on interest rates be phased out and savings institutions reformed to help increase saving and the efficiency of financial intermediation.

Economies in Transition

In the Fund's classification of countries, transition economies cover three groups: central and eastern Europe and the Baltic countries; Russia and the other countries of the former Soviet Union; and Mongolia. Although each of these displays unique traits, a characteristic common to all of them is the transitional state of their economies from a centrally administered system to one based on market principles.

Among the central and eastern European countries and the Baltic countries, the Board concluded Article IV consultations with Albania, Bulgaria, Croatia, the Czech Republic, Estonia, Latvia, Lithuania, the former Yugoslav Republic of Macedonia, Poland, Romania, the Slovak Republic, and Slovenia. In general, economic performance in these countries continued to improve; attempts to keep inflation under control were mainly successful; and further advances were made in the liberalization of trade and payments systems. Some worrying fiscal developments had emerged in many countries, however, and progress in implementing structural reforms—especially in the financial sector—was uneven.

All of these countries were pursuing serious stabilization and reform efforts. Those countries that had adopted strong programs at an early stage and were more advanced in the transition—such as Albania, the Czech Republic, Poland, the Slovak Republic, and Slovenia—were reaping the benefits in the form of rapid growth. Directors observed, however, that signs of possible overheating had emerged in the Czech Republic, and that in Poland reducing inflation had proved more difficult than anticipated.

Although most countries had succeeded in keeping inflation in check, price stability would continue to pose a major challenge. For those countries where there was a potential for overheating, Directors stressed the need to strengthen policies to achieve an early slowing of inflation and wage increases. In this context, Directors noted with concern the relaxation of fiscal policy in many countries and underscored the need for continued vigilant and prudential fiscal management.

Progress in achieving structural reform was mixed. In particular, fragile banking systems and financial indiscipline had been a major source of macroeconomic instability in some countries. In Latvia and Lithuania, the slow pace of banking reforms and the failure to react quickly to signs of trouble had resulted in full-scale banking crises. Enterprise restructuring and privatization efforts had also bogged down in many countries—even in some of the more advanced economies, such as the Slovak Republic and Slovenia. In other countries, such as the former Yugoslav Republic of Macedonia and Romania, stabilization remained fragile because of slow progress in implementing structural reforms.

Directors expressed broad support for the flexible exchange rate policies adopted by most of these countries—which gave appropriate scope to the play of market forces. Many urged other countries, such as the Czech Republic and Poland, to introduce more flexibility into their exchange rate regimes. Some other Directors counseled the authorities to guard against significant erosion of competitive positions in the wake of strong inflows of capital and their potential impact on the exchange rate. Several Directors called into question the efficiency of capital controls, however. In general, Directors urged the authorities to monitor the external situation carefully and to stand ready to adjust the policy stance as needed.

Virtually all countries in this group had taken further steps to liberalize their trade and payments systems, and several were moving toward—or had achieved—full current account convertibility. A worrisome exception was Romania: Directors noted renewed problems in the exchange market, and they underscored the importance of sustained and consistent application of the policy understandings that had been reached regarding exchange rate management as a basis for continuing Fund support.

In the case of the other transition economies, Article IV consultations were concluded in 1995/96 with Armenia, Azerbaijan, Belarus, Georgia, Kazakstan, Moldova, Mongolia, Russia, and Ukraine. Directors welcomed the determined efforts in most of these countries directed at stabilization and market-oriented reforms, although they regretted that Ukraine's effort had faltered in the second half of 1995 after a promising start. Many countries still had to contend with external and domestic instabilities, however, and slow progress in structural reform continued to keep even the more successful of them from realizing their full economic potential.

The fiscal situation in most of these countries remained fragile. Directors noted that permanent reductions in unproductive spending, together with measures to improve revenue performance, were needed. Directors cautioned, however, against deep, unsustainable expenditure cuts, emphasizing, rather, the importance of revenue-enhancing measures. In this context, they suggested that stronger efforts were required to improve tax collection and administration. Containing inflation continued to pose a major challenge, and for some countries—notably Russia—further reduction in inflation remained the policy priority. Nevertheless, Directors noted that in some countries, such as Belarus and Kazakstan, tight monetary and fiscal policies had succeeded in reducing inflation.

Table 32

GEORGIA: SELECTED ECONOMIC INDICATORS

(Data as of Board discussion in September 1995; annual percent change unless otherwise noted)

	1992	1993	1994	1995[1]
Domestic economy				
Real GDP	–44.8	–25.4	–11.4	–5.0[2]
Employment	–21.2	–9.7	–0.1	. . .
Consumer / retail prices (period average)[3]	887	3,125	18,922	160[2]
External economy				
Exports, f.o.b. (in millions of U.S. dollars)	267	457	381	181
Imports, c.i.f. (in millions of U.S. dollars)	645	905	744	399
Current account balance (in millions of U.S. dollars)	–318	–485	–446	–191
Capital account balance (in millions of U.S. dollars)	248	306	–19.3	–56.1
Gross external debt (percent of GDP)	8.2	51.7	80.2	42.6
Debt-service ratio (percent of exports of goods and nonfactor services)	0.7	2.9	31.1	51.2
Exchange rate (coupons / U.S. dollar, period average)[4]	. . .	. . .	1,102,300	. . .
Net international reserves (in billions of coupons, end of period)	–152	–37.4	3,308	–22,358
Financial variables				
General government balance (in percent of GDP; accrual basis)	–37.3	–26.2	–16.5	–5.9[2]
Broad money (end of period; including foreign currency deposits)	62	3,093	73,267	55,699
Interest rate (commercial bank deposit rate for coupons)	. . .	. . .	12.5–15	3–5

[1]January–June unless otherwise indicated.

[2]Projection for entire year.

[3]Before 1993, according to the retail price index; after December 1993 according to a 295-good Laspeyres index.

