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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/166

10:00 a.m., October 8, 1986

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
	A. R. Ismael, Temporary
	M. Lundsager, Temporary
	E. L. Walker, Temporary
	G. Ercel, Temporary
	M. B. Chatah, Temporary
H. Fujino	M. Sugita
	B. Goos
	Song G., Temporary
J. E. Ismael	
A. Kafka	H. A. Arias
	J. R. N. Almeida, Temporary
	M. Foot
	R. Fox, Temporary
	H. Fugmann
	O. S.-M. Bethel, Temporary
	W. N. Engert, Temporary
	A. Abdallah
	W. K. Parmena, Temporary
	J. J. Dreizzen, Temporary
	M. A. Weitz, Temporary
	J. E. Suraisry
	G. Ortiz, Temporary
	J. de la Herrán, Temporary
	J. E. Rodríguez, Temporary
	S. de Forges
	J. de Beaufort Wijnholds
	H.-S. Lee, Temporary
	O. Kabbaj
	A. Vasudevan, Temporary
S. Zecchini	

L. Van Houtven, Secretary
J. K. Bungay, Assistant

Also Present

IBRD: G. Koenig, Latin America and Caribbean Regional Office. Administration Department: G. F. Rea, Director; H. J. O. Struckmeyer, Deputy Director; D. S. Cutler, A. D. Goltz, L. A. Wolfe. Exchange and Trade Relations Department: M. Guitián, Deputy Director; S. B. Brown, A. G. Santos. Legal Department: J. S. Powers, J. V. Surr. Treasurer's Department: D. Williams, Deputy Treasurer; G. Wittich. Western Hemisphere Department: E. Wiesner, Director; S. T. Beza, Associate Director; J. O. Bonvicini, M. V. Carkovic, J. Ferrán, B. Fritz-Krockow, D. Lachman, G. R. Le Fort, L. L. Perez, R. Ramaciotti, C. L. Ramirez-Rojas, O. Roncesvalles, B. C. Stuart, E. C. Suss. Advisors to Executive Directors: W. R. Bengs, G. Nguyen, A. Ouanes, M. Z. M. Qureshi, R. Valladares. Assistants to Executive Directors: G. K. Hodges, O. Isleifsson, T. Morita, S. Simonsen, L. Tornetta, B. D. White.

1. PARAGUAY - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with Paraguay (SM/86/219, 8/26/86; and Sup. 1, 10/7/86). They also had before them a report on recent economic developments in Paraguay (SM/86/239, 9/16/86).

Mr. Weitz made the following statement:

My authorities are in general agreement with the staff's analysis of current economic developments in Paraguay. In their opinion, the set of papers prepared by the staff represents an objective analysis of the challenges currently facing the Paraguayan authorities.

Paraguay's economic performance in the second half of the 1970s was impressive. From 1976 to 1981, the Paraguayan economy grew at an annual average rate of about 10 percent, and the balance of payments remained strong. Moreover, there was a considerable degree of price stability. This favorable economic performance occurred under the impetus of the construction of the Itaipu hydroelectric project undertaken jointly with Brazil.

The slowing in economic growth and the emergence of a deficit on the balance of payments since 1981 can in the main be traced to the decline in foreign exchange inflows associated with the Itaipu and Yacyreta hydroelectric projects from a peak of US$450 million, or 13 percent of GDP in 1981, to about US$90 million, or just over 2 percent of GDP in 1985. In addition, over the past two years, Paraguay's export earnings have been severely constrained by the marked reduction in the international prices for soybeans and cotton, Paraguay's main export crops. These problems were compounded by an acute drought at the end of 1985 and early 1986, which severely reduced the crops of most of Paraguay's principal agricultural products.

Over the past two years, Paraguay has taken far-reaching measures to address its difficult external economic environment. These measures have mainly focused on severe restraint in central government expenditures, including a freeze in public sector wages. As a result of these measures, the overall deficit of the Central Government has been reduced by almost 3 percentage points of GDP over the past three years. During the forthcoming year my authorities intend to persevere with their policy of expenditure restraint, with a view to further reducing the public sector deficit.

My authorities recognize that there are clear limits to a policy of expenditure restraint and that the longer-term strengthening of the public finances will require a reform of the tax system. For this reason, Paraguay has requested technical assistance from the Fiscal Affairs Department of the Fund to study the Paraguayan tax system and to recommend the most efficient means of securing tax reform. Upon completion of these studies, my authorities intend to move promptly to effect the reforms of the tax system that might be found necessary.

My authorities recognize that the large investment outlays by the public enterprises have been an important factor underlying the increase in Paraguay's external debt and the widening in the public sector's overall deficit. However, they note that these projects are now nearing completion, which should diminish the pressure on the balance of payments and on the public finances.

In the area of monetary policy, my authorities have taken important measures to slow down the rate of expansion in the monetary aggregates, consistent with their objective of reducing inflation. Thus, in the second half of 1985, all rediscount operations were suspended. My authorities are especially mindful of the need to persevere with a tight monetary policy and they intend to manage rediscount policy in the remainder of this year in a manner consistent with securing a deceleration in inflation.

In the area of exchange rate policy, over the past two years a number of important changes have been introduced. In May 1984, most nonpetroleum import transactions were transferred to the free market, and during the past year, important measures were taken to stimulate exports through a lowering of minimum exchange surrender requirements. As of September 22, 1986, most imports and exports, as well as capital transactions, will operate at a free floating exchange rate, except for cotton and soybean exports and petroleum imports, for which the exchange rate was raised to ₲ 400 per U.S. dollar. The exchange rate for the public sector external debt service was raised from ₲ 160 per U.S. dollar to ₲ 240 per U.S. dollar with effect immediately, and to ₲ 320 per dollar starting June 1987.

My authorities do not underestimate the importance of maintaining adequate incentives for the export sector and of having an appropriate exchange rate for official capital and import transactions. The recent measures taken in the exchange rate area clearly demonstrate the commitment of my authorities toward the establishment of an adequate exchange rate; however, they are fearful of entering into an inflationary spiral precipitated by exchange rate adjustments that, in the end, might not produce the desired results in the balance of payments. For this reason, my authorities cannot accept the staff's recommendation that the exchange rate be unified at a realistic rate. They are also of the view that many of the adverse factors currently affecting Paraguay's balance of payments are likely to be reversed in the near future which would suggest that caution should be exercised before further adjustments are made to the exchange system.

In August 1986, Paraguay reached agreement with the World Bank on an exchange rate of ₲ 320 per U.S. dollar, at which loan disbursements from the Bank are now to occur. On the basis of this agreement, my authorities expect that loan disbursements from the Bank will regain their former rates within the near future.

Mr. Almeida made the following statement:

The Paraguayan authorities have made important adjustments in the domestic economy during the past two years. Public sector deficits have declined, and public sector savings have increased. The scope for further improvement is adequate, as the levels of expenditure and taxation are still quite low. However, the Central Bank pays heavy subsidies to the rest of the public sector through the exchange system. The authorities should therefore be commended in particular for the recent reduction in the difference between the controlled and free exchange rates, as Mr. Weitz has mentioned.

The domestic adjustment has not been accompanied by external adjustment, largely because of external developments outside the control of the authorities. A most complex exchange system has inhibited export growth and paradoxically has helped to produce a real appreciation of the guaraní in the free market, despite a growing deficit in the current account. External arrears have declined, but this has involved a considerable loss of international reserves.

Exports have been hampered, inter alia, by the current drought, which has substantially affected production of agricultural exports. Unit export values have declined, particularly for cotton and soybeans. In addition, the country's foreign exchange receipts from binational operations have declined further in these past two years; the construction phase of the hydroelectric project at Itaipu is near completion, a low pace of construction continues at the Yacyreta hydroelectric project, and receipts from electricity sales are still quite low.

The apparently high level of public savings is offset in part by the losses of the Central Bank; thus, overall domestic savings have been too low and are declining too fast. Perhaps the authorities should give more attention to real interest rates, which seem to have been negative on balance during the past few years. The authorities should consider possible reforms in the tax system, and should examine in particular the implementation of the personal income tax law and the readjustment of the property and sales tax rates. Equally important is the adjustment of public sector prices, particularly in the context of the reduced exchange rate subsidies for public sector enterprises.

I am happy to see that the authorities have slowed down the expansion of central bank credit in the first half of this year, and have significantly tightened the rediscount policy. Paraguay's past record of sound economic management enables us to look forward to its successful conduct of economic policy in the future. An example of that sound economic management is the recent improvement in the exchange rate area.

Ms. Lundsager made the following statement:

Since the 1985 Article IV consultation with Paraguay (EBM/85/178, 12/17/85), some exogenous developments such as drought and price declines of major exports have adversely affected Paraguay's external position. Nonetheless, the authorities have made initial progress in addressing some economic problems. While we welcome the steps that have been taken, the entirety of the economic policy package appears to fall short of the comprehensive financial and structural adjustment that is required to restore growth to its previously high rates and to return the payments position to viability. Furthermore, the recent acceleration of the rate of inflation--which is now about 40 percent--is an additional cause for concern, because once inflationary expectations become engrained, it is increasingly difficult to reverse those expectations with a gradualistic set of policies.

