cent. Nominal deposit interest rates had been raised to 25–27 percent in early 1996; with the core inflation rate of 20 percent, real rates had become positive. In those circumstances, the composition of broad money began to shift toward quasi-money, and the government treasury bill auctions continued to experience successful outcomes.

The tightened fiscal and monetary conditions of 1995–96 and the integration of the freed commercial bank and money-changer exchange markets helped to stabilize the floating free market exchange rate after late October 1995, indicating restored confidence in the currency and the economy.

Directors in their discussion commended the authorities for demonstrating a strong sense of ownership of the comprehensive financial adjustment and structural reform program, and for its successful implementation. They were encouraged by the deceleration in the core inflation rate, the stabilization of the free market exchange rate, and the increase in gross foreign exchange reserves to near the end-year target despite a shortfall in external financing.

Directors welcomed the marked strengthening of fiscal policy in 1995–96, which had led to substantial reductions in the budget deficit and the rate of monetary expansion. They urged the authorities to continue the fiscal consolidation by further reducing subsidies through front-loaded increases in administered prices for wheat, flour, and energy, and they endorsed the adoption of a general sales tax. Directors considered it essential to establish a well-designed social safety net to mitigate the impact of the reform program on the more vulnerable segments of the population.

Directors welcomed the authorities' increased reliance on interest rate policy and recommended that interest rates be reduced only when inflation had clearly receded. Because the goal of high growth depended on more active intermediation by the banking system to ensure the extension of credit to the private sector, Directors stressed the need for legal reforms to address loan contract enforcement.

Countries in Transition

Armenia

The Board concluded the Article IV consultation with Armenia in September 1996 and conducted the midterm review of Armenia's first annual ESAF arrangement. Following a period of steep decline in GDP and of high inflation, Armenia had stabilized its economy (Table 40). Real GDP increased by 6.9 percent in 1995, and by 4.3 percent during the first half of 1996, compared with 5.4 percent in 1994. In 1995, end-of-period inflation fell to 32 percent, from 1,885 percent in the previous year. However, at the end of 1996, regional instability and the blockade of Armenia's transportation routes through Azerbaijan and Turkey continued to pose a threat to sustained growth.

The accrual budget deficit was reduced from 16.4 percent of GDP in 1994 to under 10 percent in 1995 and to 6.8 percent for the first six months of 1996, through a combination of tax measures and expenditure restraint. However, the repayment of substantial expenditure arrears led to a cash deficit amounting to 8.4 percent of GDP during the first half of 1996. The most important budgetary problem was weak revenue performance stemming from gaps in the tax base (notably the failure to capture the emerging private sector) and tax arrears.

The government continued its program of fiscal institution building in 1996. It established a treasury department as well as a debt-management unit and large-taxpayer unit within the Ministry of Finance and set up 40 field treasuries. It targeted the social safety net better, facilitating an increase in benefits, and enacted a new pension law raising the retirement age and bringing the Pension and Employment Fund into balance.

Reserve and broad money expanded rapidly during the second half of 1995, declined in the first quarter of 1996, and increased slightly during the second quarter. The central bank's refinance rate was constant at 52 percent between October 1995 and August 1996, whereas lending and deposit interest rates varied substantially. The nominal exchange rate remained stable through May 1996 before undergoing a slight depreciation, while the real effective exchange rate depreciated by 5 percent during the first six months of 1996.

As a result of high import levels and slow export growth, the ratio of the current account deficit (excluding official transfers) to GDP increased from 36 percent in 1994 to 38 percent in 1995.

At the time of the consultation, privatization was practically complete in the agriculture and housing sectors and on track for small-scale enterprises. Although privatization of medium- and large-scale enterprises had slowed in early 1996 and fallen behind schedule, it had subsequently begun to accelerate. Most prices had been liberalized, and electricity prices were raised 40 percent between October 1995 and April 1996. Progress had also been made with legal reform, particularly in the banking sector, with the passage in 1996 of the Central Bank Law establishing the central bank's independence, the Law on Banks and Banking, and the Law on Banking Insolvency.