[4]According to the Tbilisi Interbank Currency Exchange.

Directors stressed that successful macroeconomic stabilization needed to be supported by strong and stepped-up progress in structural reform and noted with concern that the pace of such reform had been disappointing. Financial systems remained fragile, and Directors urged country authorities to take strong steps to reform the sector through improving banking supervision, enhancing banks' operational capabilities, and strengthening the regulatory framework for non-bank financial institutions. The pace of enterprise restructuring, privatization, and reform of the legal system also needed to be accelerated to ensure an effective transition from state-run to market-oriented economies.

Directors generally welcomed the pursuit of a flexible exchange rate policy by countries in the region. In the case of Russia, some Directors questioned the feasibility of simultaneously maintaining an exchange rate band and sticking to the revised money growth path needed for visible disinflation. For Russia, and for other countries as well, Directors emphasized the importance, in the light of changing circumstances, of keeping exchange rate policy under review.

Noting the fragility of the external position of many countries, which in some cases was compounded by a heavy external debt burden, Directors urged country authorities to restructure their external debt and to normalize relations with creditors. The prospects for some other countries, such as Azerbaijan, however, were more favorable, although Directors cautioned that the prospect of large revenues from oil exports should not weaken the resolve to maintain disciplined policies.

Georgia

In September 1995 the Executive Board met to conclude the 1995 Article IV consultation with Georgia and to conduct the first review of the program under a stand-by arrangement approved in June 1995. (In February 1996, the stand-by arrangement was replaced by Georgia's first annual arrangement under the ESAF; see the section on Fund Support of Member Countries.)

The Georgian economy began to show signs of stabilization in 1995, with remarkable progress in halting hyperinflation (see Table 32) and stabilizing the coupon exchange rate. The exchange rate first appreciated from an unofficial rate of 5 million coupons per U.S. dollar at the beginning of the stabilization effort in September 1994 to 1.3 million coupons by late 1994, but since then had been stable against the U.S. dollar and had appreciated against the Russian ruble. The rate of decline in output slowed, with encouraging signs of increased activity in agriculture, transportation, and retail trade.

A sharp reduction in the overall fiscal deficit from 16.5 percent of GDP in 1994 to 6.9 percent in the first half of 1995) played a central role in the stabilization effort. Revenue performance remained weak, mostly because of inadequate tax administration. Expenditure was reduced from over 24 percent of GDP in 1994 to about 13 percent in the first half of 1995, but there was little flexibility for further cuts.

Monetary expansion slowed considerably: reserve money grew by 25 percent in the first half of 1995, compared with about 400 percent in 1994. There was virtually no National Bank lending to commercial banks in the first half of 1995, and foreign exchange operations were used to partially sterilize net credit to the Government. The rise in reserve money resulted from a greater demand for newly introduced domestic currency than had been anticipated and was accompanied by stronger-than-programmed performance in net international reserves.

Structural reforms included the reorganization of the State Tax Service, the implementation of a treasury project, and an assessment of government domestic expenditure arrears. A notable action was the removal of 132,000 health sector personnel from the budgetary payroll as part of a move to a fee-for-service health care system. Draft land reform and antimonopoly laws were submitted to the Parliament. However, there were also slippages in structural reform, the most important being the accumulation of new budgetary obligations for gas imports.

Progress on statistical issues was mixed. A new consumer price index was developed, and improvements in government finance and monetary statistics were implemented, but little headway was made on national income and balance of payments statistics.

Directors commended the authorities on their determined efforts at stabilization and market-oriented reforms in extremely difficult circumstances. They were encouraged by the initial signs that output in some sectors had begun to recover and by the success in halting hyperinflation, creating a positive environment for the introduction of the new currency, the lari.

Directors noted that public finances remained weak, and that success in stabilization was therefore highly fragile. Revenue performance, although improved, continued to be disappointing. Directors urged the authorities to intensify their efforts to further strengthen fiscal institutions, improve tax and customs administration, reduce widespread tax exemptions, and further improve mechanisms for monetizing food grants. They also noted the importance of vigilance in expenditure control.

Directors observed that the acceptance of the new currency by the population would depend on the diligent implementation of supporting financial policies. They therefore urged the authorities to resist any pressures on the National Bank of Georgia to loosen its credit policies. Careful monitoring of the monetary aggregates would be essential.

The weak state of the banking system was of serious concern to Directors, who urged the authorities to speedily design and implement a program that could address the deep-seated structural weaknesses in the banking system.

Board members noted Georgia's extremely difficult medium-term balance of payments outlook, dominated by its heavy external debt burden and urged the authorities to intensify their efforts to restructure their external debt and normalize relations with creditors.

Notwithstanding strong performance to date, Directors noted the unfinished agenda of structural reforms. They were disappointed about delays in the passage of commercial banking, land, and antimonopoly laws, but welcomed the progress that had been made in privatization during the previous year. They encouraged the authorities to act soon on the restructuring of government, a further downsizing of budgetary institutions, and improved targeting of social expenditures.

Mongolia

Directors met in February 1996 to conclude the Article IV consultation with Mongolia and to review its second annual arrangement under the ESAF. The discussion took place against the backdrop of the country's substantial progress toward a market economy.

Since it began the transition process in 1990, Mongolia had gained considerable ground, notably through comprehensive liberalization of prices, trade, and the exchange system. As a result, cumulative output loss had been held at about 20 percent during 1990–93, and in 1994 positive real growth resumed.

Transition efforts continued in 1995, supported by the second annual ESAF arrangement. The Government had taken measures in mid-1995 to renew financial restraint, and all end-1995 fiscal and monetary benchmarks under the ESAF program were met. Real GDP increased by 6 percent (see Table 33), and private sector activity continued to expand in livestock, mining, construction, and trading. The current account deficit (excluding official transfers) was held to 7 percent of GDP. Copper and noncopper exports increased, more than offsetting the effect of buoyant imports owing to the higher growth rate. Net official international reserves rose but were still equivalent to only six weeks of imports. External commercial borrowing was avoided, and outstanding external debt declined in relation to GDP. Inflation, however, was higher than planned, at 53 percent for the year.