The supplement to the staff report and Mr. Weitz's statement both have provided helpful details on one important area of adjustment, the exchange market. The recent actions may generate some improvement in the payments position, and should reduce the implicit subsidy that arose because some transactions were being carried through the more appreciated rate. However, four rates remain, with the divergence between the highest and the lowest exceeding 150 percent. Given the high balance of payments deficit projected for this year, and the large decrease occurring in official reserves, additional exchange rate actions appear to be required. With most private sector transactions going through the free market, it appears that appropriate pricing signals are being provided to the productive sectors, except for cotton and soybeans. We would be interested in staff comment on the medium-term prospects for further export diversification.

Additional exchange market actions could most usefully be complemented by supporting actions to strengthen efforts to contain the overall fiscal deficit. While the overall deficit of the Central Government appears low, at less than 2 percent of GDP, the losses of both the public enterprises and the Central Bank increase the overall public sector deficit to some 7-8 percent of GDP. We agree with the staff that efforts should be made to strengthen the overall revenue effort by a broadening of the tax base, and we therefore welcome Mr. Weitz's indications that the authorities are moving forward, with Fund assistance, on a study of the tax system, and plan to move promptly to implement the recommended measures.

Such efforts could be complemented by a major overhaul of the public enterprise system. Unfortunately, it appears that several projects that are not expected to yield a profitable return are nearing completion, and the authorities seem committed to making them fully operational. Such a development might necessitate additional transfers from the Central Government, thereby putting additional pressures on the tight situation in its accounts. In that regard, we wonder whether the authorities are considering additional expenditure restraint, along with the planned tax reform, to help cover the expected transfers to these entities.

Until these imbalances are addressed, it will be difficult for the authorities to contain monetary expansion. Although some restraint was exercised on rediscounting by the Central Bank in 1985, some slippages have occurred in 1986. Mr. Weitz has indicated that his authorities plan to exercise restraint for the remainder of this year--which we welcome--but we are concerned that such restraint will not be sufficient to contain both inflation and the pressures on the balance of payments in the absence of stronger measures to contain the deficit of the overall public sector. In addition, interest rates are at present substantially negative in real terms, which appears to have contributed to the sharp drop in the national savings rate, from over 20 percent of GDP in 1983 to under 6 percent in 1986.

In sum, Paraguay is approaching a difficult period, with external arrears mounting and foreign exchange reserves declining, despite the presence of a restrictive trade and payments system. This signifies that it is difficult to contain payments deterioration solely by the use of controls. Finally, we believe that restoration of a higher growth rate would entail a freeing of these restrictions, and we urge the authorities to consider the needed comprehensive, coordinated actions.

Mr. Rodríguez made the following statement:

After nearly a decade of prosperous economic and financial developments in Paraguay, the entire picture has changed drastically. The evolution of the relevant economic indicators, especially those related to the external sector, show the difficult and worrisome situation existing at present. The slackening of economic activity in the region, together with the drop in prices of soybeans and other agricultural products, has contributed to the decline in the availability of foreign exchange. In addition, revenues from the hydroelectric projects at Itaipu and Yacyreta have also declined since 1981.

Despite the initial delay by the authorities in implementing corrective measures, the adjustment effort they have followed since 1984 to reduce the large fiscal disequilibrium has brought fruitful results in central government finances. The restraint in wages and other current and investment outlays must be seen as positive steps toward adjustment. In addition, contrary to previous occasions, the authorities are considering the introduction of revenue measures to support the fiscal adjustment. Such measures are indeed a viable mechanism, since taxes in Paraguay are among the lowest in Latin America. Moreover, efficient collection and administrative procedures will be equally beneficial and easier to implement than an entire fiscal reform.

In general, I welcome the effort made in reducing the imbalances in public finances. As a percentage of GDP, the overall central government deficit projected for 1986 is the lowest of the past four years. However, the system that has been adopted has brought strong pressure to bear on the Central Bank, which has continued to suffer important losses. Therefore, the authorities would be well advised to exercise fiscal restraint in order to reduce these losses in the future, and thus to establish more transparency in the fiscal accounts of the public sector.

I welcome the restrictive monetary stance followed since mid-1985. The slowdown in expansionary monetary aggregates will contribute to the decline of inflationary pressures. The authorities should be cautious about relaxing this stance in the future. I share the staff's concern about the adverse economic consequences of the continuation of negative real interest rates.

An adequate exchange rate supported by rigorous fiscal and monetary policies would be useful in tackling Paraguay's current economic difficulties. In this respect, I welcome the authorities' courageous exchange rate policies aimed at unification. The transfer of most import, export, and capital transactions to the free floating market will indeed lay the foundation that could allow a transition to a more acceptable exchange rate system. Given the present rate of inflation, I understand the concern of the authorities that a full exchange rate unification at present would have a devastating effect on prices. Therefore, I believe that the authorities must continue to dismantle the existing complex exchange rate system cautiously, and as conditions permit.

Mr. Fox made the following statement:

The deterioration in Paraguay's economic situation has accelerated in recent months and now demands the urgent implementation of strong, comprehensive adjustment measures. At the root of the problem have been an overvalued, complex exchange rate system and an overly large public sector deficit, both of which have contributed to the weakening trend in the overall balance of payments of the past few years, and more recently, the rapid loss of reserves. This is not to deny that exogenous factors have also been adverse. This year's drought has dealt a major blow to the economy and the prices of many of Paraguay's exports have been falling for some time. However, the effect of these exogenous factors has been to exacerbate an already weak situation caused mainly by inappropriate economic policies.

The authorities have taken some steps to stem the deterioration, but in the past these steps have fallen well short of what was required. Unfortunately, it must also be said that the recent adjustments in exchange rates, while on their own representing a significant step toward simplification and unification, are likely--without the support of considerably tighter financial policies--to have precisely the effect that the authorities fear, namely, an acceleration in the rate of inflation, which will erode the initial improvement in competitiveness and thereby inhibit the transfer of resources to the external sector. I concur with the view of the staff on this point (SM/86/219, Sup. 1, 10/7/86). I would therefore urge the authorities to follow up the recent exchange rate adjustment with a comprehensive policy package, with the goal of substantially reducing the overall public sector deficit and the growth of credit.

Since 1983 the deficit of the Central Administration has been reduced consistently, reaching a cumulative 3 percent of GDP by 1986. However, because of the losses of the Central Bank through its subsidization of foreign exchange--especially for oil imports and foreign debt service--this has not been translated into any improvement in the overall public sector deficit, which remains slightly over 7 percent of GDP, about the same as in 1983. The staff has succeeded in putting the government finances on a consolidated basis and in making explicit the losses arising from the use of exchange rate subsidies in the Government's accounts. I would encourage the authorities to do likewise in order to obtain a truer picture of the Government's overall financial operations and performance in the context of a general improvement in the quality of government statistics.

The steps that have been taken to strengthen public finances in recent years have concentrated almost exclusively on expenditure restraint, including cutbacks in capital expenditure, while revenues have stagnated at quite low levels, because of an insufficiently buoyant tax system, increasing tax evasion and, in the public enterprises, delays in adjustments to tariffs. The authorities' decision to seek the Fund's assistance in reversing this trend is therefore welcome, and I urge the authorities to implement the appropriate reforms quickly. However, the need for fiscal adjustment is perhaps too pressing to await this technical assistance report. I would be interested in staff comments on what revenue measures the authorities should take before the study has been completed. There may also be scope for further spending cuts; certainly the expenditure restraint of the past few years must be continued.

With respect to monetary policy, credit growth has been reduced in recent months with the tightening of the Central Bank rediscount policy in 1985. However, this has now been reversed and pressures for excessive credit growth will continue, while real interest rates remain highly negative.

Although the latest adjustment in the exchange rate is welcome, it still falls well short of complete unification, which, as Mr. Weitz has indicated, the authorities are still reluctant to contemplate. One reason for their reluctance is fear of the alleged inflationary consequences. However, most private sector imports already take place at the free market rate. In addition, since oil is the main category of imports still subsidized, now is a particularly opportune time for full unification, given this year's substantial fall in oil prices, which would help minimize the inflationary consequences of the unification. I would be interested in any estimates the staff may have of the direct effect on prices of full exchange unification at this time. Mr. Weitz has also indicated that the authorities are reluctant to unify the exchange rate fully because the adverse factors currently affecting Paraguay's balance of payments are likely to be reversed in the near future. This might be true of the drought and weak commodity prices, although unfortunately this cannot be relied upon. I would welcome staff views on this point. More important, however, the authorities' view seems to understate how much the Government's exchange rate, fiscal, and monetary policies have contributed to Paraguay's economic difficulties over the longer term.

In concluding, I would urge the authorities once again to adopt urgently the necessary strong, comprehensive adjustment measures in order to restore equilibrium to Paraguay's domestic and external finances, thereby laying the foundation for stronger medium-term growth.