Directors complimented the authorities on the economic growth and low inflation achieved under the ESAF-supported program and welcomed progress in systemic reforms across all sectors. However, major problems remained to be addressed, notably with regard to fiscal policy, financial sector reform, and privatization.

Table 40
Armenia: Selected Economic Indicators
(Data as of Board discussion in September 1996)[1]

	1993	1994	1995	1996 Projections at time of Board discussion	1996 Outturn[2]
			In percent		
Domestic economy					
Change in real GDP	–14.8	5.4	6.9	6.5	5.8
Change in consumer prices (end of period)	10,896	1,884.5	31.9	18.0	5.7
			In millions of U.S. dollars[1]		
External economy					
Exports	. . .	209.3	270.9	295.2	290.3
Imports	. . .	401.2	672.9	767.6	757.9
Current account balance[3]	. . .	–231.4	–483.0	–486.6	–424.3
Direct investment	. . .	2.6	19.9	33.8	12.3
Gross official reserves	4.9	32.3	107.1	132.7	161.9
Current account balance (in percent of GDP)	. . .	–35.6	–37.6	–29.5	–26.7
External debt (in percent of GDP)	. . .	30.8	28.9	35.0	37.8
Debt service (in percent of exports of goods and services)	0.8	3.0	20.6	20.2	19.7
Change in real effective exchange rate (in percent)	. . .	. . .	6.7	. . .	–14.2
			In percent of GDP[1]		
Financial variables					
General government balance	. . .	–22.0	–14.8	–11.0	–10.8
Gross national saving	. . .	–23.5	–24.0	–20.8	–20.8
Gross national investment	. . .	11.0	8.8	8.1	7.1
Change in broad money (in percent)	. . .	684.0	69.0	25.0	35.0
Interest rate (in percent)[4]	. . .	285.0	83.0	. . .	53.0

[1]Unless otherwise noted.
[2]Updated Fund staff estimates.
[3]Excluding official transfers.
[4]Average refinance rate.

Directors supported the introduction of a treasury system and elimination of all expenditure arrears. They expressed concern, however, over declining tax collections and the persistence of tax arrears. They urged the authorities to strengthen the fiscal position by broadening the tax base to include the expanding private sector and further rationalizing expenditures.

Directors welcomed the improved implementation of the monetary program and encouraged the authorities to take measures, such as expanding the use of treasury bills, to deepen the financial sector and enhance the central bank's flexibility. With respect to the exchange rate, they welcomed the move from the de facto peg to a more flexible arrangement.

The fragility of the banking system and the increase in disintermediation were of concern to Directors. They urged the authorities to take bold steps to strengthen the banking system and build public trust, including the reorganization of the Savings Bank and the restructuring or, if necessary, liquidation of large commercial banks deemed to be insolvent.

The Board stressed that the current account deficit was unsustainably high. While Armenia would continue to depend on sizable concessional assistance in the foreseeable future, it would also have to create the necessary environment for attracting foreign investment and promoting export growth.

Directors expressed concern that some structural reforms had fallen behind schedule, notably the privatization of medium- and large-scale enterprises, and that, as in other countries, reliance on voucher-based privatization had not yielded desired improvements in enterprise governance. They urged the authorities to accelerate privatization, legal reform, and the restructuring of the energy and agricultural sectors.

Following the Board discussion, updated estimates showed that real GDP increased by 5.8 percent in 1996, compared with a program projection of 6.5 percent. The current account deficit, at 26.6 percent, was lower than projected. Despite a sharp increase in broad money during the second half of 1996, inflation was lower than projected owing to a strong increase in the demand for money.

