon the elimination of arrears. His authorities had not yet taken a final position on that matter, and a staff paper on it would be helpful. The Fund should not use the extreme hardship provision in Article V, Section 7(g) and Section 8(e).

The earnings on withheld Supplementary Financing Facility Account subsidies should accrue to that account, and any surplus in that account should be transferred to the Special Disbursement Account, Mr. Fugmann considered. Should there be insufficient support in the Executive Board for that approach, he could accept the staff's suggestion that investment

income on supplementary financing facility subsidies should be used first as an offset against any outstanding overdue obligations of the member to the Fund at the time of the payment of the subsidies.

The staff paper on legal aspects of ineligibility and subsequent actions was further confirmation of the paucity of the leverage available to the Fund in its efforts to make members become current in the institution, Mr. Fugmann commented. As to the range of actions available to the Fund, the Executive Board's reviews of ineligible members should focus on specific measures that the member had adopted to bring about a settlement of arrears to the Fund. Technical assistance by the Fund should be aimed solely at helping the member to pay its arrears to the Fund. More comprehensive technical assistance and actions to obtain financial support should be used cautiously and only when the Fund believed that the member genuinely wished to normalize its financial relations with the Fund. Measures such as broader publicity after a certain period subsequent to a declaration of ineligibility and setting off claims that the Fund might have on a member against a member's claims on the Fund should be studied further. However, further financial measures, like those discussed on page 8 of SM/86/102, probably would not be effective.

He agreed with the staff that combining a resolution for compulsory withdrawal with a membership resolution for the same country would be illogical, and in any case he did not favor that possibility, Mr. Fugmann said. To expel a member from an international organization was a grave decision that, once taken, should be seen as being definitive for the foreseeable future.

The Deputy Treasurer remarked that only one member had had a record of virtually continuously outstanding arrears, although none of them had been outstanding for more than two months; consequently, no complaint had been made against the member. That member had a fairly small quota, and the amount of the arrears was not significant, but the staff was monitoring the case closely. Six countries had repeatedly incurred arrears for up to one month. Two of those cases had been a cause for particular concern, and that category of members might well be an index of future difficulties with respect to overdue obligations to the Fund. The staff was watching the two particularly difficult cases closely and would report to the Executive Board as necessary.

The question had been raised whether it was worthwhile to continue the practice of adopting a decision that included an expectation of ineligibility, the Deputy Treasurer noted. The expectation of ineligibility had been fulfilled automatically and without qualification in only one case. In a number of cases the Executive Board had agreed on an expectation of ineligibility and subsequent developments had led the Board to reassess its position. That outcome was understandable, given the changing circumstances of members, and the staff continued to believe that a decision containing an expectation of ineligibility was useful in current circumstances. Such a decision was a clear indication of the Executive Board's view that unless a member took steps to pay the Fund, a declaration

of ineligibility would inevitably be made. In such cases, the only alternative available to the Executive Board was to hold another review, something that was less significant than an expectation of ineligibility. A decision which included the expectation of ineligibility was a useful interim step that helped maintain pressure to repay the Fund.

Some contracts between the Fund and a member on the provision of technical assistance had required the member to cover some or all costs of that assistance, the Deputy Treasurer said. Sharing the costs of technical assistance was a useful rationing device; it was not discriminatory, but it did help to limit the demand for assistance to cases of genuine need.

The staff representative from the Legal Department commented that the World Bank's Articles contained a provision for the suspension of membership while the Fund's Articles did not. In the World Bank, suspension automatically led to expulsion after one year unless the suspension decision was reversed. The drafters of the Fund's Articles had considered whether those Articles should contain the same provisions concerning suspension and expulsion as the World Bank's Articles. The drafters of the Fund's Articles had deliberately decided not to include such provisions in those Articles. In the staff's view, apart from ineligibility and limitations on the use of the Fund's resources, there was no room in the Fund's Articles for suspension of a member in the normal sense of the concept, that was to say, the interruption of all of the rights of membership. That meaning was consistent with the experience of other international organizations. There was a spectrum of remedies--including suspension--in other international organizations. However, the history of the drafting of the Articles of the World Bank and the Fund and the provisions in those Articles had led the staff to conclude that suspension in the normal sense was not available to the Fund under the existing Articles.

The reference to action in national courts on page 8 of SM/86/102 was justified because the staff considered that, as a rule, such a remedy would not be appropriate for the Fund, the staff representative said. Recourse to a national court should not be ruled out in certain circumstances, but in considering that option it was important to bear in mind the particular nature of the right that was being pursued. On the one hand, it was conceivable that, in certain circumstances, the Fund might have recourse to a national court to pursue a particular legal claim--for example, a contractual claim. Under Article IX, the Fund had full juridical capacity to pursue a legal interest in a national court. On the other hand, that conclusion was different from saying that the Fund would be able to pursue a claim that had been created by its own Articles. For example, a repurchase obligation was created entirely by the Articles; it was not created by national law. There was some doubt whether a national court would recognize a repurchase obligation. In any event, there would be substantial legal difficulties in pursuing such a claim in a national court. For example, these related to questions of both the venue and procedure. In addition, the member concerned might resist on the basis of state immunity, and there would be substantial difficulty in enforcing

any particular claim. Accordingly, recourse by the Fund to national courts would require careful examination and the exercise of considerable discretion by the Executive Board, together with an appropriate examination of the likely consequences of such an action. The Articles created a legal regime that was relatively self-contained; the pursuit of claims outside the decision-making structure of the Fund was unforeseen by the drafters of the Articles. He was not aware of an action in a national court by an international organization to enforce claims resulting from the organization's own internal constitutional arrangements. While, therefore, an international right might well exist, national courts might invoke various devices in order to refrain from adjudicating on that right.

Mr. Nimatallah remarked that he wondered whether there was still any reason why the Fund's Articles should not have the same provision for suspension that was contained in the World Bank's Articles.

The staff representative from the Legal Department responded that obviously conditions had changed since the drafting of the Articles, including the evolution of the role of the Fund in ways that had been foreseen by the drafters of the Articles. Accordingly, the specific reasons for not pursuing the suspension possibility might have changed. In any event, in its analysis in SM/86/102 the staff had not attempted to deal with areas that would require an amendment of the Articles.