The staff representative from the Western Hemisphere Department said that the authorities had introduced significant exchange rate measures in May 1984, when most nonpetroleum imports were shifted into the free market. Moreover, during the course of 1985, the minimum surrender prices for exports had been reduced, thus making the exchange rate for exports more favorable. The exchange rate measures that the authorities had introduced on September 22, 1986, were another move in the right direction, namely, unification of the exchange rate at a realistic level.

The steady decline in Paraguay's export earnings since 1981 had been associated with inadequate incentives provided by the exchange system, the staff representative considered. The authorities' steps to move all exports other than soybeans and cotton to the free market rate would surely have a favorable impact on export earnings, and even more important, more of the export earnings would be channeled through the Central Bank rather than occurring in the unofficial market. The staff hoped to see the authorities move further in the direction of providing adequate incentives to the export sector. However, for such measures to be effective, appropriate supporting fiscal and monetary measures were necessary, and in that respect the staff had serious reservations about the exchange rate changes adopted in September. Those changes, if accompanied by supporting measures, would add to the Central Bank's cost of purchasing foreign exchange from exporters, which would continue to be provided to the public enterprises and other government agencies at highly subsidized rates. Concern had to be expressed about the macroeconomic implications, and in particular about the impact on the rate of monetary expansion, of failing to introduce adequate fiscal measures to support the exchange rate change.

Most nonpetroleum imports were already being transacted at the free rate, and therefore the principal direct cost effect of any exchange rate unification would be limited largely to petroleum prices, which would be significantly higher at the free rate, the staff representative indicated. However, it was crucial to adopt appropriate monetary and fiscal policies, so that the exchange rate measures would not be translated into an undue increase in liquidity. In that respect, the staff shared the concern of the authorities about the possible inflationary consequences of the exchange rate measures. It was essential for the authorities to move promptly to design and implement the supporting fiscal measures.

The authorities merited commendation for their efforts during the recent past to restrain public sector expenditures, the staff representative stated. In particular, the central administration deficit had been reduced by about 3 percentage points of GDP through such expenditure restraint. Wages had been frozen for a number of years, and capital expenditures had been slashed severely. The authorities should persevere in their efforts at expenditure control, but they should also recognize that limits were being reached and that the magnitude of the fiscal adjustment that was required to restore balance to the economy meant that they would have to begin focusing on revenue measures and on appropriate public enterprise tariff policies. The authorities were studying revenue measures, and were discussing gradual increases in public enterprise tariffs, the possible introduction of a value added tax, and the possible implementation of the income tax that had been on the books for about ten years but had never been implemented. The staff urged the authorities to move promptly to introduce such measures as soon as possible.

Through the years, the authorities had been receiving considerable technical assistance not only from the Fund, but also from the Inter-American Development Bank and the Organization of American States, to improve the administrative capability with regard to tax collection, the staff representative from the Western Hemisphere Department recalled. A number of relatively straightforward administrative reforms could be introduced that would yield quick results, because tax collection had been a particularly weak spot, with numerous exemptions and considerable tax evasion. Quick results could also be obtained in the area of public enterprise pricing policy. However, beyond such administrative reforms, what was really required were more basic, far-reaching reforms such as the introduction of an appropriate income tax or a value added tax.

Mr. Weitz made the following statement:

Among the useful remarks made by Executive Directors on the evolution of the economy in Paraguay were the references to the rate of inflation. Domestic prices have been subject to pressures, because of an expanded money supply resulting from the increase in public current and capital expenditures and the difficulty of compensating for these expenditures through budgeted fiscal resources. Moreover, there has been a reduction in the supply of goods and services. The deterioration in import capacity that accompanied the rise in domestic liquidity boosted the annual inflation rate from 25 percent in 1985 to 35 percent in 1986. The authorities are indeed concerned about this increase in the level of prices and they are aware of the need to implement sound financial policies to restore price stability.

The international trade price index has shown signs of deterioration in recent years, especially in 1986. The export/import ratio was 65 percent in 1984 and 69 percent in 1985, and is estimated at 51 percent in 1986. Moreover, external capital inflows were lower and the balance of payments situation was unfavorable during those years. The authorities financed the deficits by drawing on international monetary reserves.

Paraguay's economic recovery prospects depend not only on the domestic efforts of the Government but also to a substantial degree on the opening up and viability of external markets, which is currently beset by considerable uncertainty. It is to be expected, however, that international cooperation can be strengthened and consolidated through appropriate measures and instruments to safeguard world economic equilibrium and to extend more equitable treatment to the developing countries. In this spirit, the Government of Paraguay has taken a series of measures to help strengthen the economy, in the form of a program designed to reduce the fiscal deficit, rationalize domestic credit, bring inflation under control, and increase savings and productive investment.

The authorities' recently introduced exchange rate package constitutes an important step in the right direction to correct Paraguay's huge internal and external imbalances, but it is also recognized that the success of these measures will depend on a further tightening in financial policies. The authorities are studying possible actions both in the monetary and fiscal areas to complement the recent exchange rate measures. We expect new measures to be announced in the near future.

The Acting Chairman made the following summing up:

Directors were in general agreement with the reviews expressed in the appraisal in the staff report for the 1986 Article IV consultation with Paraguay.

Directors expressed their hightened concern about the rapid deterioration in Paraguay's economic situation since the last Article IV consultation discussions. In particular, they noted the substantial widening in the balance of payments deficit and the marked acceleration in inflation, to rates not experienced in Paraguay in the past generation. While recognizing the adverse impact of recent climatic conditions and the performance of Paraguay's export prices, Directors observed that at the heart of Paraguay's present economic difficulties were a fundamental disequilibrium in the public finances and the serious distortions to the economy caused by Paraguay's complex and unrealistic multiple exchange rate system.

Directors welcomed the efforts made over the past two years to strengthen the public finances. However, they observed that the overall public sector deficit, including the losses of the Central Bank, was unsustainably high and that the authorities should aim at a substantial reduction in the deficit. Directors placed particular emphasis on the need for a prompt and major improvement in Paraguay's tax effort--currently among the lowest in Latin America--and for a prompt revision of public enterprise prices.

Directors expressed concern about the continued rapid rate of growth in domestic credit expansion, which they believed was inconsistent with the objectives of strengthening the balance of payments and reducing the rate of inflation. In that regard, Directors stressed the need for a further tightening in the Central Bank's rediscount policy. They also pointed to the need for a significant increase in domestic interest rates, which were currently negative in real terms and thus were acting to discourage domestic savings and to encourage capital outflows.

Directors welcomed the modification in Paraguay's exchange system announced on September 22, 1986 as an important step in making Paraguay's exchange system more realistic. However, Directors emphasized that the exchange rate measures in themselves would not succeed in correcting the basic imbalances characterizing the Paraguayan economy, unless they were accompanied by supporting measures in the areas of the public finances and monetary policy. Furthermore, Directors observed that since most imports were now channeled through the free market, this should facilitate further steps toward the unification of the rate.

Directors encouraged the authorities to dismantle the restrictive trade policies and exchange controls that had come to characterize Paraguay's exchange and trade system. They also urged the authorities to eliminate the commercial payments arrears that had accumulated in recent years.

It is expected that the next Article IV consultation with Paraguay will be held on the standard 12-month cycle.

The Executive Board then took the following decision:

1. The Fund takes this decision relating to Paraguay's exchange measures subject to Article VIII, Sections 2(a) and 3, and in concluding the 1986 Article XIV consultation with Paraguay, in the light of the 1986 Article IV consultation with Paraguay conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Paraguay maintains restrictions on the making of payments and transfers for current international transactions and multiple currency practices subject to Article VIII as described in SM/86/239. The Fund notes the complexity of Paraguay's exchange system and urges the authorities to simplify it by unification of the exchange rate and by the removal of restrictions on payments and transfers for current international transactions.

Decision No. 8416-(86/166), adopted
October 8, 1986

2. PANAMA - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with Panama (SM/86/240, 9/11/86; and Cor. 1, 10/6/86). They also had before them a report on recent economic developments in Panama (SM/86/246, 9/24/86).

Mr. Arias made the following statement:

My authorities are in broad agreement with the views expressed in the staff report.

The review of the current stand-by arrangement was approved by this Board three months ago, and thus it is not necessary to describe in detail the economic policies of Panama. The Government of Panama remains committed to the policies that are being supported by the current stand-by arrangement.

As the staff report stresses, the performance of the economy under the program has been satisfactory. All performance criteria as of June 30 were met. My authorities will comply similarly with all the performance criteria during the remainder of this year, thus continuing to implement the 1986 financial program.

Fiscal policy is the cornerstone of financial management in Panama. Thus far, revenue performance has been better than projected since the beginning of 1986. Cumulative revenue collections of the Central Government through September 1986 were almost 2 percent higher than expected under the program, and 9 percent higher than those achieved during the same period in 1985. The Government has maintained strict control of expenditures. The level of expenditures has been maintained as originally projected under the program, and there will be no departure from the program. With regard to the overall size of the Government, negotiations have been concluded for the divestiture of three state-owned enterprises and that of two others is currently being negotiated. The policy of reducing public sector employment in general by attrition is being maintained.