In their discussion, Directors commended Mongolia for the progress made since 1990 in promoting macroeconomic stability and structural change. Although they expressed disappointment at the weakening of financial restraint in the first half of 1995, they welcomed the Government's corrective measures at midyear and its renewed commitment to continue reform. As a result, most program objectives had been met. Directors were particularly satisfied that real GDP growth had risen markedly for the year, and they

Table 33
MONGOLIA: SELECTED ECONOMIC INDICATORS
(Data as of Board discussion in February 1996; annual percent change unless otherwise noted)

	1994	1995[1]	1996[2]
Domestic economy			
Real GDP	2.3	6.3	5.0
Employment[3]	–12.7	0.9	3.0
Consumer prices (end of period)	66.3	53.1	25–30
External economy			
Exports, f.o.b. (in millions of U.S. dollars)	367.0	451.0	436.5
Imports, c.i.f. (in millions of U.S. dollars)	370.5	473.0	500.8
Current account balance (excluding official transfers; in percent of GDP)	–5.8	–7.1	–9.6
Direct investment (in millions of U.S. dollars)	7.0	10.0	14.0
Capital account balance (in millions of U.S. dollars)	–36.2	5.8	37.1
External debt (in percent of GDP)[4]	68.6	56.6	56.4
Debt service (in percent of current receipts)[5]	16.3	14.1	12.1
Exchange rate (Tug / US$, end of period)	414	474	539
Net official international reserves (in millions of U.S. dollars)	37.2	50.0	60.0
Financial variables			
Overall budget balance (in percent of GDP)	–24.6	–11.1	–10.9
Gross national saving (in percent of GDP)	15.1	16.6	14.8
Gross capital formation (in percent of GDP)	20.9	23.7	24.4
Broad money	81.4	27.2	30.0
Interest rates[6]	72–264	72–150	. . .

[1]Preliminary.
[2]Revised program targets.
[3]Based on a sample of the largest enterprises.
[4]Excluding debt of 10 billion transferable rubles to Russia and other former members of the Council for Mutual Economic Assistance (CMEA).
[5]Excluding servicing of medium- and long-term obligations in transferable rubles to Russia and other former members of the CMEA.
[6]Central bank clearing rate, in percent a year.

believed that prospects were good for continued strong output growth in 1996.

Directors were concerned, however, that the inflation rate remained excessively high and that Mongolia's external position was still fragile, as evidenced by the low level of reserves. They stressed the importance of implementing policies for more ambitious reduction of inflation and for strengthening the external position. Directors supported the 1996 budget, with its provisions for a higher current surplus in relation to GDP and for avoiding domestic bank financing of the overall deficit. They urged the Government to ensure that key revenue measures were fully in place at an early date, including eliminating income tax and customs duty exemptions, extending the sales tax, and strengthening tax administration. Firm control over current expenditure would be critical, Directors stressed; limiting the wage bill to less than the inflation rate and finalizing plans to reduce civil service employment were priorities. However, they said that adequate provision of education and health, in support of the country's urgent needs for human resource development, should be made during public sector downsizing.

Directors endorsed the 1996 financial program, which provided for increased credit to facilitate private sector activity while keeping strict limits on loans to public enterprises. In their view, monthly credit ceilings should be retained until banks had established a record of sound lending policies, and the gradual development of indirect instruments of monetary control should continue. Directors saw a need to strengthen the central bank so that it could effectively conduct anti-inflationary policies, and this would entail comprehensive modern banking legislation. They urged the authorities to accelerate rehabilitation of the banking system, including the strengthening of banking supervision and prudential regulation.

Directors stated that public enterprise reform was crucial to achieving budgetary, credit, and inflation objectives. In particular, energy price increases should be implemented at an early stage to cover operating costs, help meet investment needs, reduce the need for bank borrowing, and generate revenue. Similarly, the cash privatization program should be expanded to include large, profitable public enterprises, and actions taken to speed the rationalization or closure of unviable enterprises.

With regard to Mongolia's external position, in the Board's view the Government would need to improve absorptive capacity for official aid, avoid external commercial borrowing, and maintain competitiveness. Mongolia, Directors emphasized, was at a critical juncture in its economic transformation. It would be essential to implement policies resolutely under the ESAF arrangement and—in order to enhance credibility—to avoid further policy slippages. Mongolia's acceptance of the obligations under Article VIII of the Fund's Articles was welcomed.

Poland

Directors concluded the 1995 Article IV consultation with Poland in January 1996, reviewing the economic developments over the previous year. Poland continued to perform at the cutting edge of the economies in transition, and yet this strong progress had not been without its risks.

The country had enjoyed impressive GDP growth of over 6.5 percent during the year under review (see Table 34), reflecting growth of 9.4 percent in industrial production and a 13 percent increase in agricultural output. However, the expansion in activity was unbalanced, since it was driven mainly by exports and investment, while domestic demand remained subdued. Toward the end of the year, however, there had been signs of a pickup in real wages and consumer confidence.

Net international reserves had increased beyond expectations, overwhelming the National Bank of Poland's sterilization capacity and boosting broad money growth, which complicated attempts to bring down inflation. However, falling food prices, a hardening of the exchange rate policy, and some tightening of the fiscal policy led to a decline in inflation in the second half of 1995.

The authorities' main response to the surge in net international reserves was exchange rate action. The focus was initially on slowing down the rate of crawl, but in May 1995 an element of flexibility was introduced in the form of a crawling band of ±7 percent around the central parity. The zloty quickly appreciated to 5 percent (later 6 percent) above the central rate. Moreover, in December 1995 the authorities raised the central parity by 6 percent and allowed the actual rate to appreciate by 2½ percentage points.

