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Minutes of Executive Board Meeting 19/67-3

3:55 p.m., July 22, 2019

3. The State of Eritrea—2019 Article IV Consultation

Documents: SM/19/187 and Correction 1; and Supplement 1; and Supplement 1, Correction 1; and Supplement 2; and Supplement 3

Staff: Mukhopadhyay, AFR; Fletcher, SPR

Length: 42 minutes

Executive Board Attendance

T. Zhang, Acting Chair

Executive Directors	Alternate Executive Directors
D. Mahlinza (AE)	
	E. Boukpessi (AF), Temporary
G. Lopetegui (AG)	
	N. Heo (AP)
	B. Saraiva (BR)
	P. Sun (CC)
	J. Rojas (CE), Temporary
	A. McKiernan (CO)
	S. Benk (EC)
	P. Rozan (FF), Temporary
	K. Merk (GR)
	M. Siriwardana (IN)
	F. Spadafora (IT), Temporary
	H. Mori (JA), Temporary
	K. Badsi (MD), Temporary
	M. Merhi (MI), Temporary
	R. Doornbosch (NE)
	J. Sigurgeirsson (NO)
	S. Potapov (RU), Temporary
M. Mouminah (SA)	
	D. Susiandri (ST), Temporary
	P. Trabinski (SZ)
	T. Hemingway (UK), Temporary
	P. Pollard (US), Temporary

H. Al-Atrash, Acting Secretary
S. Maxwell, Summing Up Officer
E. Mannefred, Board Operations Officer
M. McKenzie, Verbatim Reporting Officer

Also Present
African Department: J. Jack, N. Koliadina, B. Mukhopadhyay, M. Newiak, F. Nyankiye, A. Selassie, P. Sharma, Z. Zeidane. Communications Department: G. Vilkas. Legal Department: K. Christopherson Puh, D. McDonnell, G. Rosenberg. World Bank Group: N. Klingen, G. Schmidt, T. Stucka. Senior Advisors to Executive Directors: M. Maidi (AE). Advisors to

Executive Directors: W. Al Hafedh (SA), X. Cai (CC), I. Fragin (GR), J. Garang (AE), S. Harutyunyan (NE), M. Mehmedi (EC), P. Mooney (CO), A. Urbanowska (SZ).

3. THE STATE OF ERITREA—2019 ARTICLE IV CONSULTATION

Mr. Mahlinza and Mr. Garang submitted the following statement:

Introduction

Our Eritrean authorities welcome the constructive engagement with staff during the recent Article IV consultation, and the resumption of Fund engagement after a decade. They broadly agree with the staff assessment and key policy recommendations.

Economic prospects for the State of Eritrea have brightened, following the signing of the July 2018 peace agreement with Ethiopia and the lifting of sanctions in November 2018. These positive developments have paved the way for Eritrea to re-engage with the international community and gain support for the significant economic reforms required to place the economy on a firm and durable growth path. With the support of international financial institutions (IFIs), including the World Bank and the IMF, the authorities seek to tackle their development challenges and build on recent progress towards the attainment of the Sustainable Development Goals (SDGs), particularly in health and education. They remain optimistic that re-engagement with IFIs will support the implementation of the much-needed reforms to advance their development agenda. In particular, they view Fund support as critical to the design, implementation and sequencing of key policy reforms.

Recent Economic Developments and Outlook

The State of Eritrea continues to face substantial economic challenges in the aftermath of two decades of conflict with Ethiopia, and a prolonged period of UN-imposed sanctions that deprived the economy of much-needed aid and investment flows.[1] Nevertheless, recent efforts to strengthen and revive the mining sector are beginning to bear fruits. Agriculture continues to expand, and real GDP growth is projected to reach 3.1 percent in 2019. Going forward, the authorities expect economic growth to further improve, as a result of the benefits provided by the peace dividend, the recent removal of UN sanctions, improved agricultural productivity, implementation of the Minimum Integrated Household Agriculture Package (MIHAP) Initiative and new mining activities. In addition, significant upside potential is expected

[1] The sanctions imposed on the country in 2009 and 2011 have negatively impacted Eritrea through weakening capacity across the board, constraining FX inflows and stifling the private sector participation in the economy.

from fishing, tourism, the development of national ports and a supportive diaspora.

Inflation which peaked at 28.5 percent in 2015, declined significantly to -14.4 percent in 2018. The decline in inflation into negative territory, reflects monetary measures taken by the government in late 2015 and early 2016 to fight inflation. Moreover, the reopening of borders with Ethiopia in September 2018, depressed food prices and further dampened inflation in 2018. Going forward, inflation is expected to rise, reaching 2 percent by 2021 in response to the relaxation of monetary controls and increased private consumption.

The current account surplus declined from 23.8 percent of GDP in 2017 to 16.6 percent in 2018 and is projected to decline further to 11.3 percent in 2019. Meanwhile, gross reserves have remained at 2.4 months of import cover over the past few years. With increased mineral export earnings expected in the medium term, the scope to build reserve buffers will increase.

Fiscal Policy and Debt Sustainability

Our authorities remain committed to maintaining fiscal restraint and undertaking revenue enhancing measures to ensure fiscal sustainability. To this end, they consider the diagnostic assessment of domestic and customs revenue frameworks by the Fund as critical to help identify the gaps that need to be addressed. In the process, the authorities plan to build a comprehensive macroeconomic database, improve debt management, and align the budgeting process with the medium-term fiscal framework.

On the expenditure side, the authorities plan to contain expenditure to create space for priority development and social spending. They will continue to redirect resources towards health and education, in order to unlock the country's long-term growth potential and further the attainment of SDGs.

To restore debt sustainability,[2] the authorities intend to rely on grants and highly concessional loans, while continuing to avoid domestic financing to the extent possible. Further, the authorities have not borrowed externally for the last four years. Meanwhile, the authorities intend to lengthen the maturity of T-bills, which is currently 6 months. They also see merit in restructuring public debt and intend to reach out to all external creditors with a

[2] The public debt ratio was about 267 percent of GDP at end-2018.

view to regularize arrears, including with the World Bank, and to initiate plans to settle outstanding obligations.

Monetary, Exchange Rate, and Financial Sector Policies

The authorities recognize the need to strengthen the current monetary policy framework, which presently relies on reserve requirements to manage liquidity. In this connection, the authorities request Fund support to explore additional monetary policy instruments to help achieve their policy objectives. They also plan to strengthen the onsite supervision of banks by improving mechanisms for monitoring financial sector developments and enforcing prudential regulations. Over time, the Bank of Eritrea (BOE) will move towards risk-based supervision, however, as a priority, they intend to address a number of challenges, including high non-performing loans (NPLs) and the acute shortage of skilled personnel.

To enhance policy credibility, our Eritrean authorities intend to gradually eliminate emergency measures, including withdrawals limit imposed during the difficult years. To this effect, a committee has been constituted to review such measures, including ensuring that taxes are paid on the previous cash deposited.

While the staff has reported the existence of multiple currency practices (MCPs) in Eritrea, the authorities emphasize that these MCPs no longer exist. They confirm that the current buying and selling rates used by the BOE and commercial banks are ERN 15.00 and ERN 15.15 per U.S. Dollar, respectively, with an actual spread of 1 percent. This spread falls within the permissible limits and does not give rise to an MCP. Further, the authorities would like to clarify that the tax on the energy sector through a more depreciated exchange rate has been suspended since 2010.

As part of an effort to improve the regulatory environment, the BOE has drafted several bills, including the Bank Act, the Banking Act, and the Insurance Companies Bill. They seek Fund TA to finalize the bills before submission to cabinet for approval. These bills will foster central bank autonomy and address legacy issues, including the central bank governance structure and the registration of banks. The authorities are convinced that these bills, together with the bank resolution framework, if promulgated, will enable them to clean up bank balance sheets.

Structural Reforms

The authorities remain committed to crafting a national development strategy, focusing on private sector development, to drive their development agenda. To this end, they remain convinced that facilitating private sector development, diversifying the economy, improving SOE efficiency, and improving the business environment will enhance productivity and engender inclusive growth. That said, they recognize that these policy measures need careful planning and would take time to implement.

While the authorities are cautious in borrowing externally, they are scaling up investment in mines. Already, the active mines of Bisha and Zara have started to create employment for both national and expatriate workers. Tapping into abundant labor supply and addressing broader unemployment issues remain a priority to the authorities. In this regard, investing in mining and agriculture remains the government's priority while efforts to create decent jobs and ensure that Eritrean nationals take more responsibility in both sectors is a longer-term objective.

Capacity Development

Our authorities appreciate the continued Fund capacity development support provided through TA and the East AFRITAC. Going forward, they are committed to improving statistical data to inform policy making, focusing on the national accounts, Balance of Payments, and consolidated government finance statistics.

Further, they welcome the Fund's intention to provide TA in the following areas: fiscal sector and public debt, monetary sector and the financial sector. Meanwhile, the authorities will prioritize measures to regain correspondent banking relationships (CBRs) in order to facilitate the processing of external transactions. In this regard, they have adopted an Anti-money Laundering Law and applied for membership in the FATF style body, ESAAMLG. They are also committed to undertake critical measures to further upgrade their AML/CFT regime.

Conclusion

Our Eritrean authorities remain committed to strengthening institutions, restoring macroeconomic stability, and attaining higher, sustainable and inclusive growth. They look forward to Fund support in providing capacity development in support of their development objectives and value the engagement with the Fund and the international community.

Mr. Merk and Mr. Fragin submitted the following statement:

We thank staff for its well-written report, and Mr. Mahlinza and Mr. Garang for their helpful buff statement.

We mostly concur with staff's recommendations. Twenty years of conflict with Ethiopia and a decade of international sanctions have taken their toll on Eritrea's economic development. The country is facing a difficult economic situation with an unsustainable public debt burden, a highly vulnerable financial system, limited foreign reserve buffers, and an economy suffering from ample distortions hampering private sector growth.