As I mentioned at EBM/86/108 (7/2/86) the Government of Panama has formulated a medium-term strategy that is to be supported by a second structural adjustment loan from the World Bank. Negotiations are well advanced, and prior to World Bank Board consideration of the SAL II, the Cabinet will approve a law that reforms the pension program of the Social Security Agency. A one-month delay has occurred in the Cabinet approval of this law, owing in part to delays in a consultant's report that provides the technical background for developing the Government proposal that will be the basis for reaching political consensus. Notwithstanding the aforementioned delay, the World Bank Board will be able to consider the proposed loan in the first part of November, thus permitting first-tranche disbursement before the end of the year. This disbursement would also allow the commercial banks to disburse the remaining amount of the new money facility before the end of the year.

The Government of Panama has already taken the first steps to begin discussing with foreign commercial banks the rescheduling of amortizations due in 1987-90.

Mr. de la Herrân made the following statement:

I commend the Panamanian authorities for the positive results that they are achieving under the stand-by arrangement. The fiscal deficit has been reduced even further than programmed, inflation is under control, and growth is picking up again. Two issues are of particular interest for the future evolution of the economy: the debt situation and the availability of external financial resources.

While Panama's debt situation remains serious, the recent performance of the economy over the past two years should provide the country with enough credibility to permit it to normalize relationships with creditors. I fully agree with the staff and Mr. Arias on the convenience of starting the process of reaching a multiyear rescheduling arrangement with the banks. This will probably lead to a further enhancement of the relationship with the Fund. In this regard, a new stand-by arrangement with the Fund could provide the necessary elements to maintain a close monitoring of the Panamanian economy and would also facilitate the rescheduling arrangement with the commercial banks.

We have observed how essential foreign financing is at this stage for Panama, and what damaging effects further delays in disbursement might have for the process on which the authorities have embarked. The negotiations with the World Bank to make the second structural adjustment loan operative seem to be practically finalized. Such an agreement appears to be the key element for solving the present financial difficulties, and I therefore urge the authorities to implement promptly the measures needed to activate the loan. I also urge the World Bank to make its best efforts to accelerate the process as much as possible in order to permit rapid approval and the consequent disbursements.

Ms. Lundsager made the following statement:

Panama continues to make quite satisfactory progress under its stand-by arrangement, meeting performance criteria and surpassing fiscal performance expectations to date. We are pleased to note this good progress and are encouraged by the authorities' continuing commitment to the adjustment effort. Furthermore, the authorities have made significant strides in the past year in tackling the structural rigidities in the economy.

The efforts of the authorities and the World Bank, supported by the Fund, to make adjustments in the industrial, agricultural, and labor areas appear to be generating a more competitive environment for the productive sectors, thus leading to more efficient resource utilization. While welcoming the tariff reform actions that have been part of this effort, including the reduced reliance on quotas, we note that these tariffs remain fairly high, with some maximum tariff rates as high as 90 percent. In addition, as we had noted at the review under the stand-by arrangement (EBM/86/108), it appears that the system of tariffs might not adequately support production of new tradables, given the lower tariff rate applied to these products. In the light of the authorities' efforts to increase the role of the private sector, particularly for purposes of generating employment, this tariff structure might be counterproductive, and we suggest that the authorities consider this possibility when evaluating the implementation of the tariff reform program.

At the same time that the authorities replaced the quotas with tariffs, they took a most welcome step by removing price controls on a number of products. Nonetheless, 34 product categories--a rather high number--remain subject to price controls. Any comment Mr. Arias could make on the potential for further reductions in the price controls would be helpful.

We welcome the increased flexibility that is being introduced into labor market regulations, but we remain concerned that one of the major impediments to hiring--the costs associated with dismissal of workers--has not yet been addressed. Perhaps further steps in this aspect of labor reforms could be contemplated in the near future.

My comments on the fiscal package are related to structural issues. Current expenditures continue to consume a high proportion of GDP, some 28 percent this year. We recognize that a large part of this expenditure is related to interest costs and the wage bill. With regard to the wage bill, a stronger private sector could provide growing employment opportunities and could facilitate a scaling back of the civil service. This aspect of the budgetary problem reinforces my earlier comments on the effects of the tariff reform and the reduction in price controls on the private sector.

Our understanding is that marginal income tax rates in Panama are high, and could be detrimental to encouraging savings and investment. While a number of revenue-generating measures have been introduced during the course of this program, we wonder whether additional consideration should not also be given to a more broadly based tax reform, designed to strengthen producer incentives and thus encourage employment.

Important progress is being made in the public enterprise sector. Some entities have been closed down and others are being divested to the private sector. In addition, significant reforms in the Social Security Agency will be implemented soon. We would be interested in learning of any further plans that the authorities might have in the public enterprise area.

With regard to the prospects for financing over the medium term, we noted that the authorities are interested in pursuing a multiyear rescheduling arrangement with commercial banks. With its good economic performance under the stand-by arrangement and its obvious commitment to important structural reforms--which should permit the second structural adjustment loan from the World Bank to be approved later this fall--Panama should be able to secure appropriate financing, both rescheduling and new money, from commercial banks. In this regard, I would reiterate our point made at EBM/86/108, that it might not be useful to assume that no new commercial bank money will be needed to fill the medium-term financing gaps, an assumption that has been repeated in the current staff report. Staff views on the role of commercial bank financing in Panama would be helpful.

In conclusion, the authorities have made commendable efforts over the course of this program to implement important reforms formulated in close cooperation with the Fund and the World Bank. We hope to see such continued good progress in the future, progress that could complement a reduction in Panama's relatively high outstanding use of Fund credit.

Mr. Bethel made the following statement:

I commend the authorities in Panama on their achievements over the past year, particularly those under the present stand-by arrangement. However, it appears that the adjustment effort must go on, and the political will to implement and to adhere to it must also continue.

As Mr. Arias has aptly noted, fiscal policy is the cornerstone of financial management in Panama; thus, the brunt of any adjustment falls there. The contraction in both capital expenditure and domestic investment over the past few years, attributable partly to a high fiscal deficit and a resulting financing gap, have affected Panama's growth. Investment for growth must be reactivated and emphasis must be placed on the control of current expenditure. The improvement in revenue over the past two years is commendable and is due in part to improved methods in the collection of taxes and administration of the system. The work of the task force on the value-added tax system is timely; the results should be reviewed in the context of the overall tax system and its contribution to private sector investment and the encouragement of competitiveness in the economy. The improved tax system should also assist in reversing the decline, by about 10 percent of GDP in the past four years, of both public and private sector savings.

The determination of the authorities to streamline the public sector enterprises and agencies is commendable. Continued strict management of these enterprises is essential. We also welcome the limited role outlined by the authorities for the Agricultural Marketing Institute.

The authorities have indicated their intention to repay the National Bank during the last quarter of 1986, and we would encourage them to fulfill this obligation, particularly in the light of the external debt situation over the medium term. We support the authorities' efforts to negotiate a multiyear rescheduling arrangement with commercial banks. This practical approach would assist Panama in returning to a sustainable external position. However, prudence must prevail in Panama's future external borrowing requirements. Accordingly, a quick completion of negotiations with the World Bank would be beneficial.

We encourage the authorities to move expeditiously on the removal of quotas on the remaining 20 products, while commending them on their actions already taken to eliminate both quotas and price controls. Such action will foster competitiveness and the efficient allocation of resources. It is probable that the revised Labor Code will also enhance competitiveness and encourage further private investment. While economic diversification may be limited, some scope for expansion in the export of manufactured goods seems possible, and it would therefore be appropriate for the authorities to encourage further private investment in the manufacturing sector.

Mr. Dreizzen made the following statement:

We are most satisfied that the strong economic policies implemented by the Panamanian authorities have resulted in a successful performance of the economy. As of June 1986, all performance criteria under the current stand-by arrangement have been met. In this respect, and given the key role of fiscal policy in a country without an independent monetary policy, it is important to stress that in the first semester of 1986, the public sector registered a small surplus in contrast to the modest deficit that had been envisaged. Moreover, real GDP is expected to grow this year above the projected figure, while the rate of inflation is being kept under control. According to the latest estimates, the external current account deficit will decline by more than had been forecast previously.

At EBM/86/108, this chair expressed its concern about the declining trend of gross domestic investment in Panama. It seems that delays in the disbursements of external credits have affected the implementation of investment projects in the public sector during the first half of 1986. We hope that these problems will not arise again in the future, as a new weakening of investment may hinder the prospects for growth in the medium term.

We share the view of the authorities and the staff on the need to smooth out the peak in amortization of public debt which, according to the current structure, will occur during the next four or five years. As Mr. Arias has said, the Government of Panama has already taken the first steps to begin discussions with commercial banks on the rescheduling of amortizations due in 1987-90. It would be highly desirable for the authorities and the banks to reach an agreement on a multiyear rescheduling, given the strong adjustment measures that the country has pursued already. Such an arrangement would allow the authorities to formulate their financial policies on a firmer basis without having to face the uncertainties raised every two years by the negotiations with commercial banks.