Mr. Nimatallah considered that the staff should have explored all the possible options in its analysis in SM/86/102. The staff paper could have usefully explained why the World Bank's Articles contained a provision for suspension while the Fund's Articles did not. The staff could have also usefully explored the consequences of an ad hoc financial penalty and means by which the Fund could ensure that it would be paid by a member that was the subject of the compulsory withdrawal procedures. As previous speakers had mentioned, if a member did not pay its arrears to the Fund, it probably could not be expected to pay a financial penalty as well. However, if a member was forced to leave the Fund, the Fund must be aware of all possible avenues of recourse to ensure that the member would meet its financial obligations to the Fund. It was important to anticipate all the various possible means of action by the Fund.

Mr. de Groote said that the former General Counsel had noted that in many cases local courts had considered as law decisions taken by the Fund, especially with respect to the exchange regime of a member. There was no difference between Fund decisions concerning a member's exchange system and a decision by the Fund concerning steps that the Fund took to maintain the quality of its claims. The staff should further examine whether such categories of claims could not be pursued in a national court. Decisions by the European Communities were regarded as law by individual member countries and were enforceable in the local courts of individual members. For example, on the basis of an EEC directive local courts in individual EEC members had recently held that certain employment practices had discriminated against women. Finally, the Fund's Articles

did not contain a provision for suspension because when the draft Articles had been debated the Soviet Union had insisted on excluding such a provision from the Articles, probably because the Soviet Union had wanted to avoid the risk of being expelled from the Fund and had had no intention of joining the World Bank.

The Chairman made the following summing up:

In the discussion of the fourth six-monthly report on overdue obligations to the Fund, there was a broad consensus and widespread concern among Executive Directors that overdue payments constitute a growing problem for the Fund. The total amount of overdue obligations continued to increase over the period covered by the latest six-monthly report, although the rate of increase slowed in the latter part of that period. The SDR 718 million in total overdue obligations outstanding at end-May 1986 is equivalent to more than half of the Fund's reserves. Moreover, financial obligations due in the remainder of 1986 and in 1987 by members that are at present subject to complaints total some SDR 1 billion. Almost all overdue obligations are now concentrated among the relatively few members--nine countries--with protracted arrears; and the arrears of two of those nine members account for almost 55 percent of total arrears. In view of the seriousness of this problem, and the risks that it entails, the Fund must act to correct it.

Let me first review the discussion on the policies and procedures examined in the six-monthly report. Those policies and procedures were tightened at the end of 1985, and the Board has not called for changes in them at this time. However, a number of points were stressed or clarified.

First, most Directors reiterated their support for the suggestion that the staff should include in use of Fund resources papers an assessment of the member's capacity to service future obligations to the Fund. This analysis should pay due attention to the particular circumstances of each member and should therefore not become needlessly standardized. Whenever the capacity of a member to service its obligations to the Fund would appear to be doubtful or in jeopardy, the Fund should take the initiative to consult with the member and urge it to take the necessary corrective measures.

Second, in making proposals concerning the timing and nature of actions by the Fund the staff will be guided by the principle of uniform treatment, which does not mean identical treatment in all cases. The course of action will be influenced by, inter alia, the member's stated intention to pay, but more so by the actual performance of a member with respect to payments, duration of arrears, specific circumstances concerning reserves, the balance

of payments and other variables, cooperation with the Fund in finding solutions to problems facing the member, and the member's will to take policy actions in order to solve its payments problem.

Third, the sense of the meeting today was not to modify the present procedures for handling cases of continuous or repeated overdue obligations, but the staff was asked to monitor the situation closely and, if necessary, to propose modifications in our rules. In that connection, some Directors--Mr. Goos and Ms. Bush, in particular--asked that consideration be given to shortening the period prior to initiating the complaint process.

Fourth, the majority of the Board favored the procedure suggested by the staff for dealing with complaints under Rule S-1 in cases where a member has already been declared ineligible to use the Fund's general resources: at the stage of the substantive consideration of an S-1 complaint, the member's right to use SDRs would be suspended without further qualification; consequently, termination of suspension would call for a further decision by the Executive Board. This would make the decision on use of SDRs comparable to the decision regarding ineligibility to use the resources of the General Department. Moreover, the member's position in the SDR Department would be reviewed regularly in conjunction with the six-monthly reviews of the member's overall situation following the declaration of ineligibility.

The fifth point concerns the disposition of earnings on the investment of SFF subsidies withheld from a member in arrears. No adjustment for such earnings should be made to special charges due by members from which SFF subsidies have been withheld. Moreover, the majority of Directors who spoke on this topic considered that earnings on withheld SFF subsidies should not be distributed to members even after their overdue SFF charges are settled.

Sixth, several Directors advocated a change in the decision with regard to the treatment of overdue charges to the effect that once overdue charges have been put on nonaccrual status because the longest outstanding obligation is overdue for six months or more, overdue charges would remain on the nonaccrual basis until they have been paid. A number of Directors are interested in this suggestion, and the staff will prepare a paper on it, although there was no agreement today to introduce the change now.

Seventh, a number of Directors commented on the recent growth of outstanding claims of the Fund pursuant to the maintenance of value provisions. With a view to reversing this rather new trend, the staff will follow up and will report on the matter as part of the regular six-monthly report. However,

a number of Directors who spoke on this matter hoped that the problem would be solved without having to introduce remedial measures.

I turn now to the second paper, which concerns the legal aspects of possible actions by the Fund subsequent to a declaration of ineligibility to use the general resources of the Fund. As a general matter, I noted that many Directors stress the point that I had made in the cover note to the paper to the effect that some of these possible actions may have the potential for both positive and negative effects on a member's efforts to settle its obligations to the Fund, and that decisions of the Executive Board on any steps to be taken in particular cases would require difficult judgments on what is likely to be most productive in furthering our relations with an individual member and in meeting the Fund's fundamental interests.

Let me come now to the salient points that were made during the discussion. First, all speakers stressed that the Fund should continue to help members with arrears to solve their problems so that they can repay the Fund. We should do this by keeping channels of communication open through Article IV consultations, technical assistance missions, missions to help the countries concerned design a comprehensive and credible adjustment program, and actions by the Fund staff and management to catalyze donor support of adjustment efforts. A number of Directors suggested that the work of technical assistance missions to members with arrears should clearly be aimed at helping the countries to repay their obligations.