The recent peace agreement with Ethiopia and the lifting of international sanctions provide a welcome opportunity to implement much-needed reforms with a view to transition from a highly state-led system to a market-oriented economy, thereby harnessing Eritrea's existing growth potential. While comprehensively tackling the country's various challenges will require some time, it is indispensable that the government builds strong credibility regarding its commitment to stay on the path of reforms, which is also of the essence to attract necessary foreign investment. In this context, we welcome the authorities' intention to reengage with the international community and regard the first Article IV consultation after a decade as well as the government's willingness to seek technical assistance, inter alia from the Fund, as a positive signal. We understand that the staff report is a rather preliminary assessment of Eritrea's economic situation given the significant data and capacity constraints. Nonetheless, we commend staff for a comprehensive report which appropriately focuses on proposing broad policy reforms and identifying capacity building needs. At the same time, we call on the authorities to rebuild a macroeconomic statistics base which is vital for effective policy making.

While Eritrea has considerable upside potential, including in the areas of mining, trade and potentially tourism, there is still a long way to go. We thank staff for their informative assessment of past transitions and agree that realizing Eritrea's economic potential pivotally rests upon the authorities' unwavering commitment to far-reaching reforms. In particular, strengthening institutions and the rule of law are prerequisites for a flourishing private sector as (foreign) investors and local entrepreneurs alike require legal certainty and the protection of private property for the implementation of long-term projects. On a similar note, protecting human rights and the freedom of speech would help alleviate some of the concerns by potential investors, including from the Eritrean diaspora, which could help spur growth and diversify the economy.

One of the most promising and currently most concrete sources of potential growth and income for Eritrea appears to be the mining sector. While the income stream from projects currently in the pipeline will potentially provide more fiscal space to the authorities, it will be crucial to manage revenues in a prudent fashion so that they are used for sustainable, growth-enhancing purposes to the benefit of the broader public. Concerning the Asmara Project, we take note of the social and environmental challenges with regard to its implementation and wonder if authorities have shared with staff any cost-benefit analyses conducted that take into account externalities on environmental and health outcomes. We understand the direct benefits from the project for public finances but underline the importance to ensure negative spillovers are contained, sustainability concerns have been taken into account and the most vulnerable are protected from adverse effects of the project.

On fiscal policy, we concur with staff that public debt is unsustainable. Eritrea needs a comprehensive debt strategy including but not limited to seeking bilateral and multilateral debt relief. Staff rightly accentuates the need to rigorously follow a prudent fiscal strategy inter alia by enhancing revenues through updating their tax laws and tax accounting system and reorienting spending towards growth-enhancing areas. In particular, we emphasize the importance of limiting and gradually reducing the size of the National Service to free up resources for other more productive uses. We would welcome staff comments on the current size of military expenditure and the potential to reduce it, considering the 2018 peace agreement with Ethiopia. In addition, we call on the authorities to rely on highly concessionary financing and grants going forward.

The monetization of fiscal deficits has been hampering effective monetary policy. Against this background, staff rightly emphasizes the importance of a comprehensive update of the legal framework for the monetary and financial sector. Strengthening the independence and operational autonomy of the BOE and limiting lending to the government is a key prerequisite for establishing and preserving macroeconomic stability.

Finally, we strongly encourage the authorities to swiftly take any needed measures to bring their AML/CFT framework in line with international standards.

Mr. Tan and Ms. Susiandri submitted the following statement:

We thank staff for the good report and Mr. Mahlinza and Mr. Garang for their informative buff statement.

We welcome the progress on the peace agreement with Ethiopia and the lifting of international sanctions, as these have provided a valuable opportunity for the State of Eritrea to regain its economic development path. Nonetheless, daunting challenges remain ahead, stemming from the tight fiscal situation, lower activities on the primary sectors, the narrow-based economic structure and limited private sector participation. Faced with limitations of a post-conflict country, we commend Eritrea's remarkable progress in achieving some of the Millennium Development Goals (MDGs) and encourage the authorities to continue its efforts. We broadly agree with the thrust of the staff appraisal and offer the following points for emphasis.

Reinforcing fiscal discipline is key to preserve macroeconomic stability. The previous expansionary fiscal operation that was financed by the central bank and external borrowings had adversely affected Eritrea's macroeconomic stability. In this regard, we strongly support the authorities' commitment to exercise fiscal restraint and minimize financing needs. Spending adjustment is imperative while keeping in mind budget prioritization for development needs. We encourage the authorities to implement policy measures on restraining wage growth to create room for capital spending. At the same time, improving revenues is also crucial and we support the prompt implementation of the recent TA recommendations on taxation. Further TA engagement to improve revenue collection is also encouraged. Fiscal reforms should also be accompanied by improvements to public financial management. In this regard, consolidating the mining account with the treasury accounts is of utmost importance to capture comprehensive fiscal figures so that the authorities can allocate the budget effectively and efficiently. Considering the urgency for capacity development on the fiscal front, we fully support further TA for Eritrea followed by close engagement during the implementation stage.

A comprehensive debt strategy should be implemented to address the unsustainable public debt level. On the external front, we agree with staff that the authorities could consider requesting debt relief under the Heavily

Indebted Poor Country (HIPC) Initiative to restore external debt sustainability. At the same time, we welcome the authorities' effort to seek debt relief bilaterally from key creditors. Staff's comments are welcome on the authorities' immediate focus at the bilateral level vis-à-vis the HIPC Initiative. On the domestic front, limiting domestic debt accumulation is a top priority given the high debt level of above 200 percent of GDP. We welcome the upcoming TA on public debt management, particularly to address macro-financial vulnerabilities related to the banking sector's exposure to government debt.

Restoring financial stability is essential to ensure that monetary policy transmission and financial intermediation are well-functioning. We note with concern that the banking system is vulnerable due to the high NPL and the large exposure to unsustainable government debt. Staff mentioned that based on other countries' experiences, such problems may be managed through bank restructuring and supportive measures to strengthen the banking sector. We note staff's encouragement on seeking TA support and would appreciate further comments on their assessment of Eritrea's financial and institutional capacity to develop and implement such recommendations in the near-term. We note that the economy could potentially benefit from greater exchange rate flexibility to help the economy absorb shocks as well as to improve economic competitiveness. Given Eritrea's high external debt and its limited monetary and exchange rate toolkit, it would be prudent to proceed with caution and in a gradual and measured manner. We welcome staff's views on the potential risks through the balance sheet channel and further elaboration on feasible measures to smooth out the transition period. In addition, we commend the authorities' efforts to enhance the legal framework on central bank's independence and to undergo a mutual evaluation of Eritrea's anti-money laundering and combating financing of terrorism framework.

Finally, we encourage the authorities to embark on structural reforms to boost long-term economic growth. To that end, we support the authorities' plan to promote private sector participation in the economy. Improving the business climate to boost market confidence is critical. Considering that restrictive measures are typically counterproductive, they should be phased out as soon as conditions permit. We concur with staff that the authorities should consider SOE reforms to level the playing field and improve their efficiency. It would be beneficial for the economy, not only to reduce the fiscal (contingent liabilities) risks but also to improve market competition. Since Eritrea's economic activities are very volatile, structural reforms to reduce the heavy reliance on the primary sectors and diversify the economy should be expedited. We welcome staff's comments on the economic sectors that could potentially be targeted as quick wins for Eritrea's economy.

With these remarks, we wish the authorities every success in their policy endeavors.

Mr. Fanizza, Mr. Rashkovan, Mr. Spadafora and Ms. Harutyunyan submitted the following joint statement:

We thank staff for an informative set of reports and Mr. Mahlinza and Mr. Garang for their insightful buff statement.

We strongly welcome Fund's re-engagement with the State of Eritrea after a decade and the authorities' commitment to seize the opportunities opened by the peace agreement with Ethiopia to rebuild the foundations for private sector-led economic development, diversify the economy beyond agriculture and mining and free up the untapped potential for growth.

As correctly underscored by staff, building momentum for private sector-led economic development rests largely on improvements in infrastructure and business climate. We find Annex 6 detailing several lessons to strengthen growth based on international experience as particularly informative. Meanwhile, we take note of the authorities' views not to commit to the timing of reforms at this juncture.

A comprehensive resolution of Eritrea's domestic debt problems is paramount to overcome the debt distress condition and place the economy on a sound footing. In this regard, we welcome the authorities' intention to develop a comprehensive debt strategy and not to resort to non-concessional borrowing but rather focus on securing grants and concessional loans to finance much-needed capital spending. Given the central role of state-owned banks, the strategy should encompass bank restructuring and NPL resolution. We also welcome the authorities' endorsement of the revenue measures and the recommendations on improving public finance management proposed by staff to achieve fiscal sustainability.

We share staff's view on the immediate priorities, notably stabilizing the difficult macroeconomic situation and addressing the unsustainable public debt burden. Recent stabilization of prices following a period of deflation is encouraging in this regard. Severing monetary policy from any obligations to government financing and restructuring of the publicly-owned banks are instrumental in restoring a proper functioning of the financial system that supports the economy.

We welcome the authorities' remarkable progress on several Millennium Development Goals (MDGs). We encourage the authorities to pursue the scope for eligibility for debt relief under the HIPC Initiative while engaging bilaterally with key creditors and the World Bank.

We support staff's call to seek much-needed technical assistance from the Fund and other development partners to acquire critical input into developing their development strategy. The Article IV Report provides an important contribution in this regard. We also appreciate the Fund's ongoing efforts toward supporting Eritrea's capacity development strategy and stress the importance of enhancing efforts to overcome severe data and capacity constraints.

Finally, we welcome the adoption of the AML law along with the application for the Eritrea's membership in ESAAML and look forward to further progress on this front.

Mr. Sigurgeirsson and Mr. Damgaard submitted the following statement:

We thank staff for the helpful set of papers and Mr. Mahlinza and Mr. Garang for their informative buff statement. The State of Eritrea is gradually opening itself to the outside world after a decade in isolation due to conflict. Economic data remain sparse, but GDP estimates point to highly unstable macroeconomic developments in recent years, primarily driven by volatile outcomes in agriculture and mining. Inflation rates have been negative since 2016 due to significant monetary controls and the border opening in 2018, and government debt exceeds 250 percent of GDP. We broadly agree with staff's appraisal and offer the following points for emphasis.