Panama has been undertaking important structural reforms in the public sector, industry, agriculture, and the labor market. These measures will improve resource allocation and the productivity of the economy, and at the same time, they should affect positively the external creditworthiness of Panama. The progress in adjustment and structural reform already achieved by the authorities should be recognized by foreign creditors, and we think that a multiyear rescheduling arrangement should be reached to consolidate Panama's external position.

The staff representative from the Western Hemisphere Department, recalling that a number of issues had been raised with regard to structural reforms in Panama, said that the authorities were planning to reduce or eliminate a few more price controls on agricultural products before the end of the year, and to reduce price controls still further within the next few years. The authorities' record in liberalizing prices in the agricultural sector had been quite good in the recent past, but they were aware of the need to continue to eliminate price controls. The authorities had had numerous discussions with the World Bank staff with regard to the labor market problems, and in particular, the high cost of dismissals of workers. Although the authorities had given a great deal of consideration to those aspects of the reform, in the end they had decided not to reduce dismissal costs, which affected primarily the medium- and large-sized firms. The staff would continue to discuss with the authorities in the future the desirability of implementing labor market reforms. In pursuing public sector reforms, the authorities had also demonstrated an active interest in selling some of the remaining public sector enterprises, in particular some hotels and a citrus company owned by the Government.

Given Panama's heavy debt service burden, it was the staff's view that Panama should rely mostly on multilateral and bilateral financing, but commercial banks did also have a role to play, the staff representative from the Western Hemisphere Department indicated. Under the 1986 program, the Government was counting on full disbursement of a new credit of $60 million. Panama would continue to make some limited use of new credit from commercial banks in the future. In the next few years, the Government would have to redeem a significant number of bonds, and even if new credits from commercial banks were obtained, there might not be a net increase in Panama's commercial debt. The authorities were in the process of formulating their external financing plans for 1987, but their views on the use of new credit from the commercial banks had not been worked out fully.

Mr. Arias noted that Executive Directors had recognized the substantial progress made by the authorities under the current stand-by arrangement with the Fund, and in the negotiations with the World Bank for the second structural adjustment loan.

Responding to Ms. Lundsager's question on price controls, additional broad tax reforms, and further actions on public sector enterprises, Mr. Arias recalled that in 1985 and 1986, Panama had worked hard to implement structural reform measures in those areas, and would continue to work closely with the World Bank in taking additional measures. The authorities were not planning to implement additional broad tax reforms at present, but were instead concentrating on improved administration of tax collection. As for the public enterprises, in addition to the three public enterprises that had been sold, the authorities were discussing the sale of two others and would continue trying to streamline the public enterprises as a way of improving the public finances of the administration.

The Acting Chairman made the following summing up:

Directors were in broad agreement with the views contained in the staff report for the 1986 Article IV consultation with Panama. Directors welcomed the progress made thus far in the implementation of the adjustment program for 1986, supported by a stand-by arrangement with the Fund. They noted that inflation was reasonably well under control and that economic activity was picking up. Furthermore, the overall public sector deficit was now expected to decline to about 1 percent of GDP in 1986, and the full amount of the excess credit extended by the National Bank to the nonfinancial public sector in 1985 would be repaid after receipt of the disbursements of foreign loans expected in the last quarter of the year.

Directors observed that fiscal performance had been in line with the program and that the measures that had been taken provided reasonable assurance that the fiscal targets for the year would be achieved. Directors were encouraged by the good performance of revenues and, noting that the current budget outlays were rather high in relation to GDP, urged continued restraint of expenditures, particularly wages and salaries. Even though public sector investment spending had been constrained in the first half of the year owing to delays in the disbursements of external credits, it appeared that the authorities would be able to achieve the level of investment projected for the year. Directors encouraged the authorities to continue improving public sector savings, to permit the strengthening of investment in the coming years, and to strengthen the financial position of the public enterprises, including further privatization.

Directors observed that Panama would continue to face a heavy debt service burden over the next few years and urged the authorities to continue to implement policies that would help deal with the problem. In that context, Directors supported the authorities' intentions to seek a new rescheduling arrangement with the commercial banks.

Directors commended the authorities for the wide-ranging reforms that they were undertaking at present in the framework agreed with the World Bank as the basis for a second structural adjustment loan from the World Bank. Those reforms should provide for improved resource allocation, encourage private initiative, and contribute to future economic growth. Directors encouraged the authorities to complete the calendar of structural policy measures envisaged under the second structural adjustment loan to ensure the benefits contemplated from those reforms and to avoid shortfalls in the financing of the program.

It is expected that the next Article IV consultation with Panama will be held on the standard 12-month cycle.

3. JOB GRADING IN THE FUND - EARLY RETIREMENT ASSISTANCE SCHEME FOR STAFF IN DOWNGRADED POSITIONS

The Executive Directors considered a staff paper outlining an early retirement assistance scheme for staff in downgraded positions (EBAP/86/207, 8/26/86). They also had before them a memorandum on the same subject from the Staff Association Committee (EBAP/86/239, 10/7/86).

The Director of the Administration Department recalled that at the discussion of job grading proposals (EBM/86/15 and EBM/86/16, 1/30/86), many Executive Directors had expressed concern about the impact on staff whose positions had been downgraded as a result of the exercise, a concern that was shared fully by the management and the Administration Department. At that meeting, the staff had outlined proposals for ameliorating that impact, first, by proposing a limited two-year grandfathering arrangement for salaries; second, by instituting a review and appeals process that could lead to adjustment in some of the job grading results; and third, by providing financial incentives to staff eligible for early retirement. Finally, the Administration Department was currently studying other long-term measures such as the retraining and redeployment of staff in downgraded positions, and possibly some sort of outplacement program. The Board had accepted the two-year grandfathering arrangement proposed at EBM/86/15 and EBM/86/16, as well as the implementation of a review and appeals process, which was currently under way. The Board was now being asked to consider recommendations for the third item, namely, a specific scheme of termination payments for staff whose positions had been downgraded and who wished to take early retirement.

He believed that there was a twofold justification for the proposal, the Director continued. First, it served as an inducement to affected staff members--at least the more senior and older ones--to take early retirement, which was in the interests of the institution. Second, it also served, for those staff members who were eligible for the payments, as some compensation for an adverse change in their status and prospects that had been imposed upon them by the institution.

Before formulating a specific recommendation to the Board, the staff had considered a number of possibilities, but had concluded that the most practicable approach should be modeled on the existing Termination Benefits Fund (TBF), which authorized the management to offer at its discretion financial assistance to those staff members whose separation was deemed to be in the interest of the institution, the Director of the Administration Department indicated. Such financial assistance took the form of a payment of up to 1 1/4 months' salary for each year of service with a ceiling of 18 years of service, the equivalent of 22 1/2 months of salary. A staff member receiving that financial assistance under the TBF scheme had a choice between taking the amount in a lump sum or requesting terminal leave status and receiving the amount by way of salary payments over a period of time.

It was proposed that those essential elements of the TBF policy should be applied as well under the early retirement assistance scheme, the Director went on. The Board was being requested to authorize the commitment of a total of $4.5 million in salary payments under the proposed scheme, which would be reserved for staff in downgraded positions who qualified in terms of age, who applied by June 1987, and who agreed to resign or to go on terminal leave status by the end of 1987. The $4.5 million was in addition to the normal appropriations for the TBF scheme, of about 8/10 of 1 percent of payroll--approximately $750,000.

The authorization sought was for an amount that would cover direct payments equivalent to salary to be paid to individual staff members, the Director explained. In addition, there were certain ancillary costs that were more contingent in nature. For example, payments made to a U.S. staff member would also entail a tax allowance, and if staff members elected to take terminal leave rather than a lump sum, then the institution would continue making contributions to the staff retirement, life insurance, and medical benefits plans. However, a staff member on terminal leave under those arrangements would not be entitled to any other benefits, and no service credits would accrue during that period.

While the cost of the direct payments of $4.5 million was a substantial amount, it was believed that the benefits were more substantial, albeit not easily quantifiable, the Director commented. Those costs would be recovered substantially over time through the abolition of some positions, and staff members taking early retirement would be replaced by new staff at a lower salary level. It was noteworthy that most of the staff members whose positions had been downgraded had salaries that were above the ceiling of the new salary ranges applicable to their positions. In addition, the change would lead to improvements in productivity and staff morale, because staff members who accepted downgrading were somewhat demoralized, giving rise in turn to demoralization of the staff members around them. Finally, it was important for the institution to recognize that there was a certain welfare objective to be attained that was not quantifiable in financial terms.

One correction was necessary with respect to the distribution of termination payments across four fiscal years--FY 1987 to FY 1990--the Director of Administration said. Although the actual outlay of early retirement payments was expected to occur as shown on page 8 of EBAP/86/207 (8/26/86), the budgetary impact would be somewhat different. The Treasurer's Department had indicated that because of a new accounting standard promulgated in the United States, which the Treasurer's Department considered applicable to the accounts of the Fund, the termination payments had to be recorded in the year in which they were committed. It appeared that the figure for FY 1988 would be $3.6 million rather than the $2.4 million listed in the staff paper, and that no costs would be accounted for in the FY 1989 and FY 1990 budgets. By the time the FY 1988 budget was being prepared, the staff would have a more precise indication of the distribution of the cost as between FY 1987 and FY 1988.