Second, there was considerable interest in the notion of concerted representations described in the legal paper. I think that we all agree that such representations should emphasize the negative impact on the membership of overdue payments to the Fund, should be made on a case-by-case basis, and should utilize the various diplomatic or other channels that are at our disposal. Peer pressure was often mentioned by Directors who spoke on this point.

Third, the Executive Board did not favor at this point the establishment of penalty charges beyond the special charges that have already been instituted to recoup the costs stemming from overdue obligations.

Fourth, Mr. Goos, supported by a few other Directors, favored the examination of the possibility of ensuring payment of obligations to the Fund by a member that has been declared ineligible to use the Fund's resources through sales by the Fund of its holdings of the member's currency. Those currencies could perhaps be sold to other members to cover some of their expenditures in the countries in question. The staff will prepare a paper on this matter.

Fifth, considerable interest was expressed in making a quota increase for a member in arrears to the Fund conditional upon the settlement of the arrears. The staff has explained that it may be possible to introduce techniques so that an individual member's quota increase would not become effective until the member had eliminated its overdue obligations to the Fund. Another possible approach that was mentioned would be to deny members with overdue payments the benefit of quota increases. I take it, however, that Directors who spoke on that subject prefer the former suggestion, and I very much agree with that view. We will examine this proposal in a further paper.

Sixth, several Directors asked the staff to examine in a paper the possible actions under Article V, Section 7(g) on the postponement of repurchase obligations, and Article V, Section 8(e) on the payment of charges in domestic currency in exceptional circumstances. The majority of Directors do not favor the activation of these provisions, and the paper will not be of an operational nature. But, in response to the speakers, the staff will prepare a paper on the legal and technical aspects of the subject.

Seventh, there was little support for the idea of pursuing the compulsory withdrawal of members that have been declared ineligible and continue to have overdue financial obligations. Compulsory withdrawal was seen as a last resort--an ultimate step to be taken only once all other avenues had been exhausted--and I think that the sense of the meeting was not to use the compulsory withdrawal option at this stage. However, the idea was put forward of examining the possibility of introducing into the Articles of Agreement a provision to suspend the membership of a country with prolonged arrears, and the staff will prepare a paper on that subject.

Finally, we will of course continue to keep in close touch with the World Bank, and I am sure that Executive Directors will continue to inform their authorities who are represented in the World Bank and other development agencies of the status of our members with respect to overdue obligations. The staff gave an interesting account of what we are doing with the World Bank at present, and I would suggest that it is indeed important that the World Bank be kept fully apprised of the cases of overdue obligations to the Fund, especially when they have reached the point of ineligibility. I think that the present procedures meet Mr. Nimatallah's final basic suggestion. They do not entail automaticity or cross-conditionality, but I think that in fact the present state of collaboration does not provide any grounds for a country that is ineligible to use the Fund's resources to consider that it has open access to new World Bank loans, and that understanding should be, if anything, reinforced.

2. THAILAND - 1986 ARTICLE IV CONSULTATION, AND STAND-BY ARRANGEMENT - REVIEW AND MODIFICATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with Thailand and the review under the stand-by arrangement (EBS/86/106, 5/9/86). They also had before them a report on recent economic developments in Thailand (SM/86/109, 5/23/86; and Cor. 1, 6/3/86).

Mr. Ismael made the following statement:

The year 1985 was a difficult one for the Thai economy, owing to a number of adverse economic developments. On the external side, export demand was badly affected by the slump in world trade. Export prices, particularly primary commodity prices, dropped sharply; and protectionist measures against Thai exports to the major industrial countries were intensified. Thus, despite the 5 percent growth in export volume in 1985, export earnings fell short of the program target by \$1 billion. At the same time, private investment declined by 10 percent in real terms, and private demand stagnated, following 10 percent and 5 percent growth rates in 1983 and 1984, respectively. The stagnation in private domestic demand weakened the overall performance of the economy.

The GDP growth rate slowed markedly to 4 percent in 1985, down from 6 percent in the previous two years. This rate was among the lowest ever recorded in the last 20 years in Thailand. Although agricultural output performed well for the third consecutive year, owing to favorable weather, farm income dropped due to sharply lower commodity prices.

With regard to inflation, consumer prices in 1985 fared much better than expected, increasing by only 2.4 percent despite the 15 percent devaluation of the baht in late 1984 and the subsequent further depreciation in the latter part of 1985. This rate compared well with the increase in the consumer price index of nearly 1 percent in 1984 and 4 percent in 1983. The sluggish demand helped to keep prices down in 1985 and was in line with the continuing low trend in prices realized over the last several years.

In the monetary sector, the weakness in demand strongly affected the use of bank credit, which rose by only slightly more than 9.5 percent in 1985 compared with 17 percent in 1984 and nearly 26 percent in 1983. The weakness of credit growth was unprecedented. The banking system remained highly liquid, mainly because banking deposits continued to be attracted by the high level of deposit rates. Nevertheless, excess liquidity

made it possible for commercial banks to reduce their level of foreign liabilities, which previously had been maintained at a relatively high level.

Fiscal policy was also affected by the weakness in domestic demand. Stagnant domestic activity lowered the collection of import duties and business taxes. Although a tax package was introduced in April 1985, additional revenue generation was disappointing. Furthermore, the budgetary outcome was exacerbated by the unexpected increase in the use of budgetary allocations by government agencies.

The acceleration in the disbursements from the budget reflected two main factors: first, the psychological effect of the expenditure cuts in the past few years prompted government agencies to accelerate disbursements; and second, the original budget was based on expectations of a higher rate of inflation than actually occurred and was, therefore, perceived to be very tight. Consequently, government agencies accelerated their disbursements. In summary, the low revenue collection, together with the high expenditure disbursement, resulted in a larger fiscal deficit than earlier envisaged.