We commend the authorities for their efforts to improve the fiscal balance, but the debt sustainability analysis clearly shows that additional measures are needed to put debt on a sustainable trajectory. Given Eritrea's limited debt servicing capacity, we urge the authorities to develop a comprehensive debt strategy and to explore the prospects for debt relief, including in the context of the Heavily Indebted Poor Country (HIPC) Initiative. We agree with staff that the authorities should focus on identifying grant financing and improving tax systems to enhance revenues, while the growing public wage bill should be addressed to keep spending in check. A sound public finance management framework should be implemented to support fiscal planning.

The monetary and financial sector frameworks need to be reformed to restore financial stability. The authorities have been monetizing fiscal deficits heavily, and the Bank of Eritrea is by far the government's largest creditor. We encourage the authorities to increase central bank independence to allow the Bank of Eritrea to conduct monetary policy and financial supervision. In addition, the banking sector is highly concentrated, and nonperforming loans have reached almost 90 percent of total loans. This vulnerable situation calls for a systemic bank restructuring with a focus on minimizing economic costs. A well-functioning banking sector will be crucial for promoting growth through financial intermediation.

We encourage the authorities to implement a broad set of structural reforms as recommended by staff. In this respect, we welcome the authorities' commitments to facilitate private sector development, diversify the economy, and improve SOE efficiency. We also agree with staff that actions to improve governance and reduce vulnerabilities to corruption should be key priorities. The implementation of significant structural reforms will strengthen macroeconomic stability and pave the way for much-needed foreign support and investment.

Eritrea's economic transition will require extensive capacity building. We welcome the capacity development strategy outlined in Annex VIII of the staff report and support the top priorities: macroeconomic statistics, fiscal and debt sustainability, and strengthening the institutional framework of the Bank of Eritrea. Could staff elaborate on to what extent this strategy has been developed in collaboration with other international organizations? And how do we best ensure that the authorities have the resources to absorb the proposed extensive volume of technical assistance?

Mr. Heo and Mr. David submitted the following statement:

We thank staff for their comprehensive reports and Mr. Mahlinza and Mr. Garang for their informative buff statement. We welcome the Fund's reengagement with the Eritrean authorities after a decade following the end of conflict and lifting of sanctions. These events have adversely impacted economic development since independence, but with a large natural resources base, Eritrea's prospects are promising if the right policy mix is implemented and the necessary reforms undertaken. We agree with staff's recommendations to enhance policies that would ensure macroeconomic stability, address the debt burden and diversify the economy.

Ensuring fiscal restraint and strengthening the banking system are crucial for macroeconomic and financial stability. Given the difficult circumstances and limited recourse to external and domestic financing, we note the role of the government and the dominance of fiscal over monetary policy. We encourage the authorities to undertake the necessary fiscal, monetary and financial sector reforms that would contribute to Eritrea reaching its growth potential. In this regard, we agree with staff recommendations, including to improve revenue collection and fiscal forecasting, address banking system vulnerabilities, and enhance the independence of the central bank. With the peace agreement reached and ending of embargoes, are there prospects for a shift from spending on the military to other areas, including health and education?

Economic activity and growth prospects remain volatile, being dependent on the mining and agriculture sectors. We note Eritrea’s large natural resources base, with several new mining projects expected to come on stream between 2020 and 2022. We agree that increasing agricultural productivity, developing the fishing sector and boosting the tourism industry will help diversify the economy and contribute towards sustainable and inclusive growth. We acknowledge the authorities’ desire to return to their policies at independence of fostering private sector development with open trade. Reforming state-owned enterprises to improve their efficiency and enhancing business, regulatory and legal arrangements would also assist the private sector to prosper. Eritrea’s strategic location in the Horn of Africa, including along the Bab el-Mandeb strait, could attract foreign investment in developing its maritime and port transportation and cargo logistic services. Could staff comment on the potential for developing this sector?

Ensuring debt sustainability will be an important focus for macroeconomic stability. With unsustainable debt levels where external and overall debt are assessed to be at risk of distress, it is important that Eritrea undertake the necessary measures to reduce arrears, improve debt servicing and build up foreign exchange reserves. We note staff advice on debt relief initiatives and agree that the authorities should also discuss with non-Paris club creditors on any relief arrangements. We welcome the authorities’ acknowledgement for a comprehensive debt strategy and encourage staff to support the authorities in their efforts to improve debt management through technical assistance (TA) and training.

Improving statistics is important for the design and implementation of appropriate policies as well as monitoring and assessing macroeconomic performance. We note the significant limitations with macroeconomic data and that assessments in the reports were based on unofficial statistics, anecdotal evidence and data series with large gaps. The authorities acknowledged these limitations and request more assistance. We therefore call on staff to increase their engagement with the authorities on TA and training, not only from the regional technical assistance center but also from headquarters. Apart from capacity development programs, given the many challenges facing Eritrea, were there any discussions on the possibility of a Fund support program to assist the authorities?

Addressing development and social needs would contribute towards inclusive growth, promoting peace and generating economic activity. We note the progress made towards the UN Sustainable Development Goals (SDGs), especially in education and health. Much more remain to be done, including increasing school enrollment, teacher training, education for girls, and access to clean water, proper sanitation and reliable electricity. We commend the authorities for integrating the SDGs into their development plans in the agreement with the UN in the 2017-2021 Strategic Partnership Cooperation Framework.

Mr. Benk and Mr. Mehmedi submitted the following statement:

We thank staff for the well-written report and Mr. Mahlinza and Mr. Garang for their informative buff statement. We welcome the Eritrean authorities' resumption of the dialogue and reengagement with the Fund and the conclusion of the first Article IV consultation in a decade. The recently signed peace agreement with Ethiopia and the lifting of international sanctions provide Eritrea with the opportunity to now develop its economy and transition to a market-oriented and private sector led growth. Faced with a dire economic situation, the authorities' policy actions will need to focus on securing macro-financial stability, restoring debt sustainability, and removing the restrictions impeding private sector development. For the transition strategy to succeed, policy actions must be well-calibrated and sequenced while taking into account Eritrea's current conditions. At the same time, garnering broad support for reforms while enhancing the safety nets to protect the most vulnerable will be essential. We broadly share staff's assessment and would like to provide the following comments for emphasis.

Implementing the reform agenda and improving the weak institutional capacities will require a scaling-up of technical assistance (TA) from donors and the Fund. Considering the immense challenges and the ambitious reform program, extensive TA, specifically related to the core fiscal functions, public financial management (PFM), banking, and statistics that comprehensively assess data availability, is urgently needed to support both surveillance and policy-making. We would therefore see value for resident advisors to assist in implementing reforms and are assured by staff's assertions that the capacity development delivery in the past was well-received and reasonably absorbed. Staff's comments on whether other development partners have already resumed the provision of TA are welcome.

Fiscal policy should be geared towards avoiding fiscal financing and restoring debt sustainability. In this vein, the authorities' policy measures should include restraining current spending, including growth in real wages, and maintaining a tight fiscal stance to avoid additional domestic borrowing. Broadening the tax base will require updating the tax legislation and implementing PFM reforms, including on enhancing budget transparency. As Eritrea is in debt distress, designing and implementing a strategy to bring public debt onto a sustainable path is essential. In this context, we appreciate staff's conclusion that Eritrea is potentially eligible for debt relief under the Heavily Indebted Poor Country (HIPC) Initiative and their assistance to the authorities to secure such relief. However, it will be equally important that the authorities approach the non-Paris Club creditors, given their significant share in total external debt.

Restoring financial stability will entail monetary and financial sector reforms. The high level of non-performing loans (NPLs) and the banking sector's large exposure to the government require broad-based reforms aimed at restructuring the NPLs. The authorities plan to join the Eastern and Southern Africa Anti-Money Laundering Group and undergo a mutual evaluation of Eritrea's AML/CFT framework under the Financial Action Task Force Forty Recommendations is a welcome development as it could pave the way for regaining correspondent banking relations with overseas banks. At the same time, we concur with staff that the Central Bank Proclamation should be significantly improved, including restating the legal basis for the BOE's independence, ceasing quasi-fiscal activities and limiting lending to the government while vesting the exclusive authority to license new financial institutions in the BOE.

Phasing out restrictions for the private sector and improving the business environment are prerequisites for a private sector led growth. We are encouraged by the authorities' intention to pursue an economic development strategy that envisages a strong role for the private sector. Diversifying the economy and reducing the dependence on agriculture and mining will require measures aimed at enhancing the business environment, increasing public and private investment, reforming the SOE sector, and improving governance. While Eritrea has made progress in improving health outcomes, the reversal of trends on education outcomes since the beginning of the decade is concerning and the authorities will need to devise a time-bound action plan to achieve the sustainable development goals.

Mr. Sun and Ms. Cai submitted the following statement:

We thank staff for the comprehensive reports and Mr. Mahlinza and Mr. Garang for their helpful buff statement. We welcome the resumption of the Article IV consultation with Eritrea after a decade, thanks to the efforts made by both the authorities and staff. After twenty years of conflict and a decade of sanctions, Eritrea is facing daunting challenges and has a long way to go to achieve a much needed economic transition. We broadly agree with staff's appraisal and would limit our comments to the following.

Fiscal reforms are essential to achieve macroeconomic stability and maintain fiscal sustainability. Civil service wages have increased since 2015 while capital spending has been significantly low, hampering productivity growth in the medium term. We encourage the authorities to develop a prudent and growth-oriented public financial management plan. Sound macro-fiscal forecasting is also important and ad hoc spending should be avoided. Preserving social spending remains crucial to reduce poverty and inequality, and the authorities need to double their efforts to improve the social safety net.

Strong efforts to strengthen debt management are critical to addressing debt vulnerability and preserving sustainability. Eritrea is in debt distress with public debt at 267 percent of GDP at end of 2018. Developing a comprehensive debt strategy is of paramount importance and is central to help unlock external support. We commend the Fund and the Bank's technical assistance in this regard. Further improvement in monitoring of public debt and contingent liabilities would also facilitate better debt management. In addition, we encourage the authorities to improve project planning to ensure efficient use of all resources.

Monetary and financial sector reforms should accelerate with a focus on updating the financial sector's legal framework. We agree with staff that the Bank of Eritrea's independence should be strengthened. In this regard, it is encouraging that several bills are to be submitted to the cabinet for approval.