The fiscal outcome in 1995 was better than expected, with the general government deficit provisionally estimated at 2¾ percent of GDP, but was still worse than in 1994. However, this good budgetary outturn was in part the result of high wage growth during 1995 (5 percent in real terms), which boosted income tax receipts and social security contributions. Privatization and corporate income tax revenues were also higher than expected, while expenditures were held slightly below projected levels.

The transformation to private ownership accelerated toward the end of the year, and a revised draft of the privatization law was being prepared. Also, a blueprint for the medium-term pension reform was approved by the Council of Ministers in December.

In their discussion, Directors commended Poland's impressive economic performance, including the very rapid industrial growth and the boom in exports, noting that the country's success was the result of several years of steadfast stabilization and reform efforts. They observed, however, that reducing inflation had proved more difficult than anticipated, and they emphasized the importance of forward-looking, reform-oriented policies for continued success.

Directors believed that further reduction of inflation should be the top priority for macroeconomic policy, and, to that effect, the framework for the conduct of

Table 34

POLAND: SELECTED ECONOMIC INDICATORS

(Data as of Board discussion in January 1996; annual percent change unless otherwise noted)

	1992	1993	1994	1995[1]
Domestic economy				
Real GDP	2.6	3.8	6.0	6.5
Unemployment rate (end of period)	13.6	16.4	16.0	. . .
Consumer price index (period average)	43.0	35.3	32.2	28.4
External economy				
Exports, f.o.b. (in millions of U.S. dollars)	13,997	13,585	16,950	22,971
Imports, c.i.f. (in millions of U.S. dollars)	13,485	15,878	17,786	24,395
Current account balance (in millions of U.S. dollars)[2]	1,575	–85	2,128	3,463
Direct investment (in millions of U.S. dollars)	284	580	542	900
Capital account balance (in millions of U.S. dollars)	–1,472	–679	–330	4,788
External debt (end of period; in billions of U.S. dollars)	48.2	48.7	40.9	39.4
External debt-service ratio[3]	20.0	21.5	16.2	15.3
Commercial exchange rate depreciation (–) against U.S. dollar (period average)	–22.4	–24.9	–20.3	. . .
Net international reserves (increase; in millions of U.S. dollars)	1,614	634	2,534	9,200
Financial variables				
General government balance (in percent of GDP)	–6.6	–2.9	–2.0	–2.8
Gross national saving[4] (in percent of nominal GDP)	17.0	15.5	17.8	18.6
Gross domestic investment (in percent of nominal GDP)	15.2	15.6	15.5	15.7
Broad money (money and quasi-money)[5]	57.5	36.0	38.3	34.0
Warsaw interbank offered rate (end of year, in percent)	44.3	34.1	28.4	25.5

[1]Fund staff estimates.
[2]Including unrecorded trade.
[3]In percent of exports of goods and nonfactor services in convertible currencies.
[4]July 1995.
[5]Percent change in stocks at end of year.

Table 35

ROMANIA: SELECTED ECONOMIC INDICATORS

(Data, except for 1995 outturn, as of Board discussion in December 1995; annual percent change unless otherwise noted)

	1992	1993	1994[1]	1995 Projection	1995 Outturn
Domestic economy					
Real GDP	–8.8	1.3	3.9	5.0	6.9
Unemployment rate	170	25.9	7.8	–10.0	–10.1
Consumer / retail prices (average)	210	256	137	31	32
External economy					
Exports, f.o.b. (in billions of U.S. dollars)	4.3	4.9	6.1	7.4	7.5
Imports, c.i.f. (in billions of U.S. dollars)	5.4	6.0	6.6	8.9	8.8
Current account balance (in billions of U.S. dollars)[2]	–1.5	–1.2	–0.5	–1.5	–1.3
Direct investment (in billions of U.S. dollars)	. . .	. . .	0.3	0.4	0.4
Capital account balance (in billions of U.S. dollars)	1.4	1.3	1.2	1.2	1.3
Gross external debt (in billions of U.S. dollars)[3]	3.4	4.4	5.5	5.9[4]	6.2
Debt-service ratio (in percent of current receipts)	8.1	5.8	8.9	13.0	12.1
Lei / U.S. dollar (end of period)	460	1,276	1,767	2,542[5]	2,578
Net international reserves (in billions of lei, end of period)[6]	80	368	2,389	2,192[5]	3,426
Financial variables					
General government balance (in percent of GDP)	–4.6	–0.1	–1.0	–2.8	–2.5
Gross domestic saving (in percent of GDP)	22.9	23.8	24.9	24.9	25.5
Gross fixed domestic investment (in percent of GDP)	18.8	17.9	20.0	21.0	20.8
Broad money (end of period)	80	141	138	52[7]	66[7]
Interest rate (weighted National Bank of Romania average, in percent)	44	416	78	56[5]	67

[1]Fund staff estimates.
[2]Excludes trade in transferable rubles.
[3]Convertible currencies, including letters of credit and payments due for imports received.
[4]September 1995.
[5]October 1995.
[6]Foreign currency and gold converted into lei at end-of-period exchange rates; gold and SDRs valued at constant dollar prices.
[7]The figure for 1995 excludes interest payments by the Savings Bank.

monetary and exchange rate policies needed to be clarified. While the crawling-peg regime had served Poland well in the past, Directors generally considered that a more flexible exchange rate policy could increase the effectiveness of monetary policy and bring about lower inflation. These policies should be supported by a tighter fiscal stance and resolute progress with structural reforms.