Azerbaijan

The Board concluded the Article IV consultation with Azerbaijan in December 1996 and considered Azerbaijan's requests for an Extended Arrangement and an arrangement under the ESAF. Targets for macroeconomic stabilization under the Systemic Transformation Facility and the Stand-By Arrangement in 1995–96 had been largely met. Real GDP grew by 1 percent in 1996, encouraged by large investments in the oil fields, and foreign direct investment increased substantially (Table 41). Inflation was sharply reduced; twelve-month inflation in October 1996 was 11.7 percent. The fiscal deficit, financed almost exclusively through foreign sources, also declined. The large oil invest-

ments helped to reverse the output decline, but the external current account deficit widened from 11 percent of GDP in 1995 to an estimated 19 percent of GDP in 1996. With higher world oil prices, the terms of trade were expected to improve in 1996. Gross official reserves, virtually nil in 1994, reached approximately $215 million in 1996. External debt in 1996 was projected to reach 16.3 percent of GDP.

Monetary expansion was stronger than programmed in 1995, but in 1996 the velocity of broad money declined in line with projections. Although the nominal exchange rate remained stable during 1995, the manat appreciated in relation to the U.S. dollar (7 percent) and the Russian ruble (20 percent) during the first 11 months of 1996. The government took steps in 1996 to streamline the exchange and payments system; however, some restrictions on current international transactions remained. Enterprise and land privatization picked up during the second half of 1996, but progress was slower in implementing the treasury system, raising residential energy prices to meet cost-recovery targets, and increasing competition in domestic markets.

During their discussion, Directors commended the authorities for implementing the stabilization and reform program supported by the Fund and welcomed the gains achieved: a sharp reduction in inflation, higher international reserves, a strengthening of the exchange rate, and resumption of economic growth. Directors were encouraged by the authorities' decision to accelerate structural reforms, stressing that maintaining momentum in this regard would be crucial to achieving sustained and balanced growth.

Achievement of program objectives would require that the hesitancy of the past few years in implementing structural reforms not be repeated, and that reforms receive strong support from both the government and the public. Expected income flows from Azerbaijan's oil wealth should not lead to complacency and delays in restructuring the economy, Board members emphasized. Balance of payments prospects would likely improve in the medium term as oil revenues came on stream, but Directors stressed the importance of structural reforms to ensure balanced growth. Strong and early implementation of structural reforms would also enhance productivity growth. Privatization, land reforms, termination of the government's involvement in production and trade, and a regulatory and legal framework were critical for allocative efficiency and the transformation to a market economy that could support the growth potential of agriculture and other non-oil sectors.

Directors welcomed the authorities' commitment to adhere to tight financial policies. They supported the authorities' intention virtually to eliminate the general government fiscal deficit by 1999 and to maintain monetary policies consistent with low inflation. Directors agreed that the projected appreciation of the real exchange rate over the medium term was appropriate

Table 41
Azerbaijan: Selected Economic Indicators
(Data as of Board discussion in December 1996)

	1993	1994	1995[1]	1996[2]
	In percent			
Domestic economy				
Change in real GDP	–23.1	–18.1	–11.0	1.2
Unemployment rate	16	15	17	20
Change in consumer prices (period average)	1,130.0	1,664.4	411.7	19.9
	In millions of U.S. dollars[3]			
External economy				
Exports, f.o.b.	697	682	680	849
Imports, f.o.b.	819	845	955	1,318
Current account balance (including transfers)	–160	–121	–311	–654
Direct investment[4]	. . .	22	275	601
Capital account balance[5]	. . .	54	456	562
Gross official reserves	. . .	2	119	214
Current account balance (in percent of GDP)[6]	–12.3	–6.6	–11.2	–19.1
External debt (in percent of GDP)	. . .	. . .	15.1	16.3
Change in real effective exchange rate (in percent)	. . .	. . .	37.0	3.9
	In percent of GDP[3]			
Financial variables				
General government balance	–12.7	–11.4	–4.3	–2.7
Gross national saving	. . .	. . .	2.8	2.3
Gross national investment	. . .	. . .	14.3	21.4
Change in broad money (in percent)	. . .	508.6	175.2	56.3
Interest rate (in percent)[7]	. . .	. . .	107	. . .