Mr. Kafka said that he was concerned by a number of points connected with EBAP/86/207. First, the main purpose of the job grading exercise had been the grading of jobs--not of people--and therefore the main response to the downgrading of jobs should have been internal transfers and retraining. He would have expected the staff to ask the Board first to consider proposals for internal transfers or at least a scheme of internal transfers, and second, to consider proposals including budgetary allocations for retraining. He was thus concerned that the initial proposal was related to financial incentives for individuals who might elect to take early retirement, because that was not the most productive order in which the matters should be considered. He preferred to postpone a decision on EBAP/86/207 until the Board had had the opportunity to discuss the internal transfer methods and a retraining scheme.

As for the early retirement scheme itself, Mr. Kafka continued, he wondered whether it was really sufficient to give assistance to those who were within a year or so of taking early retirement, or whether there should not also be some scheme for younger people that would facilitate their retirement from the Fund if other positions could not be found for them, and perhaps after they had participated in the retraining scheme.

Finally, the proposed decision raised problems, because he was not at all convinced that the Board should approve a scheme in such general outline, Mr. Kafka added. The Board might instead authorize the staff to prepare a detailed early retirement scheme, which the Board could then consider. He thought that such a procedure was preferable to the approval of the proposed decision, which would then need to be translated into precise language, during the process of which numerous unexpected points needing attention from the Fund might emerge.

Mr. Fujino, noting that discussions of staff issues often involved the issue of parallelism between the Fund and the World Bank, asked whether the proposed early retirement assistance scheme had a parallel at the Bank, or whether it was meant to apply only to Fund staff, given the relatively larger number of downgraded positions in the Fund.

He shared Mr. Kafka's view that the purpose of the job grading exercise had been to streamline the organization and not to evaluate the functioning of individuals, Mr. Fujino added. However, the staff paper gave him the impression that the job grading exercise had been used to identify some persons who had been judged deficient and who would be encouraged to leave under the proposed early retirement assistance scheme.

Mr. Suraisry, alluding to the earlier remarks of Mr. Kafka, noted that the staff paper had indicated that the administrative budget contained $0.9 million for the early retirement assistance scheme and that "the formal endorsement of the Executive Board is now requested." He wondered whether there had been an understanding at EBM/86/16 about such an early retirement assistance scheme.

Mr. Zecchini asked what the age distribution was for the employees whose positions had been downgraded. He wanted to know whether the 55-year limit applied to a large or a small group of potential users of the early assistance retirement scheme.

The Director of the Administration Department recalled that when the Board had considered the management's proposal to proceed with the job grading exercise, there had been discussion of the possibility of providing financial assistance to staff whose positions had been downgraded. While no endorsement of a specific proposal had been sought at that time, the staff had noted the considerable support that Directors had expressed for some kind of financial assistance scheme. Accordingly, some funds had been budgeted in the current fiscal year to be used for any early retirement assistance scheme that the Board might approve. Thus, the management was presently seeking approval for such a scheme.

One feature of the scheme was to restrict eligibility to those staff members who were at least 55 years old, or who would be sufficiently close to that age by December 31, 1987--when the grandfathering period expired--to permit the maximum period of terminal leave to bridge them to the early retirement age, the Director noted. That age eligibility had been incorporated in the scheme because the 55-year-old staff members would be entitled to draw their pensions immediately.

The World Bank had a termination benefit scheme similar to the TBF scheme at the Fund, the Director indicated. Although the Bank administration was aware of the proposed early retirement assistance scheme, the Fund had not sought the views of the Bank because the percentage of Fund staff in downgraded positions was much higher than that at the Bank, and the treatment accorded by the Fund to those staff members was a matter that the Fund itself would have to decide.

Rather than trying to develop retraining or redeployment schemes, the Administration Department had concentrated first on developing an early retirement assistance scheme for staff near 55 years of age in downgraded positions because it was felt to be the most cost-effective and appropriate solution for that group of staff, the Director continued. Of course, those individuals who opted not to take early retirement would be eligible for the same opportunities for retraining and redeployment that would be provided for younger staff members. However, it was important to remember that retraining and redeployment schemes involved a long-term commitment and were not inexpensive. Moreover, the prospects for meaningful retraining for senior personnel were rather limited. All those factors had led to the proposal for an early retirement assistance scheme for the 86 eligible staff members.

It was indeed possible to lower the age limit and provide financial assistance to additional staff members whose positions had been downgraded, but an enlarged program would be quite expensive, the Director of the Administration Department said. The current recommendation was to initiate an early retirement assistance scheme for age-eligible employees whose positions had been downgraded. Inasmuch as the Fund's discretionary TBF policy continued to be in effect, financial assistance could be made available on a case-by-case basis if it was decided that it was in the interest of the institution for an individual to leave, regardless of age.

The staff representative from the Administration Department said that if the age eligibility were lowered to 50 years, an additional 38 staff members would be eligible for the early retirement assistance scheme, and if the limit were lowered to 45 years, a further 40 employees would be eligible, which would of course have a significant upward impact on the estimated cost of the scheme.

As for the termination benefits offered by the World Bank, the staff representative continued, the Bank maintained a special leave policy that was identical to the Fund's TBF policy in that it allowed the Bank the discretion to provide staff members with up to 22 1/2 months' salary as severance pay or to encourage separations. The Bank had not introduced a formal scheme to assist staff in downgraded positions, but it was his understanding that the Bank had been using the special leave policy for that purpose, and had obtained approval for some expansion in the special leave budget to provide termination benefits for staff in downgraded positions.

In addition to the difference in the proportion of downgraded positions relative to total staff positions in the two institutions, there was a significant difference in the composition of the downgraded positions, the staff representative from the Administration Department pointed out. The Fund had a higher proportion of downgraded positions at the senior levels, whereas the greatest impact at the Bank had been on support staff and some lower professional positions.

Mr. Kafka commented that in comparing the cost of an early retirement assistance scheme for staff members at least 55 years old and possible schemes for younger staff, one had to take into account the salaries that were being paid to the younger individuals whose positions had been downgraded, and to consider the costs of demoralization and diminished productivity as well. Given those factors, he was not convinced that the cost of broadening the age eligibility for financial assistance would in fact be that expensive.

He understood that a retraining scheme for staff in downgraded positions would involve some time and would be expensive, but a redeployment scheme could be set up at little if any cost and could be implemented quickly, Mr. Kafka indicated. Perhaps the staff could explain further what was being done about redeployment before the discussion on the financial assistance scheme continued.

The Acting Chairman said that while the job grading exercise had indeed been undertaken to evaluate positions and not the individuals in those positions, the downgrading of any job did in fact have an impact on the staff member holding that position. One solution would have been to implement an open-ended grandfathering procedure, so that the individual in a downgraded position would not suffer any loss in salary, but such an open-ended policy would have resulted in a much longer period of streamlining. However, the Fund had agreed to a two-year grandfathering period, and thus the Board needed to discuss ways of helping the individuals who remained in downgraded positions at the end of the grandfathering period. A proposal for an early retirement assistance scheme was currently before the Board, and proposals for retraining and redeployment programs would be considered in due course.

Mr. Goos recalled that his chair had previously expressed a preference for the permanent grandfathering arrangement, despite the problems associated with such an open-ended procedure. Some of those problems could have been mitigated by the early implementation of retraining and redeployment programs; in addition, his chair previously had suggested that efforts could be made to reformulate and upgrade the job content of positions that had been downgraded. He wished to know whether that suggestion was being considered or whether it had been discarded.

The staff representative from the Administration Department replied that the enhancement of the content of some positions would certainly be pursued during the next few years. However, that process would have to be approached slowly and carefully, in view of the appeals process currently under way. He thought that difficulties would arise in the appeals procedure if actions were taken concurrently to expand the job content of a number of positions as a vehicle for raising grades.

In addition, the enhancement of job content would have to be done in a controlled fashion, since one of the objectives of the job grading exercise had been to establish greater control over the classification and the grading of positions, the staff representative indicated. It would certainly be possible to expand the job content of some positions on a case-by-case basis.

Some steps had been taken already to facilitate the redeployment of staff members in downgraded positions, the staff representative continued. For instance, when a department announced a vacancy on the Vacancy List--which covered all noneconomist positions through Grade A15--the Administration Department indicated to that department which, if any, of the applicants currently held a downgraded position, and requested that special consideration be given to those individuals who were identified by an asterisk, provided that they were qualified for the position.

New initiatives had been taken as well to begin retraining staff members in downgraded positions, the staff representative from the Administration Department remarked. Discussions had been held with a number of staff members who had expressed interest in retraining, and some individual training had already begun through the Individual Study Program, by which staff members could receive financial assistance from the Fund to undertake university course work. However, the 86 staff members in the age-eligible category that formed the basis of the proposal before the Board were occupying quite specialized positions and many had been operating in one field of endeavor for a period of 25-30 years, making difficult the process of redeployment. Moreover, those 86 individuals had a relatively short time remaining until the mandatory retirement age, which raised some cost-benefit questions about undertaking a large retraining effort that might involve two or three years of intensive training with a limited--if any--rate of return once the staff member returned to full-time employment. Finally, it was important to remember that redeployment was more difficult in an institution that was not growing. Because the Fund was not growing and was not expected to do so in the course of the next few years, it was necessary to rely almost entirely on attrition in order to have positions into which staff in downgraded positions would be redeployed. In aggregate, therefore, those factors were a constraint on the development of retraining and redeployment programs, particularly for the 86 staff members within 10 years of the mandatory retirement age.