Directors commended the authorities for keeping the general government deficit to below the target of 3 percent of GDP but emphasized the importance of making further progress, primarily through fiscal consolidation. Directors underscored the importance for continued rapid growth and fiscal viability of further structural reforms. They welcomed the progress made in mass privatization and trade and exchange reform, including the acceptance of the obligations under the Fund's Article VIII. But progress in other areas had not been so extensive, and they urged that the authorities encourage broad reform of social security, strengthening of the revised privatization law then under preparation, and a timely completion of the restructuring and privatization of the commercial banks. Also, wage indexation should be reduced.

Romania

In December 1995 the Board met to discuss developments in the Romanian economy in 1994 and 1995 in the context of the 1995 Article IV consultation. They also conducted a review of, and considered a request for the extension and augmentation of, the stand-by arrangement with the Fund approved in May 1994 (see the section on Fund Support of Member Countries).

Economic performance during 1994 was marked by a sharp improvement in confidence, reflecting forceful implementation by the authorities of restrictive fiscal and monetary policies. Real money demand increased after four years of decline. The exchange rate stabilized at a market-clearing level by mid-1994, after which substantial purchases were made to rebuild official reserves. Consumer price inflation plunged to one third of its 1993 rate. Exports grew by 24 percent, and real consumption increased substantially, with economic growth accelerating to 4 percent in 1994 (see Table 35).

Economic developments in the first nine months of 1995 were more problematic. Already in the second half of 1994, slippages in structural policies were evident. The quasi-fiscal deficit in the enterprise sector was not addressed forcefully enough, resulting in strong credit pressures by early 1995 and a rundown in reserves. Intervention by the authorities in the exchange rate worsened the situation. Thus, although growth accelerated to 7 percent in 1995, balance of payments pressures re-emerged. Exports increased by 23 percent, but imports rose by twice that much, sharply widening the current account deficit.

Unemployment began to decline in 1995, and consumer prices continued to slow dramatically. Money demand increased, but more slowly than in 1994. Real wages accelerated sharply, boosting consumption and allowing real household saving to increase at the same time. By contrast, the financial position of the enterprise sector deteriorated significantly from early 1995, in part because of heavy stockpiling of imported raw materials such as oil and increased inventories in sectors dominated by large state-owned enterprises. Plans to slim down state-owned enterprises with large losses or arrears were delayed. And the National Bank's room for maneuver in tightening liquidity was limited by a large program of subsidized agricultural financing, launched by the Government in late 1994.

Directors noted that the Romanian economy had expanded strongly in 1994 and 1995, accompanied by sharply decelerating inflation and a reduction in unemployment. A continuation of this progress required an acceleration of structural reforms and steadfast stabilization. Directors expressed strong concerns that structural policies had begun to slip subsequent to the May 1994 approval of the stand-by arrangement. There had been renewed intervention in the exchange market, and pressures for credit to agriculture directed by the National Bank had been accommodated. These were seen as worrisome reversions to non-market-oriented policies and had contributed to a rapid expansion of credit and an unsustainable widening of the balance of payments deficit during 1995.

Directors welcomed the measures taken since September 1995 to improve resource allocation in the economy and to reduce the current account deficit. The fiscal tightening begun in late 1995 and planned for 1996 was urgently needed, given the serious balance of payments pressures.

Directors urged the authorities to avoid further interference with the functioning of the exchange market; this was essential to preserving confidence in domestic financial assets and preventing a further depletion of external reserves. Directors supported flexible management of the exchange rate, accompanied by tight financial and incomes policies to reduce inflation.

Directors agreed that the core source of instability in the economy was the quasi-fiscal deficit of the state enterprise sector. While some encouraging steps had been taken lately by the authorities, structural reform remained sluggish. It was most important that forceful action be taken to reform problem enterprises in state-owned industry and agriculture. While the legal framework for privatization was largely in place, successful implementation was necessary for an increase in private sector activity, which in turn was required if sustainable growth and a continuing rise in living standards were to be achieved.

Directors encouraged the authorities to improve the quality of data on the monetary and national accounts, as well as those on the operations of the major state-owned enterprises that had large losses or arrears. In light of Romania's fragile external position, it was imperative for the authorities to avoid further policy slippages or reversals and to fulfill all of their policy commitments; otherwise they risked undermining confidence in the economy, jeopardizing the economic recovery and posing a risk to the country's external position.

Russia

In September 1995, the Board discussed economic developments in Russia during the second half of 1994 and the first half of 1995 in the context of the 1995 Article IV consultation. At the same time, they conducted the first quarterly review of Russia's program under the stand-by arrangement approved in April 1995.

The key concern for the period under consideration was inflation, which after reaching a low of 4.6 percent on a monthly basis in August 1994 accelerated to 17.8 percent in January 1995. While it then fell significantly, to 5.4 percent by July 1995, it remained considerably above the objective for July of 1 percent. The slower-than-envisaged reduction in inflation was partly the result of base money growing faster than expected, owing to the effects of substantial inflows of foreign exchange.

On the external front, the current and capital accounts strengthened significantly during the first half of 1995. Mainly because of a rise in exports to countries outside the former Soviet Union, total exports rose by 18 percent over the first half of 1994 (see Table 36) and the consolidated current account registered a surplus of $3 billion, compared with a deficit of $0.4 billion in the first half of 1994. At the same time, a strengthening of the capital account reflected a sharp decline in private capital outflow.

The authorities introduced an exchange rate band regime in July 1995, committing themselves to the management of the exchange value of the ruble.