In contrast, there was a significant improvement in the balance of payments. The better outturn was largely the result of the severely depressed import demand. In addition to the exchange rate effects of the devaluation in late 1984, sluggish domestic demand contributed to a reduction in the value of imports from \$10.3 billion in 1984 to \$9.3 billion in 1985, compared with the program target of \$10.7 billion. Consequently, both the trade and current accounts of the balance of payments stayed comfortably within the Fund's program target.

The available statistics for the first four months of 1986 continue to indicate that domestic demand is weak--demand for imports remains sluggish, industrial output has increased only slightly, inflation continues to decline, the financial system is still liquid, and government revenue remains weak. However, export performance is beginning to show some signs of improvement, with the stronger growth in volume of some manufactured export items. Since these exports account for more than half of total export earnings, the current account position is expected to improve substantially.

Taking account of these developments, my authorities share the staff's view that the general economic setting for the Thai economy, although still weak, is improving. In particular, economic activities should gradually pick up during the latter part of the year in response to the combined effects of lower domestic oil prices, declining interest rates, and an acceleration in export demand. The external balance position should

also improve, especially in view of the savings derived from the lower cost of energy imports. It is projected that a saving in foreign exchange, equivalent to almost 1 percent of GDP, can be realized for every drop of \$5 per barrel in import prices. The recent reduction in world interest rates should also reduce the burden of interest payments. A conservative estimate by my authorities suggests that a 1 percentage point decline in world interest rates should reduce the cost of interest payments by the equivalent of as much as 0.2 percent of GDP. The present policy of managing the exchange rate flexibly will also be helpful in maintaining external competitiveness.

The past several years have indeed been difficult in terms of economic management, particularly when the long-awaited global economic recovery proved to be weaker than expected. Moreover, severely depressed commodity prices have weakened both exports and fiscal revenues. Under these circumstances, my authorities are keenly aware of the need to persevere with the economic adjustment that is already under way. They, therefore, remain strongly committed to the adjustment effort, although they are also mindful of the need to encourage economic growth. In terms of fiscal policy, a decision on the appropriate choice and timing of fiscal actions has not been easy, particularly in view of the economic slowdown in recent years. There has been strong pressure on the Government to use any available means, including government expenditure, to stimulate the economy. Recognizing the gravity of the fiscal problem and the uncertainty surrounding the external environment, it is appropriate that my authorities have chosen to strike a balance between the immediate need to redress the fiscal imbalance and growth objectives.

My authorities have been firm in rejecting a more expansionary stance of fiscal policy through increasing government expenditure. In their view, this will only jeopardize the gains already made in the fiscal adjustment. Nevertheless, they have attempted to adjust policies so as to promote a recovery of growth within the constraints implied by the need to reduce the fiscal deficit. Thus, the 1986 tax reductions for both personal and corporate income, designed to improve the structure of taxes and encourage growth, will be more than offset by increases in other taxes. Moreover, measures being taken to reduce retail prices on petroleum products and the lower electricity tariffs are expected to generate an additional stimulus on the economy. Interest rates, also, were brought down during 1985 and early 1986. However, the recovery, which is expected to gather momentum during the latter half of this year, will be closely monitored in the interest of preserving stability.

With respect to fiscal adjustment, my authorities have focused their immediate attention on the expenditure ceiling and rate of disbursement. The current budget is formulated to allow for no growth in nominal terms for noninterest expenditure--implying a

decline in real terms for such spending. Despite such requirements, the authorities moved decisively, and I think correctly, to curtail expenditure allotments by B 2.26 billion after the weakness of revenues in 1986 was perceived.

In order to improve control over expenditure disbursement, a plan is already under way to request government agencies to submit cash flow projections. In other areas, supplementary tightening measures will also result in a significant reduction in expenditure relative to that targeted in the Development Plan and will have an impact on the investment programs of the state enterprises. For example, the expenditure from foreign loans will be further curtailed, as a limit is being set on the loan commitment plan. The amount of foreign borrowing for fiscal year 1986 will be less than half of the target set in the Development Plan. Tighter control over new loan commitments was also imposed on the state enterprises, and some tariffs were increased.

The authorities expect a substantial revenue gain in 1986 from an increase in tax rates on petroleum products. Two thirds of the savings expected from the reduction in the price of oil will be retained for the public sector to further strengthen its financial position. My authorities expect that government revenue, in general, will significantly improve with the projected revival of the economy.

For 1987, the new budget continues to allow for no increase in nominal terms in nonwage/nondebt expenditure. The authorities also intend to implement improvements in tax administration. Important progress has already been achieved with the recent administrative reorganization and computerization of the government revenue collection procedures. In addition to enhancing the tax reform efforts, my authorities expect to carry out a major study on direct taxation in Thailand. For this purpose, the Fund's technical assistance has already been requested.

Significant progress was achieved in Thailand's adjustment program during 1985. I am optimistic that a better balance of payments position can be realized in 1986 and in 1987, as envisaged in the report, due partly to the better world petroleum situation but also to the steady implementation of adjustment policies. The adjustment program in progress is, in my view, appropriate. The package has been carefully crafted to strike a balance between the need to redress the economic imbalances and the need to encourage a recovery. Therefore, I fully support the staff's view, which is also shared by my authorities, that a lengthening of the adjustment period is required in order to avoid unduly undermining the current recovery. On this account, a request is being made for an extension of the program from March 1987 to December 1987. A strong adjustment in 1987 will be realized when the economy strengthens.

My authorities expect that the fiscal deficit in 1987 can be reduced to about 3.5 percent of GDP compared with 4.7 percent of GDP in 1986.

The recent unexpected parliamentary dissolution and the scheduled early general election in July 1986 should not affect the present review of the stand-by program approved in June 1985. All the immediate policy adjustments agreed upon during the negotiations with the staff are already being implemented. Another review mission is scheduled to take place in November 1986. At that time, the new government will be ready to discuss policy initiatives for the remainder of the program. Directors should find it relevant that despite frequent changes in government in the past, Thailand has maintained continuity in its policies.

Thailand has had an excellent record of close cooperation with the Fund, and the authorities look forward to a continuing cordial relationship. They value the Fund's assistance highly; and they have greatly benefited from the services of the Fiscal Affairs Department, the IMF Institute, and the Bureau of Statistics.

Finally, I wish to ask for your support regarding the proposed decision.