Given the development stage, it would be appropriate to develop more standard monetary and exchange rate instruments. We encourage the authorities to gradually ease exchange rate restrictions and promote greater exchange rate flexibility.

A healthy financial system is key to support sustainable development. We agree that rules and regulations governing the financial sector should be updated comprehensively, including the revision of the Financial Institutions Proclamation. Non-performing loans are close to 90 percent of total loans outstanding and the banking sector is highly concentrated with nearly 70 percent of banking assets held by one bank. This needs to be improved and we urge the authorities to put more efforts in NPL resolution while enhancing banking supervision. We also encourage efforts to restore correspondent banking relations and improve the AML/CFT regime.

Addressing the data gap for surveillance and policy making should be one of the priorities. Systematic data reporting to the Fund is important for proper assessment of the macroeconomic situation. It is good to note that macroeconomic statistics is among the capacity development priorities with an objective to improve timeliness and data methodologies. We encourage staff to make a realistic capacity development plan with full consideration of Eritrea's specific circumstances and special needs.

Technical assistance from the international community is urgently needed and should be well planned with meaningful coordination. From the staff report, we take note that the authorities are requesting technical assistance from the Fund and other development partners on many fronts. Given the keen interest in TA, we believe that timely provision of various TA is fundamental to support the authorities' efforts to rebuild capacity and institutions. Meanwhile, integrated planning and strong coordination of the TA will be key to ensure the effectiveness, while being mindful of the authorities' absorptive capacity.

With these remarks, we wish the authorities every success in their policy endeavors.

Mr. Villar and Mr. Rojas Ramirez submitted the following statement:

We thank staff for its report and Mr. Mahlinza and Mr. Garang for their buff statement and welcome the reengagement of The State of Eritrea with the international community and the normalization of relations with international financial institutions. Eritrea is facing extraordinary challenges for achieving macroeconomic stability and sustained inclusive growth. Authorities are committed to implementing policies in line with their 1990s development strategy based on private sector proclamation—open to external trade and with a strong role for the private sector in the economy.

Building public finance management capacities is essential for The State of Eritrea to achieve macro stability and fiscal sustainability. We note the fiscal policy actions taken by the authorities to achieve fiscal stability. Nevertheless, weak fiscal revenues—with limited access to domestic and external financing—and lingering expenditure structures with a growing wage bill make it difficult to redirect resources to uses such as health and education that are crucial to Eritrea's long-term growth potential, and to support investments to improve agricultural productivity.

We concur with staff's recommendations for enhancing revenue collection. We encourage the authorities to seek assistance for cleaning, updating and maintaining the business register, filing payments of tax returns, enhancing tax accounting and auditing modules and updating the tax laws framework. On the expenditure side, we agree with actions to rationalize and create a more cost-efficient national service structure while addressing wage levels for generating fiscal space. We encourage authorities on Public Financial Management (PFM) reform implementation as well as on establishing strategic priorities and transparency in fiscal policy. We commend authorities for employing technical assistance (TA) from the East Africa Regional Technical Assistance Center (East AFRITAC) to this aim.

Eritrea's external position remains vulnerable. International reserves represent only 2.4 months of imports. Exchange rate remains fixed and several exchange restrictions persist. Authorities emphasize that multiple currency practices (MCPs) no longer exist but the staff report mentions on page 7, ¶8 that Eritrea maintains several exchange restrictions and multiple currency practices (MCPs) and does not recommend approval for the maintenance of those exchange restrictions and MCPs. Could staff clarify? We agree with staff's recommendation for considering further flexibility on the exchange rate and eliminating exchange restrictions. We also encourage authorities to enhance the legal framework for the monetary and financial sectors, including the legal basis for the Central Bank of Eritrea (BOE) independence, halting quasi fiscal activities and lending to the government.

Authorities are committed to a comprehensive debt management strategy to address Eritrea's debt distress. Since Eritrea is potentially eligible for debt relief under the Heavily Indebted Poor Country (HIPC), we concur with staff in encouraging authorities to explore this possibility and to approach non-Paris Club creditors, given their significant share in total external debt.

The banking sector is highly vulnerable, with poor asset quality and extremely high non-performing loans (NPL) indicators. We agree with staff and encourage authorities to seek TA assistance for restoring financial intermediation and implementing measures for restructuring and strengthening banks, restoring correspondent banking relations and bringing their AML/CFT regime in line with international standards.

Mr. Rosen and Mr. Shenai submitted the following statement:

We welcome Eritrea's reengagement with the international community including its first Article IV consultation in a decade. We appreciate staff's analysis of Eritrea's economy, despite data limitations and broadly agree with the policy recommendations. We thank Messrs. Mahlinza and Garang for the helpful buff statement. The current period provides an opportunity for the Eritrean authorities to take stock of the country's economic challenges and opportunities to develop an updated development plan, which could unlock the country's economic potential.

The assessment in this year's Article IV report bears unfortunate similarities to the last report in 2009. Then, as now, staff noted that "data provision has serious shortcomings that significantly hamper surveillance." Then, as now, staff noted that public debt was unsustainable, and that fiscal dominance has hampered monetary policy. In 2009, staff concluded that "With current policies, the medium-term outlook will continue to impose hardships on the population." We can only wonder to what extent these issues could have been addressed and the people of Eritrea could have been better off if the Eritrean authorities would have been willing to engage with the Fund over the past 10 years.

Fiscal and Debt Policy: Eritrea's fiscal policy has led to an unsustainable debt burden, and the state's large presence and financing requirements leave limited space for the private sector. Improving fiscal policy will yield multiple dividends, including, in combination with other reforms, creating space for the private sector, enhancing monetary policy effectiveness by reducing fiscal dominance, and reducing banks' sovereign risk. Given that civil service wages were unchanged between 1997 and 2015 despite substantial inflation, we recognize that adjustment in wage policy was needed. However, we urge the authorities to limit future wage growth and strongly support staff's call for a gradual reduction in the size of the National Service. Reorienting fiscal expenditures toward capital spending and improving public financial management will be critical to support the substantial development needs of the economy and reduce fiscal risks. We agree with staff on the need for the authorities to consider state-owned enterprise (SOE) reform to reduce fiscal costs and improve competitiveness. We also urge the authorities to consolidate public spending into a single set of accounts. Does staff have a sense of the scale of off-budget financing and whether this financing extends beyond the mining sector?

Developing a comprehensive strategy to address Eritrea's unsustainable debt is key to macroeconomic stability. We recognize that this will not be an easy process but encourage the authorities to continue their engagement with the World Bank to reduce the stock of IDA arrears. We also agree with staff on the need to reach out to non-Paris Club creditors who hold the bulk of Eritrea's bilateral debt. Given its debt distress we would urge the authorities to rely solely on grant financing. We would welcome staff comments on the status of any bilateral debt discussions.

Monetary Policy and Financial Sector: Restoring the legal framework for the independence of the Bank of Eritrea is necessary to eliminate the monetary financing of the fiscal deficit. We also note the importance of developing monetary policy tools to allow the central bank to implement policy. Exchange rate flexibility could help the economy better absorb exogenous shocks and eliminate the parallel market, but we acknowledge the authorities' concerns about the impact of a depreciation on the already unsustainable external debt. Could staff comment on how they see the timing of introducing a more flexible exchange rate? Does staff agree with the authorities' assessment made in the buff statement that multiple currency practices no longer exist in Eritrea?

Reducing bank exposure to the public sector can improve the health of the banking sector and increase private credit. Additional efforts to diversify and reform the banking sector beyond Eritrea's three publicly owned banks, including by easing restrictions on private sector banking activity and increasing private sector financial access, should be considered. Does staff have information on a breakdown on banks' sectoral exposure, particularly their vulnerability to a sudden fall in agriculture and metals prices?

We urge the authorities to work with the Eastern and Southern Africa Anti-Money Laundering Group (ESAAMLG) and implement existing regulations to build a track record of effective anti-money laundering (AML) risk mitigation. Publishing Eritrea's AML laws, regulations, and proclamations may help build international confidence in Eritrea's banking sector regulation and enhance correspondent banking access. Moving financial intelligence functions from the Income Assessment Unit of the Bank of Eritrea to the Financial Intelligence Unit while undertaking an illicit finance national risk assessment, in line with Financial Action Task Force/ESAAMLG standards, should be prioritized. Formalizing remittances corridors may also reduce transactions costs, increase financial inclusion, and enhance private sector credit.

Capacity Development: We welcome the Capacity Development Strategy outlined in Annex VIII to address Eritrea's substantial needs. We support the three priority areas: macroeconomic statistics, fiscal and debt sustainability, and strengthening the institutional framework of the Bank of Eritrea. The lack of national accounts data is a serious concern, and this is critical for an analysis of debt and the economy. We see this as the first priority for improving data provision.

Mr. Lopetegui and Ms. Moreno submitted the following statement:

We thank staff for the report and Mr. Mahlinza and Mr. Garang for their useful buff statement.

We welcome the resumption of Fund surveillance with Eritrea. As evident from the staff report, we view this Article IV Consultation as providing a very preliminary assessment of the country's situation, given the significant data gaps that hamper adequate surveillance. Not surprisingly, the absence of formal consultations over the last decade coincided with the emergence of severe macroeconomic imbalances and structural regress, admittedly also due to the conflict with Ethiopia, which must be addressed to allow the country to restore its chances of achieving sustainable and inclusive growth. We think this is a good opportunity to remind ourselves that the Fund's policy does not provide enough encouragement for countries that are unwilling to consult, and that an upgrade of the remedial framework to deal with excessive delays is necessary.

The peace agreement provides the opportunity to address serious structural constraints and normalize macroeconomic policies. Economic development has been severely impaired in Eritrea after twenty years of conflict with Ethiopia. Challenges include severe capacity constraints and an unsustainable public debt burden. The external current account is in surplus, with significant flows of remittances, but errors and omissions are highly negative; there are restrictions to access foreign exchange, which lead to a parallel market, and international reserves are low. Regarding multiple currency practices, can staff comment on the different view with the authorities, who emphasize they no longer exist? In addition, the Central Bank is the lender of last resort of the government given the limited access to external financing, and the highly vulnerable domestic banking sector. Could staff comment on the health of the central bank balance sheet? It is notable that against this background the country has recently suffered a sizable deflation. Can staff further elaborate on the reasons to such developments and link them to imbalances in the monetary market? In the financial sector, banks are likely to be undercapitalized due to large non-performing loans. International financial relations are impaired by the absence of correspondent banks relationships.