In the fiscal area, the federal government deficit was reduced through expenditure compression in excess of the shortfall in all major revenue categories. The poor revenue performance was caused by a number of factors, including delays in implementing revenue-enhancing measures and in eliminating exemptions, a rise in tax arrears, continued difficulties in tax compli-

Table 36

RUSSIA: SELECTED ECONOMIC INDICATORS

(Data, except for full year 1995, as of Board discussion in September 1995; percent change over same period in previous year unless otherwise noted)

	1992	1993	1994	1995 Jan.–Jun.	1995 Full year
Domestic economy					
Real GDP[1]	–19	–12	–15	–4	–4
Registered unemployment[2]	0.8	1.1	2.1	2.7	3.2
Open unemployment[2]	4.8	5.5	7.1	7.7	8.3
Consumer price index, average	1,353	896	302	186	190
External economy					
Exports, f.o.b. (in billions of U.S. dollars)[3]	52.1	58.3	69.6	36.9	78.6
Imports, c.i.f. (in billions of U.S. dollars)[3]	46.5	44.2	55.2	28.9	60.6
Current account balance (in billions of U.S. dollars)[3]	–4.2	2.6	3.4	2.9	4.7
Capital account balance (in billions of U.S. dollars)[3]	. . .	–12.3	–19.3	–2.3	0.2
External debt	. . .	. . .	120.6	. . .	115.9
Debt-service ratio[4]	. . .	. . .	24.9	. . .	20.3
Average exchange rate (rubles / U.S. dollar)	222	1,034	2,262	4,594	4,560
Net international reserves[5]	538	300	1	38	40
Financial variables					
Federal government balance (in percent of GDP)[6]	–11.1	–6.9	–11.1	–3.4	–4.6
Enlarged government balance (in percent of GDP)[7]	–18.9	7.6	–10.1	–2.9	–4.9
Gross national saving	. . .	. . .	28.9	. . .	27.0
Gross national investment	. . .	. . .	27.7	. . .	25.9
Base money[5]	1,070	647	186	71	118
Net domestic assets of the monetary authorities[3, 8]	531	347	185	15	78
Refinance rate of central bank (end of period, percent)	80	210	180	180	160

[1]Goskomstat has recently revised its GDP statistics for 1992 and 1994. The figures shown here are based on the official (unrevised) data.
[2]End-period level, in percent of the labor force.
[3]Consolidated for transactions both with states of the former Soviet Union and with other countries.
[4]Public external debt service due, in percent of total exports and nonfactor services.
[5]Changes in relation to base money at beginning of the period.
[6]On a cash basis.
[7]Includes the federal and local governments, all extrabudgetary funds, and unbudgeted import subsidies associated with foreign disbursements.
[8]The monetary authorities are defined to include the Central Bank of Russia and the Government.

ance (including from the emerging private sector), and the impact of the nominal appreciation of the ruble. The authorities also successfully introduced a treasury bill market, which provided a critical source of noninflationary finance.

Structural reforms during the year under review included further trade liberalization (notably in the export sector) and liberalization of the oil export regime, but the rate and scale of privatization and land reform were slower than expected. Major social programs, including that for unemployment benefits, were both inadequate and financially inviable.

Notwithstanding these difficulties, Directors noted, the Russian authorities had met all the targets under the program to date, and they commended the authorities on their strenuous efforts to persevere in stabilization process. Their progress had been impressive when viewed against the conditions at the beginning of 1995. There were signs that the real economy had finally begun to recover from the collapse it had been enduring since 1991, and inflationary pressures had eased considerably.

Directors particularly commended the resolve with which the authorities had pursued the goal of fiscal deficit reduction. Expenditure had been severely compressed. However, Directors expressed concern over the sustainability and possible economic costs of that compression. Noting that the fiscal situation remained fragile, they stressed that permanent reductions in unproductive spending, together with measures to improve revenue performance, were urgently needed. They welcomed the revenue package introduced by the authorities, but they considered that more needed to be done to ensure the viability of fiscal policy over the medium term.

Directors emphasized that the further reduction of inflation must remain the policy priority. The growth of the monetary base needed to be firmly restrained. The authorities would have to pay particularly close attention to the operation of the exchange rate band. Directors emphasized the need to keep exchange rate policy under continuous review, and for the authorities to remain prepared to make adjustments if necessary.

Directors expressed concern over difficulties in the banking system and encouraged the authorities to take strong steps to improve banking supervision and accelerate reforms that would lead to the restructuring of the banking sector. In a number of other structural areas, notably land reform and privatization, Directors urged the authorities to accelerate the pace of reform.

During the latter half of 1995, following the Board discussion, the Russian authorities continued to comply with all the program's monetary and fiscal targets, although with increasing difficulty toward the end of the year. As a result of Russia's performance under the program, for the year as a whole inflation fell to an average rate of 190 percent, compared with 302 percent in 1994. The year 1995 also saw the first signs of a recovery of industrial activity, particularly in such areas as energy, metallurgy, and chemicals. Real GDP remained broadly stable in the course of 1995, at an average level some 4 percent below that recorded in 1994. On the external front, the current account surplus widened to 4.7 percent of GDP from 3.4 percent in 1994. The introduction of the exchange rate corridor with the stated purpose, among others, of stabilizing exchange rate perceptions, is generally judged to have been a success. On the structural front, policy performance continued to be uneven. The restructuring of the banking sector, for example, was slow, and the pace and scale of the privatization program was below expectations. Little progress was achieved in the area of land reform. In March 1996 the Fund approved an arrangement under the extended Fund facility totaling SDR 6.9 billion (see the section on Fund Support of Member Countries).