Mr. Romuáldez stated that he supported the proposed decisions. In spite of a mixed performance in 1985, resulting mainly from adverse external developments, the Thai authorities deserved commendation and support. Weakened export markets, a decline in export prices, and protectionist barriers against some of their traditional exports had not prevented the authorities from broadly achieving their external targets. They had succeeded in bringing down the current account deficit of the balance of payments beyond even program requirements. They had realized an overall surplus of \$0.2 billion, better than the targeted deficit of \$0.2 billion. At the same time, they had been able to keep the rate of GDP growth at a relatively respectable, by international standards, rate of 4 percent. He hoped that the authorities would respond flexibly to recent developments, which seemed to indicate a sluggishness in domestic demand that had spilled over into 1986, resulting in staff estimates of a lower than 4 percent growth rate during the past 12 months. Inflationary pressures had been kept under control thus far, with consumer prices in 1985 rising by only about 2 percent.

The revised program for 1986 seemed to incorporate less--rather than more--adjustment than originally envisaged, Mr. Romuáldez commented. While a case could perhaps be made for slowing the adjustment process for a period following an external shock in order to allow the economy to absorb that shock, and while he was willing to accept that approach in the present case, he was not sure that that was the best course to follow.

The danger was that by deferring action, the adjustment task ultimately became larger and more difficult. He was not sure whether a more expansionary fiscal policy would sustain economic activities. For instance, it would not be helpful in bringing down interest rates, the stickiness of which had been a major problem, nor would it free resources for a strong revival of private investment while maintaining progress toward a sustainable external position. Therefore, the establishment of quarterly indicative targets was appropriate. Given the gradualist approach to fiscal adjustment that the authorities proposed to follow in early 1986, it was important that they closely monitor developments, particularly in current expenditures, and that they stand ready to make budgetary adjustments should slippages occur. Developments in 1985 had demonstrated the need for those provisions: an early-warning system might have triggered timely adjustment that could have minimized--if not prevented--the slippages that had occurred.

An intensified and perhaps more closely programmed effort toward reforming the planning and investment processes of the state enterprises might be necessary, Mr. Romuáldez continued. Again, the events of 1985 demonstrated that need. Part of the problem in the fiscal sector had stemmed from substantial increases in government net lending to state enterprises, whose financial position had deteriorated in 1984/85. The role of the World Bank was important with respect to the operations and pricing policies as well as the capital expenditures of the state enterprises. Those areas had benefited from World Bank technical advice in the context of two structural adjustment loans--in 1982 and 1983--and under other technical assistance programs. He would welcome information on the prospects for further work in those sectors, considering the obvious need. The authorities had attached importance to World Bank assistance in connection with the port construction component of the proposed Eastern Seaboard Development Program, the viability of which remained in question. He commended the measures taken concerning the state enterprises, for example, the sale of some of the smaller enterprises to the private sector, the general thrust toward privatization, and the strengthening of the State Enterprise Committee and the National Debt Policy Committee.

Rigidities persisted in the determination of interest rate levels in Thailand, Mr. Romuáldez noted; those had long been a feature of the country's financial system. The longer-term health of the financial sector depended critically on the authorities' success in strengthening market mechanisms in the determination of interest rates. It had been intimated that oligopolistic banking practices were to be blamed for the system's present predicament. He wondered what the authorities were doing to improve competitiveness and efficiency in the banking system and whether they could not do more. To date, the authorities' efforts toward coping with that problem had clearly fallen short of their own expectations. While he welcomed the recent enhancement of the supervisory powers of the Bank of Thailand, he wondered whether, in seeking to do more, the authorities should not make use of technical assistance--for example, from the World Bank--in studying the structure of the financial system and the roots of its problems; he asked the staff to comment.

He commended the authorities for their successes in structural adjustment, Mr. Romuáldez remarked. In the export sector, for example, progress had been made in raising the level of efficiency and improving incentives, in diversifying into crops with higher export potential, and in liberalizing conditions for rice exports. With respect to trade policy, the authorities had reduced effective protection for manufacturing, notably, the textile sector. In addition, prices and wages had been allowed to become more fully responsive to market forces.

Mr. Fujino said that he supported the proposed decisions. In spite of the policy measures for 1985 intended to enhance export competitiveness, restrain domestic demand, and reduce fiscal deficits, the slow growth in the export market and weak commodity prices had resulted in slower growth than programmed. Although GDP growth of 4 percent was not low by international standards, it was considerably lower than programmed and than the actual rate of 6 percent in the previous two years. That weak economic performance had manifested itself particularly in the sharp deterioration in the budgetary position. The lower rate of inflation--basically a favorable development--had helped to aggravate the situation; coupled with inadequate control over expenditures, those developments had led to a slippage in meeting the fiscal target of the program. The ceiling on new external public debt commitments had also been exceeded.

To the extent that the deficit overrun was financed by bond issues to the nonbank sector and by foreign borrowing, it might not be regarded as a serious aberration from the program course, Mr. Fujino continued. Indeed, aside from that slippage the adjustment program had been adhered to and implemented effectively. Monetary policy had been conducted prudently, and the interest rate had been maintained at a level sufficient to encourage domestic savings and capital inflows. Exchange rate policy had been conducted flexibly in a way that provided adequate incentives for exporters while avoiding disruptive capital movements. The weak export performance had been more than offset by lower imports, and the current account deficit had declined significantly, with sufficient nonmonetary capital inflows to meet such a deficit.

The magnitude of the slippage in the fiscal deficit pointed to the need for stronger fiscal adjustment, Mr. Fujino remarked. However, in view of the authorities' determination in implementing the adjustment program, as well as the recent weakness of the economy, he could support the proposal to achieve the fiscal adjustment over a somewhat longer period of time than originally envisaged.