Given that the economy will remain under pressure for some years, the authorities should build credibility regarding their commitment to implementing the necessary reforms. We believe that strengthening institutions and the rule of law, including to protect human rights, constitutes an essential priority of the reform process to create an environment propitious for growth, rooted in a larger participation of the private sector. This area of reform will also be particularly important to attract foreign investors. The authorities will need to appropriately prioritize and sequence other reforms, focusing upfront in correcting the macroeconomic imbalances. As staff correctly points out, short-term costs will have to be addressed and mitigated. Authorities are encouraged to draw from the country's experience after gaining independence in 1991 and from transitions in other regions (Annex VI).

We support the authorities' request for technical assistance from the Fund to rebuild capacity and institutions. As mentioned above, the challenges ahead are numerous as are the areas that need to be tackled. Improving Statistics (e.g. national accounts, inflation, fiscal and BOP data) is extremely relevant to make a genuine assessment of the economic situation and we call on the authorities to make this a high priority. On the legal framework, designing Central Bank and Financial Institutions laws, developing debt resolution strategies, are issues that we agree are key to include in the roadmap. Another important area where the Fund can use its expertise is to support the authorities in the fiscal sector and debt management, as well as in financial sector issues.

Fiscal sustainability needs to be restored. We agree with staff that more prudent fiscal management is needed. The strategy should include both revenue enhancing measures as well as control of expenditures, to create space for priority development and social spending. We underscore the importance of adequate public fiscal management so that the resources are effectively directed towards growth-enhancing areas and further attainment of SDGs. We endorse staff's recommendation to rely on highly-concessional financing and grants, and to encourage the authorities to regularize its arrears to the World Bank.

With these comments we wish The State of Eritrea and its people the best in their future endeavors.

Mr. Trabinski and Ms. Urbanowska submitted the following statement:

We thank staff for their informative set of reports and Mr. Mahlinza and Mr. Garang for their helpful buff statement. We welcome the resumption of consultations under Article IV with Eritrea. We note with concern the very difficult macroeconomic situation the country is facing, as well as its large capacity development needs. The reestablished peace agreement with Ethiopia and the removal of UN sanctions provides an opportunity to launch the reforms needed to realize the country's substantial potential for growth. We broadly agree with the thrust of staff's appraisal and we would like to offer the following comments.

Restoring macroeconomic stability will be critical. Given the unsustainable levels of domestic and external debt, a comprehensive strategy to address the debt burden is key. We agree with the authorities that priority should be given to securing new grants and highly concessional financing, while avoiding domestic borrowing. Fiscal discipline, including wage restraint, and redirecting spending to growth-enhancing areas will be essential. Furthermore, we agree with staff that consolidation of fiscal accounts, particularly the government's mining account held at the central bank, is needed for a clear assessment of the fiscal stance. We note the potential eligibility for debt relief under the Heavily Indebted Poor Countries (HIPC) initiative. We also note the authorities' intention to seek debt relief from key bilateral creditors.

Financial sector repair and central bank independence will be key. The authorities will need to comprehensively address weaknesses in the banking sector, including the large stock of NPLs. Meanwhile, prioritizing measures to regain correspondent banking relationships (CBRs) would be important to facilitate external transactions. In this context, we welcome the adoption of the Anti-Money Laundering Law and the strengthening of the AML/CFT regime, as stated in the buff. Furthermore, we encourage the authorities to revise the monetary policy framework, and in particular to provide a legal basis for the central bank's independence. We echo staff's call to limit monetary financing of the government. Could staff comment further on the multiple currency practices (MCPs), given the differences in view with the authorities mentioned in the buff?

Promoting private sector-led growth over the medium term will be essential. Easing restrictions on imports, particularly those financed through foreign exchange sources, would help businesses acquire means of production and facilitate resource allocation in a more efficient way. A level playing field for private and public enterprises will be needed to restore competition. Also, improving access to financial services and developing business-friendly policies, including by protecting property rights, would underpin the country's medium-term strategy for healthy and sustainable growth. Also, providing social safety nets to protect the most vulnerable and safeguarding their access to education and health care should be a priority.

Finally, rebuilding the macroeconomic statistical database will be crucial for policy planning and Fund surveillance. We encourage the authorities to continue to seek technical assistance provided by the IMF and development partners to support these efforts. Given the data limitations, could staff inform on the extent to which Eritrea is currently fulfilling its obligations under Article VII, Section 5?

Mr. Castets, Mr. Ronicle, Mr. Hemingway and Ms. Van Hoek submitted the following joint statement:

We would like to thank staff for an informative set of documents and Mr. Mahlinza and Mr. Garang for their helpful buff statement. We are very pleased to see an Article IV consultation was conducted this year, ten years after the last review. The July 2018 peace agreement with Ethiopia and subsequent lifting of international sanctions provide a window of opportunity for the State of Eritrea to reform its economic model and implement long-awaited reforms. We welcome the authorities' commitment to reforms and their high-level demand for technical assistance in several fields. We urge the IMF to provide TA and assist the authorities as much as possible to make this transition successful.

Nonetheless, it is difficult to separate economic policy from the political situation in the Eritrean context. Despite recent progress, the broader situation in Eritrea remains concerning. Despite the peace accord and lifting of sanctions, we understand this has yet to lead to substantial changes on the ground. For example, we note that the lack of clarity on border arrangements, with no agreements on customs, trade or movement of people, risks unravelling progress. We are also aware that few donors are present in Eritrea and further progress, including on the human rights situation, will be necessary to increase support. Progress in these broader areas will be necessary – though not sufficient – to achieve economic objectives.

All evidence points to major economic vulnerabilities across the economy. Growth has been very volatile over the last ten years, oscillating between -21 and +31 percent, driven primarily by agriculture and mining. Inflation has also been highly unstable during a period when monetary policy has been characterized by strong fiscal dominance. The money-to-GDP ratio reached 230 percent in 2015 due to the lack of external financing and constrained domestic financing and the subsequent response to inflation and exchange rate pressures effectively tightened cash in circulation and forced the economy into a deflationary phase. Relatedly, with an almost 90 percent non-performing loan ratio, the concentrated banking sector, made up of three publicly owned banks, is in a difficult situation and must be reformed.

The debt situation is particularly concerning. The DSA clearly shows that the State of Eritrea is in a situation of debt distress, with public debt at 267 percent of GDP. We positively note that the authorities have acknowledged the need for a proactive debt-management and resolution strategy, will seek debt relief bilaterally from key creditors and intend to look into the possibility to receive debt relief under the Heavily Indebted Poor Country (HIPC) Initiative and the Multilateral Debt Relief Initiative. We encourage the authorities to draw on support from the Fund and World Bank to pursue these aims. We agree with staff that reaching out to non-Paris Club members in this context will be critical. What can the IFIs do to support the Government of Eritrea in this non-Paris Club outreach? However, the domestic debt burden is a larger problem, which HIPC or other external debt relief would not address. Given this high public debt level, what support can the IMF offer of the Eritrean authorities' in developing a 'comprehensive strategy to address the domestic debt burden'? Are there lessons from elsewhere?

In this context, containing fiscal risks is essential to reduce debt levels while supporting growth. We note the sharp fiscal consolidation in recent years and support the authorities' objective to focus on securing grant financing. Increasing revenues while controlling spending will also be essential. We share staff's recommendation to reform the tax system to enhance revenue collection. Addressing the growing wage bill will also be key, including considering reversing the recent decision to increase military wages and reducing national service. Sound and reliable macro-fiscal data and forecasting is needed to allow strategic budgeting, which also implies the need for a consolidation of fiscal accounts for better transparency. We urge the authorities to rebuild their macroeconomic statistics base to be used as a basis for effective policy making.

We support staff recommendation to reestablish financial intermediation so that the Central Bank can focus on its mandate to conduct monetary policy. It should cease quasi-fiscal activities and lending to the government. To ensure this, a new version of its Proclamation should be adopted to restate the legal basis of its independence. We were pleased to read in the buff statement that such a bill has been drafted and should be approved in the near future. The banking sector should be restructured and strengthened, while it is also essential that correspondent banking relations be restored, so that banks can undertake foreign exchange transactions.

Given capacity constraints and remaining vulnerabilities, prioritization and sequencing of reforms will be critical. Given this, we note the authorities' concern that the greater flexibility of the exchange rate recommended by staff would have negative consequences on the already very high level of external debt (65 percent of GDP and 308.5 million USD of arrears). In addition, given the current lack of tools to conduct active monetary and exchange rate policy, we believe a more sequenced approach could be considered with the use of technical assistance in this field. Staff comments on the appropriate sequencing and plausible timing of relevant technical assistance, a decrease of the level of external debt, and moves towards a more flexible exchange rate system would be appreciated.

In order to create more sustainable and inclusive growth, economic diversification is essential. The State of Eritrea has real potential for diversification in sectors such as marine trade, tourism, or manufacturing. Its large diaspora is also a strong asset. Reforms such as MIHAP should boost productivity in the agricultural sector which employs 43 percent of the active population. Private sector development will also play a major role in boosting growth provided the authorities remove the distortions that were created during the war and that have constrained private sector growth (notably restricted access to financing and the monetization of fiscal deficits). We share the staff position that state-owned enterprises should be reformed, and their fiscal oversight reinforced, given their weight in the economy, with entire sectors in which they have a monopoly (construction, telecommunication, electricity and procurement). Advances by the Central Bank to non-financial SOEs should be eliminated.

Finally, growth should not only be more sustainable but also more inclusive. We were somewhat surprised that no mention of social measures or social safety nets appear in the report itself and are only present in Annex IV “Lessons from Transition”. Comments from staff are welcome. We concur with staff’s recommendation in the report to explicitly budget any implicit subsidies but caution against phasing them out immediately given their importance for the most vulnerable households. The transition and numerous reforms that need to be put in place should be accompanied by social policies to protect the vulnerable and to provide common opportunities relating to employment and investment. The authorities’ commitment and progress towards the development goals, especially in the field of health, are encouraging, even though progress remains to be made in education.