[1]Fund staff estimates.
[2]Program or projected.
[3]Unless otherwise noted.
[4]Including portfolio investment.
[5]Capital and financial account.
[6]Including oil consortiums.
[7]Central bank refinancing rate; end of period, compounded.

and that it should occur through nominal appreciation of the currency.

Directors stressed that achieving fiscal targets and improving the structure of the budget would require improved tax collection. At the same time, expenditure policies must remain tight, and current spending should be rationalized and prioritized in light of absorptive capacity. Directors noted that introduction of a treasury system would improve budgetary management, and that the authorities' establishment of a separate oil account at the central bank would strengthen discipline in the use of oil revenues. The magnitude of interenterprise arrears was a matter of concern, and Directors emphasized the importance of imposing measures to harden budget constraints on enterprises.

Directors stressed that it was crucial to adhere to the restructuring program for state banks; banks that failed to restructure and restore solvency should be liquidated. At the same time, concerted efforts were needed to encourage development of the domestic money market and the payments system. Directors urged the authorities to eliminate barriers to the operations of foreign banks, in order to spur competition and facilitate privatization. The Board also emphasized the importance of strengthening prudential standards and banking supervision and of increasing central bank independence. Although progress had been made in liberalizing the exchange system and trade regime, further improvements in the functioning of the foreign exchange market and the international payments system were warranted. Directors strongly urged elimination of remaining restrictions on access to foreign exchange auctions, advance import payments, and transfer of foreign exchange for current international transactions by individuals.

Estonia

The Board concluded the Article IV consultation with Estonia in July 1996 and considered Estonia's request for a new precautionary Stand-By Arrangement. Economic performance under the 1995–96 precautionary Stand-By Arrangement had broadly met policy objectives. Activity picked up, inflation declined, the external current account deficit was contained at a level that could be financed by foreign direct investment, restructuring of the banking system accelerated, and enterprise privatization was almost completed except for infrastructural enterprises. Financial imbalances emerged in late 1995 and early 1996, however, as a decline in public saving and increased reliance on foreign borrowing for public investment caused the general government deficit to grow.

Real GDP grew by 4.3 percent in 1995, up from negligible growth in 1994 (Table 42), and was led by expansion in the services sector and by export-based growth in manufacturing and other industrial sectors. The decline in public saving was largely offset by gains in private saving. Owing to the absorptive capacity of the emerging private sector, unemployment remained low in 1995 at 5 percent. Consumer price inflation was 28.8 percent at the end of 1995, compared with 41.6 percent at the same time in 1994. General government operations registered a deficit of 0.8 percent of GDP in 1995. The fiscal policy stance for 1996 aimed at limiting the overall fiscal deficit to no more than 1.4 percent of GDP.

Net domestic credit rose by 63 percent in 1995, more than double the projected increase, owing to buoyant demand by the private sector. Interest rates on kroon deposits and loans drifted downward in 1995 and early 1996, but rates of return offered by Estonian banks continued to attract foreign inflows. Interest rate differentials and risk premiums narrowed further, but real interest rates remained negative.

Export volume grew by about 20 percent in 1995, while import volume growth exceeded 30 percent, causing the trade deficit to widen to almost 20 percent of GDP. Increases in net receipts from nonfactor services, however, more than offset the rise in the trade deficit. The external current account deficit was lower than expected, the overall balance of payments was in surplus, and gross international reserves remained at the equivalent of close to three months of imports.

Most of the structural reforms under the 1995–96 stand-by program were implemented. However, progress in reforming the fiscal system and in land privatization continued to be slow.

In their discussion, Directors praised Estonia's strong record in implementing stabilization and structural reforms, which were paying off: economic recovery had gained momentum, a viable private sector had developed, unemployment remained low, and foreign direct investment flows had continued. However, Directors were concerned about persistent high inflation and the financial imbalances that had emerged in late 1995 and early 1996, resulting in a decline in public saving and a widening general government deficit.