Stronger control over public expenditure was urgently needed, as the slippage in the fiscal deficit had come at least partly from that source, Mr. Fujino noted. With stable prices, the task became all the more important and demanding. The establishment of quarterly indicative targets over expenditures and revenues was therefore most welcome. He asked the staff for any comments on the availability and timeliness of statistical data related to such targets, which would be an essential condition for effective monitoring. The lower elasticity of the tax

system had long been a problem, and it was somewhat disappointing that the tax package introduced in January had failed to address that problem fully. Instead, new revenue measures had relied heavily on the increase in petroleum product excise taxes, taking full advantage of the recent decline in oil prices. Basic reform of the tax system was indispensable and would constitute a cornerstone for effective fiscal adjustment. The comprehensive tax study undertaken by the authorities with the assistance of the Fund was most welcome, and he hoped that on the basis of that study, tax reforms to create a viable system of taxation would be implemented as soon as possible.

The poor performance of public enterprises was another area of weakness in public finance, Mr. Fujino continued. Although a certain amount of progress had been made in strengthening the financial position of some state enterprises, further efforts, particularly in setting tariffs at appropriate levels and in containing investments, were needed. The priority given to large-scale investment projects had to be made carefully in light of economic viability and resource constraints.

Several new initiatives had been taken in the monetary area, Mr. Fujino remarked. The attempt to introduce flexibility in the interest rate structure, the strengthening of the supervisory authority of the Bank of Thailand, and the establishment of a fund to deal with the liquidity problems of ailing financial institutions were all welcome developments. The program envisaged the growth of broad money in 1986 to reach about 15 1/2 percent, on the assumption that there would be a substantial decline in velocity. The authorities were aware of the uncertainties in the projected velocity and had stated their intention to restrain credit if the external objectives of the program were threatened. However, additional source of uncertainty seemed to lie in the export and demand growth projections. Given the composition of Thai exports, and particularly the recent weak performance in certain manufactured products such as integrated circuits, the actual growth of exports in 1986 might turn out to be somewhat lower than projected, which could have adverse implications on the GDP growth rate. The authorities should be prepared for such contingencies and, in the monetary area particularly, must be careful to avoid excessive credit expansion.

While the debt burden was relatively high, it remained within a manageable level, and the staff's medium-term scenario indicated prospects for moderate acceleration of GDP growth with a reduction in the debt-service ratio, Mr. Fujino commented. However, there were certain downside risks associated with developments in interest rates, export volume, and international oil prices. Moreover, the future course of commodity prices remained uncertain. In such a setting, it was important for the authorities to expedite the adjustment process and lay the groundwork for future growth, in spite of the temporary lengthening of the adjustment period. Particular emphasis should be placed on fiscal adjustment, focusing on tax reform, and on structural policies directed toward export diversification.

Mr. Hodgson noted that prospects for adjustment in Thailand during 1985 had been impaired by a weakening of external conditions, as its external markets had not grown as expected. Thailand had also experienced a further decline in its terms of trade, resulting in an overall decline in export receipts of about 3 1/2 percent. Domestically, the central government deficit had exceeded the program target by some 2 percent of GDP, which gave cause for concern.

Nevertheless, in many respects the Thai authorities had been able to maintain the momentum of adjustment, even if specific performance targets had not been achieved, Mr. Hodgson continued. Despite the export shortfall, the current account target had been more or less met, as a decline in exports, related to slower economic growth, had more than offset the shortfall. More important, the Thai authorities had renewed their commitment to adjustment under the stand-by arrangement, and they were prepared to put the program back on track. He therefore supported the proposal to extend the arrangement to December 1987 while reducing the total resources available under the program.

Much of the slippage that had occurred in 1985 in meeting the fiscal targets of the program could be attributed to growth in nominal GDP, which had been much lower than projected, owing to the combined effects of slower price inflation and weaker growth, Mr. Hodgson remarked. As a result of slower nominal growth, revenues had been less than projected while expenditures had continued as if nominal income were growing more rapidly. However, while the reasons for the larger fiscal deficit were understandable, the result was still disappointing, particularly when the deterioration in the state enterprises' balance was added. For 1985/86, the planned reduction in the central government deficit to 4.7 percent of GDP would be a step in the right direction, but only a first step. The staff had correctly recommended that stronger fiscal adjustment be undertaken in 1986/87; the staff and the Thai authorities had reached a workable compromise by agreeing to set fiscal targets for the remainder of the program later that year. The addition to the program of a criterion testing the overall deficit of the central government was a useful renovation in the present case.

While he welcomed the cut in budgetary allotments that had been made that year, there was a need to strengthen overall expenditure control as well as to improve expenditure monitoring, Mr. Hodgson noted. Indeed, stronger expenditure control and better monitoring during the past fiscal year could perhaps have prevented the sharp rise in the deficit. As for revenue, the most striking problem was the lack of buoyancy in the tax system, where new tax measures seemingly were required each year simply to maintain the revenue/GDP ratio. In light of that problem, the Government's intention to undertake a comprehensive study of the tax system was well conceived. The measures taken in January 1986 to enhance the efficiency of the tax system were important for that year's budget, but a more comprehensive re-examination seemed justified.

The state enterprises' performance had been mixed, with some enterprises strengthening their finances and others unable to act on price adjustments, Mr. Hodgson commented. The staff had suggested greater central control of public sector investment; he would be interested in knowing from the staff of the Fund or the World Bank whether specific steps had been taken to ensure better central monitoring of those investment outlays.

The authorities had attempted to maintain a neutral monetary stance in recent years, with sufficient credit growth being permitted to match the increased real demand for credit, Mr. Hodgson said. Because of the strong increase in demand for credit expected in 1986, it was reasonable to expect that financial deepening to continue, although the central bank should avoid allowing monetary policy to become too accommodative. While the recent decline in interest rates in the Thai economy suggested that some flexibility existed in capital markets, oligopolistic banking practices remained. A move to more market-determined rates, with less dependence upon credit ceilings, could therefore be achieved only if the competitiveness and efficiency of the banking system were improved. He endorsed the staff's views on that matter, and he would be interested in its comments on other measures that would improve competitiveness in the banking sector.

The maintenance of a flexible approach to the exchange rate had permitted the external sector to adjust more rapidly to less favorable external developments, Mr. Hodgson observed. The medium-term outlook indicated a further strengthening of the external account; to achieve that forecast, the authorities would have to watch carefully the exchange rate relationship between the baht and the U.S. dollar and not allow a reversal in trends in exchange rates between major currencies to undermine competitiveness. Recent experience suggested that the authorities understood the need for caution.