Table 37

SLOVAK REPUBLIC: SELECTED ECONOMIC INDICATORS

(Data, except for 1995 outturn, as of Board discussion in September 1995; annual percent change unless otherwise noted)

	1992	1993	1994[1]	1995 Jan.–June	1995 Outturn
Domestic economy					
Real GDP	–7.0	–4.1	4.8	6.1	7.5
Unemployment rate (in percent of labor force, period average)	11.3	12.8	14.6	14.3	13.8
Consumer price index (CPI; 12-month change)	9.1	25.0	11.7	10.5	7.2
External economy					
Exports, f.o.b. (in billions of U.S. dollars)	6.5	5.4	6.7	4.2	8.6
Imports, c.i.f. (in billions of U.S. dollars)	7.2	6.4[2]	6.6	4.2	8.5
Current account balance	0.0[3]	–0.6	0.7	0.3	0.6
Foreign direct investment, net (in billions of U.S. dollars)	0.1	–0.4	0.3	0.1	0.2
Other medium- and long-term capital (in billions of U.S. dollars)	0.3	0.6	0.7	0.1	0.7
Overall balance (in billions of U.S. dollars)	–0.5	0.4	1.4	0.6	1.6
External debt (in billions of U.S. dollars, end of period)[4]	2.8	3.4	3.9	. . .	4.5
Debt-service ratio (in percent of total exports)	3.3	8.9	8.7	. . .	12.0
Real effective exchange rate (CPI-based; average)	1.1	0.8	–0.3	1.5	1.9
Official reserves (end of period; in billions of U.S. dollars)	0.8	0.9	2.2	3.1	3.9
Financial variables					
General government balance (in percent of GDP)	–12.8	–7.6[2]	–1.4	2.0	0.6
Gross national saving (in percent of GDP)	23.2[3]	18.0[5]	22.8	21.5[6]	. . .
Gross domestic investment (in percent of GDP)	22.8[3]	21.9[5]	17.1	19.5[6]	. . .
Broad money (end of period)	4.7	18.5	18.4	2.9	20.8
Interest rate (credit to private sector; average)	16.1	14.1	14.9	14.6	14.5

[1]Preliminary.

[2]Military imports of $170 million in 1993 (in exchange for a write-down of Slovak claims on Russia) are captured in the external accounts (imports) but not in the fiscal accounts.

[3]After fiscal transfers from the Czech lands, estimated at about 7 percent of GDP.

[4]Excluding disputed interbank liabilities to the Czech Republic.

[5]Military imports from Russia are excluded from foreign saving and the general government deficit.

[6]Projection for the whole year.

Slovak Republic

The Board met in September 1995 to discuss under Article IV the economic performance of the Slovak Republic over the past year. The economy had turned around dramatically during 1994, with 5 percent growth, a 6 percent surplus on the current account, a doubling of official foreign reserves, and a halving of inflation to 12 percent (see Table 37). These developments resulted from the combination of a 20 percent surge in exports (spurred on by productivity growth and progress in restructuring) and low domestic demand resulting from sizable fiscal adjustment and tight credit. Growth was sustained in the first half of 1995, with preliminary data pointing to a stronger-than-expected recovery of domestic demand led by investment and nongovernment consumption.

The fiscal deficit was reduced by 6 percentage points to 1½ percent of GDP in 1994, much below the program target (under a stand-by arrangement approved in July 1994) of 4 percent. Nominal expenditures were slightly higher than projected, but the cut in the deficit was made possible by higher revenues from direct taxes owing to stronger-than-expected economic activity. This good performance continued into the first half of 1995, when general government operations showed a sizable surplus, as spending was held below budgeted amounts by controlling discretionary expenditures.

Broad money rose faster than targeted during 1994, but this was consistent with increased demand for financial assets and stemmed entirely from a rise in net foreign assets of the banking system. From mid-1994 the National Bank of Slovakia sterilized large foreign exchange inflows associated with the surge in export receipts. Continued sterilization and a fiscal surplus kept growth in broad money to 3 percent during the first half of 1995.

The Slovak Republic had benefited from structural reforms introduced in earlier years, and tight financial policies that imposed hard budget constraints on enterprises. However, political instability and administrative constraints had delayed implementation of structural reform in recent years. The Slovak Republic had met the performance criteria for its precautionary program at the end of 1994, but progress was hampered by slow formulation of structural policies and an unexpected shift in privatization policy. In June 1995 the Government decided to cancel the second-wave voucher scheme; to distribute privatization bonds (valued at the equivalent of 8 percent of GDP) to the population; and to maintain state ownership or control in a large number of enterprises.

Directors commended the Slovak authorities for achieving an impressive economic turnaround based on tight financial policies and earlier structural reforms. They noted, however, that the recent slippages in structural policies had delayed the completion of the first review under the stand-by arrangement and hoped that the authorities would regain the momentum of reform, thus improving the prospects for a sustained recovery in growth and investment.

Directors were concerned that setbacks in privatization had damaged the credibility of the Government's commitment to a market economy and reduced the attractiveness of the Slovak Republic to foreign investors. They urged the authorities to reinvigorate the privatization process, stressing the need to harden budget constraints and eliminate state interference in privatized enterprises.

Directors emphasized that tighter financial policies were needed to prevent the economy from overheating. In light of the risks stemming from rapidly rising domestic demand and from the inflationary effects of the privatization bonds, they recommended the adoption of a more ambitious fiscal target for 1995, based on spending cuts. They also noted that the cost of future structural reforms would put additional pressure on the fiscal accounts in the coming years.

Directors noted that the National Bank's prudent policy stance had been key to the gains in stabilization, and they welcomed the authorities' recent decision to tighten credit policy and to adopt additional measures if necessary. They encouraged the authorities to complete the transition to market-based instruments as soon as feasible, and to strengthen the independence and effectiveness of the National Bank. Directors welcomed the recent steps to strengthen the financial position of the commercial banks.

Directors commended the Slovak authorities for their intention to liberalize the exchange system further, with the aim of full current account convertibility and accepting Article VIII status by January 1, 1996. They regretted the authorities' decision to maintain the import surcharge until mid-1996 and urged its early removal.

Ukraine

Directors met in January 1996 to conclude the 1995 Article IV consultation with Ukraine. Since the last consultation, the authorities' commitment to policy reform had varied, with three main phases. In late 1994 and the first half of 1995, the authorities pursued strong policies to lower inflation and reform the economy. In April 1995 they adopted a budget that reduced the role of the state in the economy and reformed the system of taxation. They obtained a rescheduling of their outstanding debt and payments arrears and pledged to service their rescheduled obligations on time. They also took steps to speed up mass privatization and open up the foreign trade regime.