Most Directors agreed that the currency board arrangement at its current peg remained appropriate. Directors emphasized the need to continue monitoring capital inflows and to ensure that banks could adjust to a reversal of short-term inflows. Concern was also expressed that credit growth might be too rapid. Board members stressed that continued flexibility in the goods and labor markets, as well as productivity growth, would be essential given the inflationary pressures generated by ongoing adjustment to relative prices.

Directors cautioned that continuing deterioration of public finances could undermine inflation reduction and credibility of the currency board; the fiscal position, therefore, should be strengthened as soon as pos-

sible. They welcomed the commitment to reduce public expenditures in 1996–97, to exert greater control over local government borrowing, and to strengthen tax administration. Additional revenue measures should be taken if a revenue shortfall reappeared.

Directors encouraged the authorities to streamline further the government's role in the economy, including through structural reform of public expenditures and the pension system. They welcomed the progress made in banking supervision and the restructuring of commercial banks. Although some elements of the financial system remained fragile, Directors commended the authorities' commitment to seek market-based solutions to problem banks and to limit the risks to public funds. Directors urged decisive movement on plans to commercialize and privatize infrastructural enterprises and to accelerate land privatization. Speedy adjustment of administered prices, particularly of energy prices, was also needed. Noting Estonia's remarkable record on free trade, Directors urged the authorities to resist pressures to introduce protective import tariffs, especially in the agricultural sector.

Table 42
Estonia: Selected Economic Indicators
(Data as of Board discussion in July 1996)[1]

	1993	1994	1995	1996 Projections at time of Board discussion	1996 Outturn[2]
			In percent		
Domestic economy					
Change in real GDP	–8.4	–0.1	4.3	3.1	4.0
Unemployment rate[3]	5.5	5.4	5.0	. . .	5.5
Change in consumer prices (end of period)	35.7	41.6	28.8	23.7	15.0
			In millions of U.S. dollars[1]		
External economy					
Exports, f.o.b.	811.5	1,328.6	1,861.3	2,330.3	2,060.4
Imports, f.o.b.	956.3	1,689.9	2,553.5	3,100.9	3,144.0
Current account balance	23.3	–171.0	–185.2	–302.9	–428.5
Direct investment	154.4	212.2	202.3	210.0	93.7
Portfolio investment	–0.2	–14.1	–16.3	60.1	30.8
Capital account balance[4]	222.2	175.2	258.9	442.5	478.5
Gross official reserves	388.4	447.0	582.8	706.2	639.6
Current account balance (in percent of GDP)	1.4	–7.5	–5.1	–6.9	–10.1
External debt (in percent of GDP)	8.6	7.4	6.6	7.6	7.2
Debt service (in percent of exports of goods and services)	1.4	0.4	0.5	0.8	0.8
Change in real effective exchange rate (in percent)	. . .	30.8	9.8	. . .	6.5
			In percent of GDP[1]		
Financial variables					
General government balance	–0.7	1.3	–1.2	–1.4	–1.5
Gross national saving[5]	22.4	17.7	18.1	17.5	17.1
Gross national investment[6]	26.5	28.9	26.8	26.1	29.9
Change in broad money (in percent)	. . .	29.6	31.2	36.7	36.8
Interest rate (in percent)[7]	22.1	21.3	16.1	. . .	13.8

[1]Unless otherwise noted.
[2]Updated Fund staff estimates.
[3]Unemployed job seekers as a percentage of total labor force; period average.
[4]Financial and capital account.
[5]Gross domestic saving.
[6]Gross domestic investment.
[7]Weighted average annual interest rates (end-December) on 6- to 12-month commercial bank kroon loans to individuals and companies.