Structural measures would also be needed if the external outlook was to be realized, Mr. Hodgson added. To that end, a range of measures had been introduced during the past year to liberalize export markets--notably for rice, rubber, and tin--upon the recommendation of the World Bank. Those measures were being supported by efforts to diversify exports, which, in light of recent difficulties with export market growth, were prudent and necessary policies for the Government to follow. One area of concern remained: the highly protective tariff structure in Thailand. High tariffs were, of course, a stable source of revenue, but he hoped that as the comprehensive review of the tax structure was completed, the Government would consider shifting away from tariffs toward more internal sources of revenue and would thereby provide a more liberal and competitive trading regime.

While the prospect of a change in government following the general election scheduled for July 1986 often created doubts about the continuity of an adjustment program, Mr. Ismael's reminder that changes in government

in the past had not introduced abrupt shifts in policy provided some reassurance, Mr. Hodgson commented. He would urge the new government to stay the course. Finally, he supported the proposed decisions.

Mr. Ebrill remarked that Thailand had been notable for the success of its economic policies over the past decades, with real growth rates of 6 percent not uncommon. However, the past year had been particularly difficult for the Thai economy due to an unusually severe, and largely unanticipated, deterioration in external conditions. As a consequence, some of the objectives in the current stand-by arrangement--especially with respect to the fiscal deficit--had been temporarily compromised. The response of the Thai authorities to those developments had been encouraging. In particular, at the aggregate level, the strategy of aiming for a small reduction in the fiscal deficit in 1985/86, with a larger reduction targeted for 1986/87, was well conceived. It was important not to undermine the incipient recovery in the economy by being excessively contractionary at the present stage.

The Thai economy had little room for maneuver, however, as indicated by the sensitivity analysis presented in the staff's medium-term scenario and the inevitable uncertainties surrounding the projections of external events, Mr. Ebrill continued. Furthermore, the consolidated fiscal deficit was generally larger than that of the Central Government. He therefore hoped that the authorities would meet the targeted central government fiscal deficit of 3 1/2 percent of GDP in 1986/87.

The staff had stated that expenditure controls should be strengthened, Mr. Ebrill noted. It was important, in the short run, to avoid expenditure slippages from emerging between allotments and cash outlays; therefore, the measures being adopted by the authorities to improve control over expenditure disbursement were encouraging. As to tax revenue, the underlying elasticity of the tax system was low, necessitating repeated implementation of discretionary tax measures. That not only complicated the conduct of short-run demand-management policies but raised the possibility that incentives were being progressively distorted, with negative implications for longer-term development. The recent measures taken by the authorities in that area, in particular the reductions effected in the highest nominal tax rates on personal income, as well as in some corporate tax rates, were commendable. He also welcomed the commitment of the authorities to a thorough rationalization of the tax system as evidenced by their intention to undertake a comprehensive study of the system. He wondered whether, even through reduced, the top marginal rate on personal income remained relatively high--at 55 percent--compared with the equivalent rate in other countries of the Association of South East Asian Nations. Furthermore, the business tax was a single-stage tax levied at all stages of production, and as a result contained undesirable cascading features that could especially hamper export industries. The corporate tax system also had many deductions and exemptions. The potential existed for a tax with a low yield but a high marginal distortion, and in that respect he

was encouraged by the recent emphasis, in promoting foreign investment, on improving services to foreign investors rather than on granting tax privileges.

Those fiscal efforts could be usefully supplemented by measures to strengthen the state enterprise sector, Mr. Ebrill continued. He welcomed the recent tariff increases, the projected decline in the overall deficit of the state enterprise sector, and the authorities' commitment to subject further work on the Eastern Seaboard Development Program to tests of economic viability.

The authorities' cautious approach to monetary policy was commendable, Mr. Ebrill said. Changes in the underlying structure of the economy implied that income velocity would drop by 7 percent in 1986. That dynamic situation should be monitored carefully. Close attention should be paid to external developments, particularly capital flows, so that monetary developments would reflect the expected results.

The authorities had taken a number of steps to liberalize trade and to adjust to changed circumstances, Mr. Ebrill remarked. For example, the reductions in the premiums on rice and rubber exports and the royalty on tin exports were welcome. However, as indicated by the fact that in 1985 the five most important exports had declined in value, further efforts were clearly necessary, particularly with a view to continuing the diversification of the export base. The World Bank had concluded that the tariff structure afforded excessive effective protection, raising the possibility of inefficient import substitution. In addition, some of the decline in Thailand's exports had been due to increased protectionism in its export markets. It was important that those protectionist trends be reversed so as to allow countries such as Thailand to pursue markets in areas where they had a clear comparative advantage.

The authorities were to be commended for the flexible and determined fashion in which they had adjusted to changed economic circumstances, Mr. Ebrill concluded. More generally, it was clear that they faced the medium- to long-term task of implementing structural change in the economy. The World Bank had played and would continue to play a role. The Fund could also contribute by helping to set up an appropriate environment in which that structural adjustment could take place. He supported the proposed decisions.

Mr. Tamami commented that although during 1985 Thailand's economic performance had been constrained by, inter alia, a sharp drop--8 percent-- in export prices and protectionism abroad, the authorities had been able to generally meet the external targets of the program. The significant decrease in the current account deficit--equivalent to \$1.5 billion--had been mainly due to the large decline in import payments. Despite a substantial real depreciation of the baht as the result of a sharp drop in prices, export receipts had fallen by 3 1/2 percent as against the programmed target of a 10 percent increase. As to the rate of inflation, in spite of the devaluation of the baht in late 1984 and further

depreciation in the latter part of 1985, consumer prices in 1985 had increased by only 2.4 percent. The monetary sector had registered an unprecedented weakness in credit growth, while performance in the fiscal area had fallen short of the program's objectives.

Nonetheless, a more favorable outlook for export markets and a substantial decline in oil prices were expected to improve Thailand's terms of trade by the end of 1986 and during 1987, Mr. Tamami continued. To stimulate the economy and reach revenue objectives, the authorities had enhanced the procedures for expenditure control and had established a mechanism of quarterly targets for fiscal development in order to take early corrective measures against likely slippages. Meanwhile, the Fund's technical assistance, which had already been requested by the authorities, would greatly help their initiatives to carry out a major study on direct taxation along with other government administrative measures for revenue collection procedures.