During the following months, the pace of reform slowed. In July, the Government renewed various forms of financial support to the enterprise sector, including through direct budgetary lending. External payments arrears were incurred, both on payments for gas imports and on foreign debt-service obligations, and structural reforms lagged behind schedule.

In the closing months of 1995, in view of the negative impact of these slippages, in particular on inflation, the authorities tightened monetary policy somewhat. This helped to reduce inflationary pressures and stabilize the exchange rate. Other corrective actions to bring the program back on track, however, were postponed.

Economic activity remained weak during most of 1995, but the estimated decline in GDP of 13 percent for the year was a significant improvement over 1994 (see Table 38). Lower-than-expected agricultural output contributed to the decline in real GDP.

Exports performed strongly in 1995, especially those to countries outside the former Soviet Union, which were estimated to have increased by about 40 percent in U.S. dollar terms over the first three quarters of the year, more than offsetting the fall in trade with countries in the former Soviet Union. This good performance reflected earlier trade liberalization measures. Imports remained essentially flat, as a contraction in energy imports offset an increase in other imports. The exchange rate was relatively stable during much of the first half of 1995, when capital inflows helped to strengthen the balance of payments. But as policy implementation weakened during the summer, the karbovanets depreciated, stabilizing again in October–November when the National Bank took steps to tighten monetary policies to restore confidence. The real exchange rate appreciated by about 60 percent over 1995, but the economy's external competitiveness continued to be supported by a low level of dollar wages compared with the country's main competitors.

Consumer price inflation slowed significantly during the first half of 1995, but it picked up in September and October because of the loosening of monetary policy, administered price adjustments, and seasonal factors. When the National Bank tightened its credit policy in October, this helped to correct the inflationary trend, and the monthly inflation rate fell to 4.6 percent in December.

Table 38

UKRAINE: SELECTED ECONOMIC INDICATORS

(Data as of Board discussion in January 1996; percent change over same period in previous year unless otherwise noted)

	1992	1993	1994	1995[1]
Domestic economy				
Real GDP	–17	–17	–23	–13
Employment	–2.0	–2.3	–3.8	. . .
Consumer price index	1,210	4,735	891	376
External economy				
Exports, f.o.b. (in billions of U.S. dollars)	11.3	12.8	11.8	12.3
Imports, c.i.f. (in billions of U.S. dollars)	11.9	15.3	14.2	14.4
Current account balance (in millions of U.S. dollars)	–621	–854	–1,395	–1,380
Direct investment (in millions of U.S. dollars)	170	200	91	120
Capital account balance (in millions of U.S. dollars)	–2,087	–317	–238	–2,206
External debt service (in millions of U.S. dollars)	16	197	1,787	1,531
Debt-service ratio	0.1	1.2	12.4	10.2
Exchange rate (Krb / US$ auction rate; end of period)	749	25,000	104,200	183,000
Net international reserves (in millions of U.S. dollars; end of period)	. . .	. . .	284	–486
Financial variables				
General government balance (in percent of GDP)	–29.3	–11.8	–8.2	–4.1
Gross national investment (real percentage change)	–36.9	–10.3	–22.7	. . .
Broad money (M3)[2]	921	2,103	465	105
Statutory refinance rate (in percent a year; end of period)	. . .	. . .	252	105

[1]Fund staff estimates.

[2]Foreign currency deposits valued at parallel exchange rates through September 1994. For purposes of comparison, foreign currency components of actual observations for 1995 are valued at the program exchange rate, which is an accounting exchange rate.

Directors regretted that Ukraine's reform effort had faltered in the second half of 1995, after a promising start under the adjustment program supported by the Fund. Although impressive achievements had been realized initially, including lower inflation, a reduced budget deficit, and a liberalized exchange and trade system, slippages in important policy areas in the second half of 1995 had damaged the credibility of the authorities' policies. In particular, Directors noted with concern the continued accumulation of external arrears on debt-servicing and current payments obligations, weakening fiscal performance, slow progress in areas of systemic reform, and limited progress on privatization and private sector development.

Directors were encouraged by the implementation of corrective actions in some areas, including the tightening of monetary policy late in the year. They urged the authorities to take further actions to revive the adjustment and reform program and pave the way for a resumption of financial support from the Fund and the international community. The highest priority was correcting Ukraine's macroeconomic imbalances, which required sustained fiscal adjustment. The authorities' budgetary targets for 1996 were not attainable on the basis of the current policies. They emphasized the need for a prudent wage policy, a better targeting of social benefits, and a move to a commercial system of interenterprise dealings in external energy trade.

Directors agreed that a flexible exchange rate regime should be maintained, supported by financial restraint to contain inflation and preserve competitiveness. They were concerned by the large increase in base money during December 1995 and urged the authorities to reinforce their efforts to reduce monetary and credit growth through a strengthening of fiscal adjustment and enterprise reform.

Directors underscored the need to speed up structural reforms, including faster privatization of state enterprises, enterprise restructuring, and financial sector reform.

Directors encouraged the authorities to remove all remaining export restrictions. They noted the need for a comprehensive energy policy. They welcomed the authorities' intention to restructure the energy sector and encouraged the enforcement of payments discipline, thus ensuring steady gas supplies from abroad without reliance on government guarantees. They strongly urged the authorities to remain current on foreign debt obligations.

Directors recommended that the authorities improve their coordination of economic policy and encouraged them to cooperate more closely with the Fund staff in designing and implementing economic policies. Sustained and coherent implementation of strict financial policies and structural reforms would be essential to move the Ukrainian economy along the path of financial stability, market transformation, and sustained growth, and to re-establish credibility with donors, creditors, and investors.