Mr. Raghani, Mr. N’Sonde and Mrs. Boukpessi submitted the following statement:

We thank staff for the report and Mr. Mahlinza and Mr. Garang for their insightful buff statement.

At the outset, we would like to commend staff’s efforts in conducting the first Article IV consultation with the State of Eritrea in almost a decade. We welcome the reengagement of Eritrea with the international community, notably the normalization of relations with international financial institutions.

Eritrea’s macroeconomic situation is very challenging, with external and public debt in distress, a highly vulnerable banking sector and significant institutional and capacity constraints. We, therefore, urge the authorities to swiftly move ahead with the necessary polices aimed at restoring macroeconomic stability, tackling the debt overhang, building capacities and mobilizing resources to sustain critical structural reforms and lay the ground for a sustainable and inclusive growth. To this end, wide international support in the form of aid, policy advice and technical assistance to Eritrea will be of importance at this critical moment.

We broadly agree with the thrust of the staff appraisal although we note that staff’s analysis is constrained by data shortcomings. We would like to focus our remarks on the following issues.

The materialization of the country’s positive prospects ultimately hinges on the authorities’ strong commitment to deliver on reforms to address the challenges facing the country. The favorable growth forecasts are predicated on strong investments, development of the mining sector and coastal tourism, and activity in the fisheries and agriculture sectors. Therefore, we encourage the authorities to smoothly implement their Minimum Integrated Household Agricultural Package (MIHAP) initiative, pursue the development of infrastructure projects and make utmost efforts to improve the business environment. That said, we wonder if the projected growth rates, ranging from 3 to 4 percent, will be sufficient to increase per capita income and begin reducing poverty. Staff's elaboration will be appreciated.

Fiscal discipline is essential to recover macroeconomic stability and tackle the unsustainable public debt level. The authorities should continue to rely on grants and concessional loans to support infrastructure building while undertaking actions to reduce the country's public indebtedness. Along with these actions, efforts aimed at enhancing domestic revenue mobilization should be pursued to increase space for spending, including for much-needed capital expenditures. Containing Eritrea's wage bill and steadily reducing the size of the National Service are also key to make room for social spending. We see merit in reforming public financial management as it would improve the budget process, and in furthering transparency in government operations. We welcome the measures underway with the support of East AFRITAC.

We concur with staff that a comprehensive debt strategy is needed to address the unsustainable public debt. We encourage progress in discussions to obtain debt relief from bilateral creditors, including non-Paris Club partners, which account for more than 30 percent of the total external debt. Could staff elaborate on the steps taken by the authorities in this regard? Additionally, details on the ongoing discussions with the World Bank for the repayment of IDA arrears would be appreciated. We have the sense from the report that the authorities do not seem to seek for a debt relief under the HIPC Initiative and the Multilateral Debt Relief Initiative (MDRI). Staff's comments on this matter would also be welcomed.

Reforms of the financial sector are required to restore stability and allow the Bank of Eritrea (BOE) to better conduct its monetary policy. Tackling the high level of non-performing loans and the sector' s large exposure to the government should rank high among the authorities' priorities. Moreover, the independence of the BOE should be further strengthened and we strongly encourage the BOE to refrain from carrying on any fiscal activities. We commend the authorities' intention to restore correspondent banking relations and would like to take the opportunity to underscore the need for Eritrea to swiftly adopt an AML/CFT framework aligned with international standards. In this context, we welcome the positive update provided in Messrs. Mahlinza and Garang's buff statement.

Fostering private sector development and enhancing the legal and institutional frameworks in the context of a new national development strategy are crucial for the country's development agenda. We agree with staff that this new development strategy could be drawn upon the 1990s private sector proclamation. However, measures such as restrictions on imports should be halted. In addition, efforts towards improving the efficiency of state- owned enterprises, easing labor shortages, enhancing the business climate and promotion of good governance should also be pursued.

Finally, we urge the authorities to address statistics deficiencies and reinforce capacity building with a view to better inform policymaking and ensure more accurate assessments. In addition, we welcome the areas of priorities as outlined in the Annex VIII of the staff report notably; statistics, fiscal and debt sustainability, PFM, as well as legal frameworks in the monetary and financial sectors. We urge the Fund to step up its tailored assistance as much as needed.

With these remarks, we wish the Eritrean authorities success in their endeavors.

Ms. Levonian and Mr. Williams submitted the following statement:

We thank staff for their well-written set of reports. Rebounding from the setback caused by two decades of conflict and international isolation will be a challenging task for Eritrea. Nevertheless, as conveyed in the insightful buff statement of Messrs. Mahlinza and Garang, the authorities remain committed and are showing steely resolve to restore macroeconomic stability and generate strong and inclusive growth. Solid financial and technical support from international development partners will be crucial during this phase of transition, and for enabling Eritrea to exploit its immense potential. We broadly concur with staff's assessments and recommendations and offer the following remarks for emphasis.

Eritrea will need strong institutions and enhanced capacity to advance its development agenda. The recent peace accord and lifting of UN sanctions provide the appropriate setting for Eritrea to take determined steps to place the economy on a firm footing. However, thin capacity and inadequate data will hinder timely and efficient implementation of key macroeconomic policies and reform measures. Urgent support from the Fund and other TA providers through a well-sequenced capacity development (CD) strategy tailored to Eritrea's circumstances is vital to drive the reform agenda. In this regard, we appreciate staff's presentation in Annex VIII, which underscores the importance of strongly integrating CD needs with surveillance. The shortcomings with the current data set may warrant closer and more frequent engagements with the authorities. With this in mind, we urge staff to remain flexible and be prepared to adjust their policy advice once better data become available.

Bold steps are required to durably reduce the high debt burden. At 267 percent of GDP, debt remains a stranglehold on growth and development. Steady and sustained actions to mobilize revenue and contain wage costs will be crucial to creating space for development spending in areas such as health, education, and the strategically important agriculture sector. So too will be efforts to secure grant funding and limit non-concessional borrowing. These undertakings should be augmented by an upgraded public financial management framework to include improved budget planning and fiscal reporting. Taken together, these actions will be key to alleviating debt distress and fostering macroeconomic stability. Furthermore, we welcome the authorities' intent to settle outstanding debt obligations and share staff's view that they should consider pursuing debt relief under the HIPC initiative.

Going forward, Eritrea should take meaningful steps to modernize the monetary policy framework and strengthen the financial sector. That said, we encourage staff to ensure that the authorities are provided with needed TA to enhance the monetary policy toolkit, which would better equip the central bank to respond to exchange rate volatility. Can staff comment on the information in the buff that, contrary to its views, Eritrea no longer maintain MCP? On the financial sector, efforts to address high NPLs and improve the regulatory environment should be accelerated. As we have observed, some countries that have taken meaningful steps to improve their AML/CFT regimes still face challenges restoring CBRs. We welcome staff's elaboration on how Eritrea may overcome impediments to regain CBRs.

Reinvigoration of private sector activity will be key to uplifting and sustaining inclusive growth. Eritrea has considerable scope for expanding the dominant agriculture and mining sectors, as well as diversifying into other areas such as tourism. To engender business confidence, the authorities should continue to implement policies aimed at entrenching macroeconomic stability, as well as reforms to improve the business and regulatory environment. Regarding the latter, easing of restrictions on financial transactions and licensing requirements, among others, will be important steps toward inducing greater private investment, including from the sizeable Eritrean diaspora.

Mr. Mouminah, Mr. Alkhareif and Mr. AlHafedh submitted the following statement:

We thank staff for a well-written report and Mr. Mahlinza and Mr. Garang for their informative buff statement. Since we broadly agree with the thrust of staff's assessment and policy recommendations, we would limit our comments to the following issues for emphasis.

We welcome the resumption of Fund engagement with the State of Eritrea after a decade. The country has significant potential in mining, agriculture, fishing, tourism, and ports, which can be realized through maintaining peace and normalizing relations with the international community. We take note of the authorities' efforts to implement reforms to regain macroeconomic stability, build on the success in a number of key development areas, and advance Millennium Development Goals (MDGs), such as eradicating poverty and hunger, as highlighted in Annex I. Here, we are encouraged by the authorities' plans to pursue a private-sector led economic development strategy and urge further efforts in this area. Furthermore, we note that data and capacity constraints have limited the scope for informed policy making. In this context, the authorities' commitment and scaled-up Fund capacity development support aimed at improving data and capacity will be key going forward. Here, we are encouraged by the capacity development strategy proposed by staff (Annex VIII), and we see merit in proper sequencing of TA's to reduce implementation risks.

The authorities' plan to maintain fiscal restraint and undertake revenue-enhancing measures to ensure fiscal sustainability is appropriate. Indeed, it is important to control spending while improving tax collection and broadening the revenue base. Additionally, improvements in PFM, including realistic budgeting and fiscal transparency, will facilitate sound macroeconomic policy implementation, and enhance the country's ability to secure grants and concessional resources to meet future financing needs.

Setting public debt on a sustainable path is urgent and will require a comprehensive strategy. In this context, we agree with staff on the immediate need for policies to address the domestic debt overhang, external arrears, possibly through debt relief in the context of the HIPC Initiative and MDRI, and implement a borrowing policy that relies on grant and highly concessional financing. Here, we encourage the authorities to proactively engage with external creditors.

The current pegged regime seems appropriate. Given the large external debt and the lack of tools to conduct active monetary and exchange rate policy, we agree with the authorities that exchange rate flexibility could be introduced only in the future. Here, we encourage the authorities to strengthen international reserves to mitigate external vulnerabilities. We also urge the authorities to continue their efforts to restore correspondent banking relationships. In this connection, we are encouraged by the authorities' plan to join the ESAAMLG and undergo a mutual evaluation of AML/CFT framework. Indeed, we welcome their commitment to bring their AML/CFT regime in line with international standards.

Finally, we emphasize the need for economic diversification, facilitating private sector growth by removing impediments, and strengthening social safety nets. Indeed, inclusiveness of the transition requires not only providing adequate social safety nets to protect the most vulnerable, but also providing common opportunities relating to employment and investment. This can be done through measures to attract productive enterprises and investments in physical and human capital and improve the legal and judicial system. In this regard, we look forward to the authorities' national development strategy, focusing on facilitating private sector development, diversifying the economy, improving SOE efficiency, and strengthening the business environment.