Hungary

The Board concluded the Article IV consultation with Hungary in August 1996 and conducted the first review under the Stand-By Arrangement approved in March 1996. Macroeconomic conditions in Hungary had improved significantly since the beginning of 1995, owing to the stabilization program enacted by the authorities. Adjustment measures included an up-front devaluation of the forint; a preannounced crawling peg for the exchange rate, along with tight incomes policies to anchor wage increases and drive down inflation; fiscal retrenchment; and acceleration of structural reforms.

As a result, the balance of payments improved (Table 43). The external current account deficit dropped to $2.5 billion in 1995, from almost $4 billion in 1994, and declined further to $934 million during the first half of 1996. Output rose 1½ percent in 1995, although production declined slightly in the second half of the year, unemployment increased slightly, and domestic demand contracted sharply. Export and import flows had increased considerably since 1994, a sign of further opening of the economy. The strengthened external position was accompanied by a surge in direct investment and other private capital inflows, which boosted gross official reserves and led to a drop in the ratio of net external debt to GDP.

After devaluation of the forint and increases in administered prices in early 1995, inflation picked up and then abated, but it lingered at 24–25 percent through June 1996. Real wages dropped by more than 10 percent in 1995, and in June 1996 the 12-month rate of increase in gross wages was holding at about

Table 43
Hungary: Selected Economic Indicators
(Data as of Board discussion in August 1996)[1]

	1993	1994	1995[2]	1996 Projections at time of Board discussion	1996 Outturn[3]
			In percent		
Domestic economy					
Change in real GDP	–0.6	2.9	1.5	2.0	1.0
Unemployment rate	12.1	10.4	10.4	. . .	10.5
Change in consumer prices (end of period)	21.1	21.2	28.3	16.6	19.8
			In billions of U.S. dollars[1]		
External economy					
Exports	8.1	7.6	12.8	12.6	14.2
Imports	11.3	11.2	15.3	14.2	16.8
Current account balance	–3.5	–3.9	–2.5	–1.8	–1.7
Foreign direct investment, net	2.3	1.1	4.4	1.6	2.0
Capital and financial account balance[4]	6.1	3.4	7.8	2.1	0.4
Gross official reserves	6.7	6.8	12.0	11.4	9.8
Current account balance (in percent of GDP)	–9.0	–9.5	–5.6	–4.0	–3.8
External debt, net (in percent of GDP)	38.8	45.8	36.8	39.5	31.7
Gross interest payments (in percent of exports of goods and nonfactor services)[5]	14.6	18.2	13.8	. . .	12.1
Net interest payments (in percent of exports of goods and nonfactor services)[6]	10.4	12.1	9.4	. . .	6.1
Amortizations (excluding prepayments; in percent of exports of goods and nonfactor services)[7]	24.1	30.5	29.9	. . .	32.6
Prepayments (in percent of exports of goods and nonfactor services)[8]	6.4	9.5	5.7	. . .	8.8
Change in real effective exchange rate (in percent; based on consumer price index)	9.3	–0.8	–4.0	. . .	2.2
			In percent of GDP[1]		
Financial variables					
Consolidated government balance	–7.6	–6.4	–3.8	0.6	–0.2
Excluding privatization receipts	–7.8	–7.1	–6.6	–3.9	–3.5
Gross national saving (national accounts basis)	10.6	14.4	18.8	21.6	21.7
Gross national investment (national accounts basis)	20.0	22.2	22.4	24.4	23.7
Change in broad money (M2; in percent)	16.8	13.0	18.5	13.7	20.9

[1]Unless otherwise noted.
[2]Estimated.
[3]Updated Fund staff estimates.
[4]Includes errors and omissions but excludes the change in reserves. In 1996, includes concepts of the capital and financial accounts in IMF, *Balance of Payments Manual,* fifth edition (1993).
[5]Interest expenditure on all external obligations.
[6]Interest expenditure on all external obligations minus interest receipts arising from external assets and foreign exchange reserves.
[7]Principal repayments on all external obligations minus payments made during the year on obligations falling due after the end of the year.
[8]Principal repayments made during the year on obligations falling due after the end of the year.