Mr. Kafka said that he was surprised and disappointed to hear that the only method of redeployment being used was what might be called "redeployment by asterisks." He did not consider such a method efficient, and thought that a serious effort at redeployment would involve additional steps. For example, one might interview those individuals in question to ascertain where in the organization they thought that they might be able to serve usefully and at a higher grade; and one would then request the administrators who had such positions available to consider those individuals. The Administration Department should not rely solely on attrition or asterisks to solve the problem of downgrading, but should try to develop a broader, more efficient system of redeployment and retraining.

The Director of the Administration Department pointed out that the Department had no intention of limiting its efforts to what had been done to date. Over the next few years, a great deal of time and effort would be devoted to the development and implementation of a broad strategy that would take into consideration each individual's potential as well as the overall needs of the institution.

The Acting Chairman commented that in addition to the efforts of the Administration Department, the Senior Review Committee--which he chaired--was devoting a great deal of attention to strategies by which senior staff members at the B1-B4 grades could be offered positions in which they could serve effectively. The development of those strategies extended beyond the placement of an individual senior staff member in a position that had become vacant by attrition; it included a broad review by the Committee of the overall short- and long-term needs of departments and how those needs might best be met.

The Fund had been making efforts to improve mobility at all levels of the institution, the Acting Chairman continued. Although more needed to be done to enhance mobility at the senior levels, that would not be easy to accomplish for a number of reasons. Sometimes individuals were resistant to mobility schemes, and sometimes department heads were reluctant to lose the skills and expertise of staff members who had had considerable experience in a given endeavor. Of course, the issue of mobility for senior-level personnel was a general one that was not directly related to programs for individuals whose positions had been downgraded, but it was important to note that the Fund was devoting considerable attention to the overall question of the most effective employment and redeployment of the staff, at all levels.

Mr. de Forges asked how many staff members whose positions had been downgraded effective January 1, 1986 had subsequently obtained a new position at their former or even higher level.

The staff representative from the Administration Department replied that five to six staff members whose positions had been downgraded had either resigned or retired from the Fund, and that a similar number--five to six--had taken positions at a higher grade since January 1, 1986. In addition, it was likely that the first phase of the appeals procedure would lead to the reclassification at a higher level of a proportion of the staff whose positions had been downgraded.

Mr. Vasudevan noted that the World Bank had a policy that was similar to the TBF policy at the Fund and that the Bank had not adopted any special scheme to assist staff members in downgraded positions. Therefore, he wondered whether it was necessary to take a special decision to establish an early retirement assistance scheme when the TBF policy was already in effect.

The Director of the Administration Department replied that more funds were needed for the early retirement assistance scheme than were available under the standard TBF appropriation, which was about 8/10 of 1 percent of payroll. Although funds would be included for the TBF scheme in the budget for the current year as well as for future years, the nature and magnitude of the early retirement assistance scheme required an additional appropriation.

Mr. Vasudevan suggested that it would be preferable to continue with the year-by-year authorizations rather than to make a four-year commitment. It would thus be possible for the Board to assess how well the early retirement assistance scheme was working and to compare the experience of the World Bank with that of the Fund. In addition, current details about redeployment and training possibilities would be available to the Board each year when the decision was taken.

The Director of the Administration Department indicated that the Department needed to have a budgetary commitment before making a commitment to staff members, and that $0.9 million was insufficient to meet the scale of commitments expected. The Department did not wish to wait for a budgetary authorization for FY 1988--when the bulk of the funds would be committed--because the affected staff members needed, for planning purposes, to be given sufficient advance notice of their eligibility for the early retirement assistance scheme. The Department considered that the question of the older staff members in downgraded positions was special, and that it therefore needed the authorization to deal globally with the special circumstances.

Mr. Fugmann commented that implicit in the remarks of the Director of the Administration Department was the need for an automatic system under the early retirement assistance scheme as distinct from the discretionary approach applied under the TBF policy. Even though there was still scope for discussion of the general rules that would apply under any early retirement assistance scheme, he certainly supported the concept of automaticity for eligible staff members.

Mr. Vasudevan, noting that the proposed early retirement assistance scheme would require eligible staff members to agree to separate from the Fund by end-December 1987, asked why it would not be possible instead to provide benefits under the TBF policy on a case-by-case basis, supported by annual budgetary appropriations.

The Director of the Administration Department responded that authorization had been requested to offer early retirement assistance benefits to ageeligible staff members so that they could leave the Fund before suffering the impact of having their salaries frozen on December 31, 1987, the end of the grandfathering period. It was important to have financial authorization from the Board that was sufficient to provide for all the eligible applicants, so as to avoid the difficult situation that the Administration Department would otherwise face, namely, of having to select the eligible applicants and having to tell the others that they would have to wait until additional funds became available. The issue of morale was not insignificant, particularly since the staff members in downgraded positions already felt injured by what had happened to them. He thus urged the Board to authorize a more appropriate way of dealing with the affected staff members, namely, equally, and as a group, rather than on a case-by-case basis.

Mr. Vasudevan inquired whether staff members wishing to participate in the early retirement assistance scheme--but not until FY 1990--would have to indicate by June 30, 1987 their intention to separate from the Fund.

The Director of the Administration Department replied that under the proposed early retirement assistance scheme, all staff who wished to participate would need to notify the Administration and make appropriate arrangements prior to end-December 1987, including an agreement that they would retire by end-1987. Staff members could either leave the Fund immediately and take a lump sum payment, or they could opt for terminal leave status whereby they would continue to be maintained on the books as staff members, with their payments spread over a period just as salary payments would be. Thus the payments shown in EBAP/86/207 extended from FY 1987 through FY 1990 because the staff members in terminal leave status would still be receiving payments under the scheme. According to the accounting system that the Treasurer's Department had noted, however, the commitment for all funds to be paid under the early retirement assistance scheme would now be accounted for on an accrued basis in the FY 1987-88 budget.

Mrs. Walker said that it was clear from the discussion that the difficult policy matter of providing financial assistance to staff members in downgraded positions was one that was of concern to everyone. The matter needed to be handled in a way that was best for the staff involved as well as the institution, and thus she preferred that the early retirement assistance scheme be treated as a total package with the necessary funds committed so that all eligible staff could participate. Financial assistance might also be extended to younger staff members on a case-by-case basis, although the cost of expanding the program did have to be kept in mind. It might also be worthwhile to apprise younger staff members of the existence of the TBF policy.

In addition to the financial assistance, emphasis should be given to retraining and redeployment where it was feasible, Mrs. Walker continued. It was true that retraining and redeployment might be difficult to effect in the Fund--an institution that did not have a large number of areas in which staff could work--and she recognized that the Administration Department would face some limitations as it developed those programs.

Information on the World Bank approach to the problem was most relevant, and should have been included in the paper, especially since World Bank policies had been discussed in depth for all other aspects of the job grading exercise, Mrs. Walker indicated. It would also have been helpful to have additional statistics on the number of months of salary being given under such schemes in other international organizations or other appropriate comparator organizations. Perhaps the staff could elaborate further on those schemes. She recognized that the 22 1/2 months under the proposal in EBAP/86/207 was to the period in the TBF policy, which obviously had been included for a particular reason, but it would have been useful to have comparative data.

Mrs. Walker wondered whether it was necessary to offer the financial assistance scheme to employees age 63 or 64 who were only two years away from retirement in any case. It seemed that the Fund would be paying simultaneously for their salary and that of their replacement. Any staff comments would be appreciated.

The staff paper had not mentioned the termination grant, which was available to any staff member who left the Fund after five years of service, Mrs. Walker remarked. She wondered whether staff members receiving benefits from the early retirement assistance scheme would also benefit from the termination grant. It would be difficult for her to support a scheme that included both of those benefits.

Mr. Suraisry made the following statement:

> The paper before us raises a number of important issues bearing on how the Fund can provide equitable treatment of staff in downgraded positions, while at the same time protecting staff morale and ensuring an efficient use of limited staff resources.
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> I agree that the proposal before us is sensible under the circumstances. I welcome the fact that the projected costs will be contained well below those incurred by the 1980 scheme. The proposed scheme is also preferable to the 1980 scheme in that it should not raise so many equity and morale issues. In this respect, the principle of ensuring that this scheme is neither more nor less attractive than the current termination benefits system is crucial. Therefore, I support the proposed decision.
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> More generally, I believe it is important to review the issue of the early retirement assistance scheme in the broader context of the conditions affecting staff mobility. As the staff paper indicates, over the past few years the Fund has taken a number of measures to improve termination benefits and to encourage early retirement. These measures have been made necessary, in part, because of the relatively low turnover in Fund staff. In the present system there is a bias against leaving the Fund. In particular, I am concerned that the financial incentives to stay may be so large as to lead to a situation in which staff members may wish to remain at the Fund even though it may be neither in their interest nor that of the institution for them to do so. This clearly exacerbates the difficulties associated with the downgraded

positions. Therefore, there may be a need for correcting this bias. Of course I understand that this is not the occasion on which to discuss how best to modify the entire benefits package. I hope, however, that such considerations will be taken into account.