With these comments, we wish the authorities further success in their future endeavors.

Mr. Saraiva and Ms. Florestal submitted the following statement:

We thank Mr. Mahlinza and Mr. Garang for their statement. We also thank staff for the report. We strongly commend the mission team for completing the first Article IV consultation with Eritrea in 10 years, and for their effort to engage with the authorities and normalize relations between the IMF and the country. In our view, today's Board meeting is an important display of the Fund's capacity to engage with countries in fragile situations.

Data limitations remain a critical constraint to macroeconomic evaluation and policy formulation in Eritrea. However, the staff report provides a useful glance at the Eritrean economy since the 2016 briefing note. The Eritrean economy faces several challenges during this initial period of re-integration in the international scene and re-opening of borders with Ethiopia. Despite AFRITAC East's continued technical support in recent years, public institutions are generally in severe need of being strengthened. In this regard, we note that the authorities welcome the Fund support being offered in statistics, PFM, revenue mobilization, legal framework for taxation, financial sector, and domestic debt. We encourage staff to work in close coordination with other development partners to maximize the impact of TAs, enhance complementarity and avoid overlaps.

The primacy of subsistence agriculture and mining make the Eritrean economy very vulnerable to weather shocks and international price fluctuations. We concur with staff that significant investments will be required to diversify the economy and untap its potential. We also agree that "macroeconomic stability is a prerequisite to attract private investment", as well as the removal of structural impediments to private initiative, including from the Eritrean diaspora. Improving the business environment would include taking adequate measures to promote financial intermediation. Unfortunately, the current concentration of the banking system in a failing public bank does not bode well. Could staff elaborate on the desirability and possibility of new private players entering the banking system and what role, if any, other financial institutions play in serving the population?

In the near term, addressing domestic debt problems is paramount to achieving sustained macroeconomic stability. As underscored in the staff report, "efforts to achieve fiscal sustainability should encompass increasing revenues and reorienting spending to growth-enhancing areas". While we concur that the authorities should focus on identifying grant financing, we wonder how much grant resources are effectively available in the short term and what would be the prerequisites for tapping into substantial concessional and grant financing?

Eritrea is considered in debt distress, while important data is missing on both domestic and external debt, and BOP data, even if incomplete, portrays a worrisome picture. We note that an internal investigation is being undertaken to determine the nature of the long-standing advance by the Central Bank to a state-owned enterprise that represents about a quarter of the domestic debt. Also, the maturity of foreign currency loans by commercial banks is unknown. In addition, we learn from the report that 28 percent of total external debt, as well as a large portion of the arrears are to IDA. Could staff explain more in detail the debt situation towards IDA, for which arrears in 2015 were estimated to be at US$55 million and increasing by US$12 million every year? Information on prospects for IFC and MIGA support to private sector initiatives would also be useful.

More information on whether Eritrea plans to request debt relief under HIPC and MDRI and how the rules and processes would be applied today is needed. In particular, we wonder (i) whether staff has already determined with management what would be the length of time required for Eritrea to establish a track record under a program; (ii) if a PRSP would still be requested; and (iii) what is expected from discussions with the World Bank to "regularize" arrears?

The task ahead is enormous, and reforms need to be comprehensive. Success will depend on the authorities' determination and capacity to establish the proper sequencing and timing of reforms. We note that authorities did not commit on when to undertake some of the critical reforms staff has suggested (e.g. private sector measures, reduction of National Service, greater exchange rate flexibility). We encourage staff to assist the authorities in developing a strategy to implement their reform agenda with realistic and properly sequenced steps.

The Acting Chair (Mr. Zhang) made the following statement:

This is Eritrea's 2019 Article IV consultation, which is the first after a decade. It is an important milestone, which signals the country's willingness to come back and to open up to the international community. This is a welcome step.

The country has suffered a protracted conflict and decades of sanctions, which have resulted in a very difficult economic situation. Following the peace agreement last year, the country has re-engaged with the international community, and all of this has been recognized in Directors' gray statements. All of us welcome the opportunity to discuss this Article IV consultation. Given the substantial development needs, gray statements called for the implementation of much-needed reforms to restore economic stability and particularly to support the private sector development, strengthen institutions, and above all, reduce the debt burden.

Directors also recommend seeking extensive technical assistance (TA) to support all of these reforms in order to achieve the objectives. The staff will stand ready to assist the authorities in their efforts to address the economic challenges and to achieve inclusive growth, which will benefit the entire population of the country.

Mr. Mahlinza noted that it was an historic moment for Eritrea and expressed happiness to have arrived at that moment.

The staff representative from the African Department (Mr. Mukhopadhyay), in response to questions and comments from Executive Directors, made the following statement:[3]

> As has been said, the 2019 Article IV consultation with Eritrea was the first one in a decade. The team greatly appreciated the authorities' cooperation and candor in discussing the challenges that the country faces.
>
> I would like to thank Directors for their remarks on the staff report. We have provided responses to all of the questions that were raised in the gray statements, and we stand ready to answer any further questions that Directors may have.

Ms. Mehri made the following statement:

> We thank staff for the excellent work and Mr. Mahlinza for his informative buff statement and for his remarks today.
>
> We did not issue a gray statement, but we would also like to strongly welcome the Fund's re-engagement with Eritrea after a decade, with the first Article IV consultation. We also welcome the authorities' commitment to seize this opportunity of the peace agreement to address their substantial development needs and secure macro financial stability.
>
> We agree with the staff's recommendations, and I would like to stress the importance of technical assistance (TA) in supporting the country's development, as well as the authorities' efforts to rebuild capacity and institutions. In this regard, we believe that strong coordination with other development partners will be key to ensure the effectiveness of the deliverance of TA, while being mindful of the authorities' own capacity needs.

Mr. Hemingway made the following statement:

> We issued a reasonably lengthy gray statement with Mr. Castets. Our reflections on Eritrea are not unique to Eritrea, but it is particularly extreme in this case, where you can look at the staff report and see this is either a glass half full or a glass half empty situation. Clearly, there are some huge

[3] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

challenges still in Eritrea. It is impossible to ignore the political situation, the consequences that has for the economy and the recovery. The debt situation stands out as well as a major challenge for the authorities to tackle. I welcome your explicit statement that the Fund stands ready to help on that.

This is an historic moment, as Mr. Mahlinza has just said. It is great that there is re-engagement here, and hopefully that momentum will continue going forward. We commend the authorities on their work to date and the re-engagement that has happened so far. We thank staff for their efforts in that regard, including going into the country and engaging with the authorities as much as possible. We wish both sides luck as this continues. Hopefully, we will have more positive news on things like progress in the Heavily Indebted Poor Countries Initiative (HIPC) process and so on in the coming years.

Ms. Pollard made the following statement:

I thank the Acting Chair and the staff for their remarks. We agree that this is a momentous occasion and certainly welcome the re-engagement of Eritrea with the Fund.

That said, we share Mr. Lopetegui and Ms. Moreno's concern, that this also points out the weaknesses in the current framework for addressing the excessive delays in Article IV surveillance but wonder what could have been gained if the Fund had been able to engage with the authorities over the last decade.

Like Mr. Hemingway, we see great potential and also many challenges facing the country. We believe the two priorities are improving capacity, including data provision, and TA is critically important, and then also addressing the unsustainable debt.

We welcome the discussions with the World Bank, as staff indicated in their answers, to eliminate the International Development Association (IDA) arrears, but we are concerned that Eritrea's ability to repay a Development Policy Operation (DPO) would be limited, given that it is in debt distress. Certainly, we would like to see a more comprehensive debt restructuring framework.

We also agree with staff, that it is too early to consider a Fund financing program, but we support their close engagement with the Fund to address the substantial challenges and development needs.

We wish the authorities all success.

Mr. Sigurgeirsson made the following statement:

We thank staff for a sensitively drafted and focused report.

Like Ms. Pollard mentioned, the engagement with the authorities begs the question about long delays in engagement with individual country authorities. Nevertheless, I welcome Eritrea's re-engagement with the international community and would like to take this opportunity to highlight two main priorities.

First, as Mr. Hemingway mentioned, there is a clear need to address public debt and place it on a sustainable path. Given Eritrea's difficult situation, the debt strategy should be centered on debt relief and concessional lending, while developing a sound public financial management (PFM) framework to ensure fiscal sustainability. The successful implementation of these measures and steps to diversify the economy will create the underlying conditions for stable macro and financial conditions. These objectives will need to be met to attract much-needed foreign support.

Second, the availability of macroeconomic statistics in Eritrea seems to be very limited. I support the top priority that is being given to statistics in the capacity development strategy. As we all know but sometimes need reminding, without the appropriate data, managing an economy is like sailing a boat without a compass. Statistics can provide direction, which allows us to see where we came from and where we are going. In other words, reliable and timely macroeconomic statistics are a prerequisite for sound policy decisions. And in Eritrea, that is very much needed for a quick fix in this area.

Mr. Trabinski made the following statement:

I thank staff for the informative report and for providing clear answers to our questions enclosed in the gray statements. We also thank Mr. Mahlinza and Mr. Garang for their buff statement.

We welcome Eritrea's re-engagement with the international community and the resumption of the Article IV consultation with the Fund. The country is facing extraordinary challenges, and the restoration of macroeconomic stability would be essential to bring the economy back on a sustainable growth path.

At the current juncture, the authorities should seize the opportunity to harness the existing growth potential and rebuild the country's institutional capacity. In this regard, we encourage the authorities to seek TA on many fronts, given the large capacity development needs. This critically includes the need to improve the collection and the dissemination of economic data, as mentioned by Mr. Sigurgeirsson. The Fund's TA would be key in this regard.

On the fiscal front, limiting debt accumulation is essential, given the unsustainable levels of domestic and external debt. Fiscal discipline, in particular, on the spending side and an expenditure re-orientation toward capital spending will be crucial to reduce fiscal risks and support the substantial development needs.