25 percent. The deficit of the consolidated government (excluding privatization receipts) fell by ½ of 1 percentage point of GDP in 1995, and further cuts were budgeted for 1996. The better-than-expected performance of the central government budget during the first half of 1996 more than compensated for the growing deficit of the social security funds.

The goal of monetary policy was to support the exchange rate policy and keep interest rates positive in real terms despite pressures arising from the conversion into forint of foreign exchange assets. Exchange rate pressures intensified in early 1996, entailing sterilized intervention by the central bank, owing to an interest rate differential (adjusted for the announced rate of crawl) of 13–14 percentage points. Nevertheless, broad money accelerated, and treasury bill rates dropped by some 7 percentage points during early 1996. Market rates stabilized, and intervention subsided during May and June as the interest rate differential narrowed to about 5 percentage points.

Privatization increased, marked by the sale of some major public utilities at the end of 1995, but the downsizing of health care facilities, the tightening of pharmaceutical subsidies, and disability pension reform lagged. However, the retirement age was raised for both men and women (after a transition period), and progress was made in preparing a comprehensive pension reform, including introduction of a fully funded component.

In their discussion, Directors welcomed the marked improvement in macroeconomic conditions: the fiscal and external current account deficits had declined sharply, structural reform had gained momentum, and the stronger external performance had led to a sizable decline in net external debt. The international financial markets were rewarding the authorities' strong adjustment efforts. Moreover, the rebound in exports had made possible positive economic growth, despite the sharp contraction in domestic demand. Progress in reducing inflation, however, had been slower than expected, and Directors highlighted the consequent risk to the

adjustment program. They regretted the authorities' decision to raise inflation targets rather than to tighten policy. Entrenchment of inflationary expectations, Directors cautioned, could undermine the progress achieved, and they urged strengthened policy implementation. This would require tight financial policies and structural reforms to alleviate supply constraints and to enhance competition, as well as wage moderation.

Directors commended the authorities' continued commitment to fiscal consolidation. In light of the slippage in inflation, they stressed that it was essential to achieve, as a minimum, the 1996 deficit target of 4 percent of GDP. Several risks threatened achievement of that goal, in particular the social security deficit and delays in structural reforms. Directors urged the authorities to take swift corrective action if revenue from consumption taxes and the recovery of social security arrears did not pick up as the authorities expected.

Capital inflows, Directors observed, had complicated the implementation of monetary policy. Although the decline in the interest rate differential could lessen these inflows, they cautioned against underestimating the potential for continued inflows and the cost of continued sterilized intervention. As elements of an anti-inflationary strategy, some Directors suggested a more flexible exchange rate policy, while others felt that moving to a new anchor might undermine credibility; other Directors suggested slowing the rate of crawl. Directors emphasized that success in structural reform was a prerequisite for strong macroeconomic performance in the medium term. Although important steps had been taken—most notably on acceleration of privatization and an increase in the retirement age—delays in health and pension reforms, and the continuing large deficits in the social security budget, were worrisome. Directors welcomed the authorities' intention to seek parliamentary approval of pension and disability pension reforms.

Subsequent to the Board's August meeting, macroeconomic performance continued to improve in 1996. The current account deficit dropped below $1.7 billion, while the consolidated government deficit (excluding privatization receipts) was 3½ percent of GDP (below the program target), with a primary surplus of 5 percent of GDP. After stagnating in the first half of 1996, economic activity expanded by an annualized 3 percent in the fourth quarter, boosting GDP growth to 1 percent for the year as a whole. The discipline imposed by the crawling-peg regime, containment of domestic demand, and the postponement of energy price increases contributed to a marked decline in inflation in the second half of 1996. However, the deficit of the social security funds exceeded 1 percent of GDP, compared with a target of ¼ of 1 percent of GDP under the program, owing to delays in structural reform.