Finally, I concur with Mr. Kafka's remarks about the need for the Fund to do more in relation to staff mobility and retraining.

Mr. Fugmann said that the early retirement assistance scheme outlined in the staff paper was reasonable and was fair both to the staff members and the institution. Therefore, he supported the proposed decision. He attached considerable importance to the automaticity of the scheme. While he shared fully the views of Mr. Kafka and Mr. Goos on the need to accelerate the development of retraining and redeployment programs, he did not wish to postpone the decision unless it was absolutely necessary. Although he would have difficulty supporting any lowering of the age eligibility limit for the early retirement assistance scheme, he wondered whether a tightening of the TBF policy would put Fund staff at a significant disadvantage vis-à-vis past policies if, as had been stated in the staff paper, "a very restrictive stance would be taken in approving termination payments under the existing discretionary TBF policy."

Mr. Foot agreed with Mrs. Walker that it was important for papers such as EBAP/86/207 to include information on the parallel policies in operation at the World Bank. There was a fine line between insufficient information and sparing the Board from too much detail. His feeling was that he did not have the entire picture, and he would have liked to have more information in the staff paper.

On grounds of equity, the proposed early retirement assistance scheme seemed clearly justified, and he therefore fully supported the proposed method of helping staff members adjust to the results of the job grading exercise, despite the considerable cost, Mr. Foot continued. While the decision did not have to be taken that day, it did have to be taken quite soon, so that the scheme would be adequately financed to permit the Administration Department to make commitments to all eligible staff.

He preferred for the moment to keep the age eligibility limit at 55, but if the staff came back to the Board in due course and said that problems had been arising with staff members at a lower age, he would be willing to consider any subsequent proposals to expand the termination benefit scheme or some other approach, as necessary, Mr. Foot added. It was clear that such issues were difficult, and the Fund had little experience with them.

His chair had supported the concept of an early retirement assistance scheme in principle in January 1986 because of considerations of equity, but also because of the potential for savings in overall staff costs, Mr. Foot remarked. However, the grounds for support in terms of staff costs currently seemed somewhat less firm. The data in the interim report on the job grading exercise (EBAP/86/132, 6/5/86) showed that the results had differed from those originally forecast by the management. The results appeared more favorable than initially expected, in the sense that a lower percentage of staff would be downgraded, and if anything the figures were liable to additional change in that direction by the appeal procedure that was currently under way. At the time of a subsequent review of the job grading exercise, it would be helpful to discuss how the changes in the results had occurred and what the future implications were for the Fund. Another important point that merited future discussion was the question of the pension system and whether its current mode of operation discriminated unduly heavily on staff members wishing to leave the Fund after a short tenure, with a resulting bias against leaving the Fund. That feature of the present system was one reason that an ongoing TBF scheme was needed.

Finally, it was important for the staff to receive a clear, unambiguous answer on the early retirement assistance scheme, Mr. Foot concluded. It was essential to have a decision immediately, and he hoped that the decision would be favorable.

Mr. Fujino said that he understood the need for an early retirement assistance scheme, but the figures in the staff paper had given rise to some questions. It was estimated that nearly half of the 86 eligible staff members would participate in the scheme, and that that number was over and above the usual number of early retirements and other departures. He believed that the departure of some 40 or 50 staff members should lead to a reorganization of various positions or the staffing of those positions, along with additional streamlining. He wished to have some indication of what reorganization was being planned and what savings effect was envisaged. Although he could basically support the proposed scheme, he wished to have more information on the projected savings.

Mr. Engert said that he favored the automaticity of the proposed early retirement assistance scheme before the Board because he believed that an ad hoc or discretionary approach would not enable affected staff members to take informed decisions on the basis of the Board's commitment to a particular scheme. We shared Mr. Kafka's concern with respect to the order in which specific proposals had been presented and to importance of providing options for retraining and redeployment of staff. He would be interested in seeing progress in those areas. In addition, Mr. Goos's suggestion to upgrade the job content of certain positions could be useful. Finally, this chair supported the proposed decision, and he hoped that the Board would be able to reach an unambiguous, positive decision at the present meeting.

Mr. Zecchini said that he would have appreciated having better information in the staff paper on several points raised already in the discussion, particularly on the World Bank approach to early retirement assistance.

He was in agreement with the principle that in order to have a better-motivated staff and to preserve staff morale in the face of the recent job evaluation exercise, it was advisable to provide additional incentives for age-eligible staff members in downgraded positions to take early retirement, Mr. Zecchini continued. In that respect, he believed that the proposed scheme was a viable one that had some merits. First, it provided objective criteria for eligibility for the early retirement assistance scheme: age and the fact that the staff member's position had been downgraded. Second, the scheme would be part of the existing TBF policy, thereby avoiding the perception by other staff members that individuals whose positions had been downgraded had been offered an excessively generous treatment. On that basis, he could support the proposed scheme.

He wished to know whether the staff held the opinion that the proposed scheme would provide adequate incentives to age-eligible staff members to opt for early retirement, Mr. Zecchini commented. Furthermore, he believed that there was still some scope for bringing the age limit down to 50 years. Finally, as to the general approach to easing the hardship involved in the transition to the new job grading system, he considered staff mobility, retraining, and enhancement of job content just as important as the early retirement assistance scheme.

Mr. Wijnholds agreed with other speakers that early retirement was not the only way to deal with the problem of staff whose positions had been downgraded, but he thought that redeployment and retraining, while important in principle, were difficult to effect and were probably not of great significance for the group of staff members who were 55 years of age.

He could support the proposed scheme, and he thought that the Board should not delay further in taking the decision, Mr. Wijnholds indicated. The early retirement of individuals in downgraded positions had to be facilitated immediately to promote the separation of those staff members who were feeling somewhat demoralized and who might have a negative influence on others working with them. As for the age limit, he preferred to retain the 55-year limit, but if necessary, he was willing to reconsider that issue in the future.

Mr. Parmena made the following statement:

> I support the staff proposals before us today for a scheme to encourage and facilitate early retirement of staff members whose positions have been downgraded. The administration will be in a better position to handle this issue if the decision is taken today rather than later, and in a global, not in a piecemeal, fashion. It is in the Fund's interest, if its efficiency is to be enhanced, to adopt a general policy that will apply to all staff members adversely affected by the job grading exercise. In this connection, it may be appropriate to quote the Managing Director's remarks at the 1986 Annual Meetings when he said, "Let us never forget that an institution ultimately draws its value from the men and women who make it up. Let us find a way to motivate them, to

show them our esteem, and to assure them of our commitment to a truly international and high quality staff."

Since the basic rationale of this scheme is to eliminate, as soon as possible, the negative impact of the job grading exercise on staff morale and efficiency, then a comprehensive solution should embrace the total number of staff members in downgraded positions. The object should be to overcome the morale and efficiency problem by seeking an early replacement where possible, and by uplifting the morale and efficiency of those staff members who will be retained. The proposed scheme is focused on only 86 staff members who will be within reach of 55 years by the end of 1987, when the grandfathering period expires. The reason for targeting this small group is quite understandable. For the younger staff whose positions have been downgraded, the retirement option is not a practical solution, even with some financial inducement, in the absence of alternative employment.

For the larger proportion of staff whose positions have been downgraded--the 184 who are not targeted under the proposed scheme--we share Mr. Kafka's view in strongly urging the Administration Department to pursue vigorously alternative lines of action that will eliminate the frustration associated with downgrading. This should include redeployment through internal transfers, retraining including the use of all the Fund's training facilities and policies, and assistance in the location of suitable jobs outside the Fund. In this connection, I would reiterate the position stated by this chair in January 1986 when we called for an active policy to mitigate the effects of downgrading by, inter alia, the establishment of a unit in the Administration Department to assume the responsibility for the rehabilitation of downgraded staff members, or the assignment of an existing unit to perform those functions. The importance of this policy to the Fund's efficiency cannot be overemphasized. We appreciate the staff explanation for limiting the age eligibility under this scheme to those staff members who are within reach of the early retirement age. We have noted, nonetheless, that those who are not within reach of 55 years can also apply for the benefits under the TBF policy but that their applications will be considered on a case-by-case basis along with other applications, and within budgetary limits. If this does not prove to be too costly, I would recommend that their applications be looked at more favorably if it will induce their faster separation from the Fund.

Finally, I note that the cost of this scheme compares well with previous schemes such as the pension augmentation scheme, which was in operation for a short period in 1980 and aimed at the replacement of 20 senior staff members, 17 of whom accepted accelerated retirements at a high cost of $4 million. The present scheme, with the objective of inducing more than twice the number to retire, costs only $4.5 million and I would urge the Fund to ensure that the costs be held to the minimum.