With regard to structural weaknesses in the economy, the authorities' commitments to assist the exporters of rice, rubber, and tin and to promote diversification of crop production were among the commendable measures taken against the weak export markets and protectionism abroad, Mr. Tamami said. In conclusion, he was optimistic that under the present adjustment program, Thailand would achieve--as in 1985--significant economic progress in 1986 and 1987 and that a better balance of payments position could be attained.

Mr. Bertuch-Samuels stated that his authorities were in broad agreement with the staff appraisal and had no objection to the extension of the program period. The failure to meet the fiscal deficit target for 1984/85 reflected exceptional circumstances rather than a weakening in the resolve of the authorities to carry on with the necessary adjustment. That assessment was underscored by the fact that despite unfavorable external developments, the external targets of the program had been met and the current account deficit had actually turned out to be lower than expected. Nevertheless, the slippages that had occurred in the fiscal area reflected the continued existence of significant administrative and structural weaknesses in the public sector, such as inadequate expenditure control mechanisms, the low elasticity of the tax system combined with the problem of tax evasion, and the financial weakness of public enterprises. As pointed out by his chair at the time of the Board's approval of the stand-by arrangement (EBM/85/96, 6/14/85), corrective action in those areas were of central importance for the success of the adjustment program.

The authorities had taken a number of steps, such as the establishment of quarterly revenue and expenditure targets, which had strengthened the conduct of fiscal policy, Mr. Bertuch-Samuels noted. He also welcomed the inclusion of a ceiling for the budget deficit under the performance criteria. Strict monitoring of expenditure seemed to be particularly called for since the targeted fiscal adjustment for 1986 would be moderate; it was therefore imperative that slippages did not reoccur.

He agreed with the authorities' strategy to use a large part of the savings from the reduction in oil prices to strengthen the public sector's financial position, Mr. Bertuch-Samuels said. However, since the future development of oil prices was surrounded by uncertainty, it would not be prudent to count on those savings over the medium term. A stronger domestic effort aimed at improving tax administration and at a comprehensive tax reform was therefore clearly needed. The first steps taken in that direction were encouraging, and he urged the authorities to make speedy progress in implementing the envisaged reform of the tax system.

Further attention would have to be given to the state enterprise sector, Mr. Bertuch-Samuels added. While the financial position of some public entities--such as the telephone organization and the provincial and metropolitan water authorities--had been strengthened through recent tariff increases, similar steps needed to be taken for the electricity and transportation sectors. More generally, particular emphasis should be placed on improving the efficiency of resource allocation in the public sector, especially with regard to investment. In that context, he welcomed the tighter controls over new loan commitments that had recently been imposed on state enterprises, as well as the process initiated in 1985 of privatizing certain state enterprises.

The urgent need to consolidate public finances was most drastically illustrated by the fact that interest payments had already claimed 14 percent of total central government expenditure in 1984/85 and were expected to increase to 16 percent in the current fiscal year, Mr. Bertuch-Samuels observed. In sum, the authorities would be well advised to monitor closely developments in the remainder of 1986 and during 1987 and to stand ready to take additional budgetary measures, if needed, to keep up the momentum of adjustment. Such a prudent stance was particularly called for as the medium-term scenario appeared to be somewhat optimistic. In the short run, a trade-off between the adjustment goals and the growth target could not be ruled out. Should external conditions turn out to be less favorable than expected, it would be appropriate for the authorities to adhere to the planned external and fiscal adjustment path rather than strive for a growth rate of more than 5 percent at all costs--even at the price of a significant deterioration of the external account.

He supported the proposed decisions, Mr. Bertuch-Samuels said. Mr. Ismael's comments on the excellent record of cooperation between the Thai authorities and the Fund and their firm commitment to the process of adjustment were particularly welcome at a time when future prospects for the economy were fraught with considerable uncertainty.

Mr. Yang remarked that as a result of the general downturn in world commodity markets and increased protectionism in industrial countries, growth of the Thai economy had been significantly depressed in 1985. The slowdown of the economy had squeezed government revenues and worsened the fiscal situation. However, the improved outlook for export markets, the recent sharp drop in oil prices, and the reduction in interest rates had brought prospects for a gradual rebound in the economy.

The authorities' resolve during that difficult process of adjustment was commendable, Mr. Yang commented. Most notably, the monetary policy stance had remained consistent with both domestic and external conditions. Consumer prices had been kept at a low level. In addition, the depreciation of the baht had helped to maintain external competitiveness, and the balance of payments had improved remarkably. One of the more far-sighted measures had been the promotion of export diversification, which would be beneficial as a means not only of coping with weak export markets and the present surge in protectionism but also of achieving a more sustained and balanced growth for the economy in the future.

The authorities had made great strides in controlling the deficit, partly by establishing a system of quarterly targets to monitor budget developments more closely, Mr. Yang observed. In addition, tighter control over budget investment programs had also been imposed. The authorities had been very subtle in balancing the needs to reduce the budget deficit and to maintain the necessary fiscal stimulus of the economy. In short, the response of the authorities to the adverse external conditions of the past year were appropriate, and the authorities' adjustment efforts had been impressive.

Although the authorities' decision to undertake a study of the tax system was welcome, he wondered whether the new tax package, introduced in January 1986, would have the effect of creating a fairer system of income distribution, Mr. Yang noted. The reduction in personal income tax seemed to benefit mainly those with higher incomes, and he would appreciate the staff's comments on that point. The tax package had also included an increase in petroleum product excise taxes. That measure would effectively generate additional revenue and contain the increase in consumption of diesel and liquid petroleum gas products, which were mainly imported. However, given the uncertainty regarding the future development of world oil prices, the increased petroleum excise tax might imply a substantial subsidy on fuel retail prices. The authorities were aware of limiting the downward adjustment of those prices; he welcomed that cautious stance and hoped that additional emphasis would be placed on flexible fuel prices.

His chair supported the authorities' request for an extension of the stand-by arrangement and endorsed the proposed decisions, Mr. Yang concluded.

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

APPROVED: February 25, 1987

LEO VAN HOUTVEN
Secretary