Also, in the near term, we encourage the authorities to refrain from nonconcessional borrowing and to focus on mobilizing grants and donor support. In a similar vein, we concur with staff that a possible debt relief under the HIPC Initiative would provide the authorities with some space and would help restore external debt sustainability in the longer term. Additionally, restoring financial intermediation and implementing measures to restructure commercial banks would lay down the foundations for a healthy banking system.

Finally, we would like to emphasize that the authorities' strong commitment to the reform agenda will be key to attract the necessary foreign capital and increase investors' confidence.

Ms. McKiernan made the following statement:

I thank staff, once more, for this comprehensive report, their responses to questions, and their helpful remarks. I thank Mr. Mahlinza and Mr. Garang for the insightful buff statement. The Acting Chair's comments at the outset were very insightful.

We issued a gray statement, so I will just make a few brief remarks.

I liked Mr. Hemingway's expression, whether this is a case of the glass half full or half empty. I am inclined to think it is half full because it is a major accomplishment to have Eritrea reintegrating into the international community and re-engaging with the Fund. It is very heartening. But reversing years of socioeconomic setback will be very demanding. Eritrea will need to upgrade its institutional capacity to secure macroeconomic stability and advance the development agenda. Technical and financial support from the international donor community will be critical for the authorities in this challenging period. We see capacity development as being the most pressing need, as Ms. Mehri also highlighted.

There is a long list of priorities. In that vein, it is important for staff and the authorities to work closely together to streamline the activities, and that is to ensure optimal benefits for all.

To that end, we welcomed the outlines of a capacity development strategy in Annex VIII. It is our hope that, as soon as practicable, staff and the authorities can agree on plausible timelines for the listed priority reforms.

We noted and welcomed that data coverage and quality are rightfully areas for prioritization. Mr. Sigurgeirsson set out the case better than I can on the importance of those.

Mr. Spadafora made the following statement:

I congratulate staff on the very interesting report. We are pleased about the country’s re-engagement with the Fund, and we are sure that the staff has contributed to this welcome outcome.

We are confident that the authorities will seize the opportunities opened up by the peace agreement with Ethiopia in order to re-establish the conditions for private-led economic development. The staff report, in this regard, is a very useful contribution to lay out the main priorities that the authorities should follow.

Several Directors have raised the issue of the possible role for the Fund at the current juncture in Eritrea. For sure, TA is at the top of the list. We welcome the capacity-building strategy, which is laid out in the report. We join staff in encouraging the authorities to take advantage of the Fund’s TA.

Eritrea is potentially eligible for the HIPC and Multilateral Debt Relief Initiative (MDRI), but from our understanding, the authorities are not showing yet a clear resolve in pursuing the HIPC debt relief initiative, nor are they at this time considering a Fund-supported program.

We understand from the staff report that there are a number of preconditions for a country to qualify for the HIPC debt relief initiative, in particular, a track record of macroeconomic policy implementation. However, we would like to ask staff if they could elaborate on the following questions.

First, can staff provide us with some further information on the reasons that keep the authorities from pursuing the HIPC Initiative more strongly and more decisively?

Second, is there scope for a Staff-Monitored Program (SMP)? One of the aims of this program usually is to establish a good track record of policy implementation.

My third question is whether you can clarify Footnote 1. It is not clear where Eritrea stands now in terms of the HIPC thresholds or the net present value of debt. At some point, the footnote says that Eritrea has yet to qualify for debt relief based on the most recent debt and macroeconomic data.

Finally, on national service, which is a very contentious issue, I am refraining from expanding on the non-economic importance of this issue. But the staff report highlights the macro-critical role of this service in terms of its impact on public finances. There is a very welcome call on reducing the size of this service. But we would like to know whether staff is aware of plans to revise the very long—at times indefinite—length of this service.

Mr. Mouminah made the following statement:

We thank staff for a well-written report and Mr. Mahlinza and Mr. Garang for their informative buff statement. I will be extremely short. We issued a gray statement.

Just for the context the Acting Chair mentioned, I want to reemphasize and welcome the resumption of the Fund’s engagement with the State of Eritrea.

The second message is that, like other Directors, we encourage the authorities to utilize the capacity development strategy proposed by staff and to maintain close constructive dialogue with the Fund and donor community.

With this, we wish the authorities the best.

Mr. Saraiva made the following statement:

We thank the Acting Chair for his initial remarks. We thank Mr. Mahlinza and Mr. Garang for their useful statement. I thank staff for the report but also for their persistence in re-establishing their engagement with Eritrea. This is a very historic occasion that we have Eritrea at the Board for the Article IV consultation after 10 years.

I also would like to highlight that the answers to the technical questions were very useful and informative. In particular, I would mention question 12, which shows that there is a potential for increasing concessional financing but after clearing the operation with the World Bank.

I took notice of what Ms. Pollard said. It is very important to consider the whole situation of the debt and the arrears. This also links to what Mr. Spadafora was asking about the possibility of Eritrea accessing the HIPC and MDRI, which requires a track record with the Fund. Staff made it very clear twice in the same paragraph in their answers to the technical questions that, at present, the authorities are not willing to establish any engagement in the form of a program with the Fund.

But I believe that especially after this long period of disengagement with the international community, the payoffs for enhanced engagement with the Fund are very high. I would encourage the Eritrean authorities to consider that possibility and to try to bring the Fund in as much as possible to face the significant challenges that they have.

Finally, I would just like to highlight something that Mr. Castets and Mr. Ronicle pointed to in their gray statement. At the end of the day, progress in addressing those challenges and reaping the peace dividends will depend on the developments on the ground, especially related to their border with Ethiopia. In this sense, the half full glass is still an indefinite situation. It could go either way. It is important to have the support of the international community and to pursue further integration with their neighbors and with their partners to effectively overcome the amazing challenges that the country faces.

The staff representative from the African Department (Mr. Mukhopadhyay), in response to further questions and comments from Executive Directors, made the following additional statement:

> As we have said in our responses to the questions, the authorities are not at a point right now where they are considering HIPC or MDRI. Their priority is to pursue their arrears clearance with the World Bank. Once they have done that—and they are also discussing debt relief with some of their other bilateral creditors—and depending on how they make progress on those fronts, then they would at a later point decide on whether they want to pursue the HIPC and MDRI.
>
> There was no discussion on an SMP. Our engagement with Eritrea has only just started. The authorities are interested in deepening their engagement with the Fund. They see increased TA and support through the Article IV process and even regular staff visits as being important. They have mentioned that. Initially, that is the way the Fund is going to try to assist Eritrea, not through an SMP.
>
> On the HIPC thresholds and Footnote 1, at the time that the HIPC Initiative was ring-fenced, countries were assessed based on their end-2004 and end-2010 data as to whether they met the thresholds under the HIPC Initiative. Eritrea met those thresholds, so it is part of the ring-fenced countries that can benefit from HIPC and MDRI relief. But in order to do so, they would still need to meet these criteria based on a HIPC Debt Sustainability Analysis (DSA) at the time of the decision point. That is still to be done. Obviously, that can only happen in the future. That is the reason why they are eligible, but they might not actually receive debt relief. It depends on what the data say at that time.
>
> Finally, on the national service tenure, we did not discuss why people remain in the national service for an extended period of time, and we have no information as to when that practice might change.

Mr. Mahlinza made the following concluding statement:

> I thank Directors for their constructive comments and support towards the completion of the 2019 Article IV consultation for Eritrea. My authorities appreciate the resumption of engagement with the Fund 10 years after their last consultation.

As noted in our buff statement, Eritrea continues to face substantial economic challenges, following two decades of conflict and an extended period of U.N. sanctions, which deprived the economy of much-needed aid and investment flows, weakened the state capacity, constrained foreign exchange inflows, and subdued their private sector development. This notwithstanding, the authorities continued to ensure economic stability and have made improvements in living standards.

Following the signing of the peace agreement with Ethiopia and the lifting of the U.N. sanctions in 2018, economic prospects have brightened. Nevertheless, a number of challenges lie ahead. My authorities, therefore, remain committed to crafting a national development strategy to drive their development agenda going forward. They concur that private sector development, diversification of the economy, and improving the business environment remain key to enhancing productivity and engendering sustainable growth. In this respect, they are determined to take advantage of this opportunity to re-engage with the international community, including the Fund, to address the debt burden, enhance private sector development, improve statistics, and undertake the necessary reforms to place the economy on a sustainable growth path. No doubt, these reforms will take time and resources and will require the continued support of the international community.

In their gray statements and in their interventions, Directors have emphasized the need to maintain a tight fiscal stance and embark on revenue-enhancing measures to ensure fiscal sustainability.

My authorities will prioritize expenditure containment to create fiscal space and re-orient spending toward investment in education and health. To restore debt sustainability, they plan to rely on grants and highly concessional loans, while investing in key projects, including the mining sector, to spur growth and create jobs. In this respect, their immediate focus is to regularize arrears with their external creditors, including the World Bank. At the same time, they will continue debt restructuring discussions with bilateral partners.

To anchor inflation expectations, my authorities will continue to relax monetary controls and boost private consumption, with a view to move inflation into positive territory by 2021. In addition, they plan to strengthen the monetary policy framework, improve their onsite supervision of banks, gradually eliminate emergency measures, and intensify efforts to build foreign exchange buffers while addressing the legacy issues, such as high nonperforming loans, the loss of correspondent banking relationships, and the shortage of skilled personnel.

My authorities recognize the centrality of capacity development in their reform efforts. In this respect, they wish to express appreciation to the Fund for the efforts thus far, including the capacity development and TA provided by the East African Regional Technical Assistance Center. They look forward to receiving further TA in the fiscal sector and public debt, the monetary sector, and the financial sector.

Given their huge capacity development needs, they would appreciate that emphasis be placed on in-country training and resident advice. They view Fund support as critical in the design and implementation and sequencing of key policy reforms.

In conclusion, I wish to convey my authorities' appreciation to the Fund for the resumption of the surveillance with Eritrea and to thank the mission chief, Mr. Bhaswar, and his team for the invaluable support to authorities. I also wish to thank them for providing comprehensive responses to the questions raised by Directors, as well as for issuing the requested corrections in the supplements. My authorities continue to value Fund advice and look forward to further collaborations in advancing their reform agenda.

Regarding the publication of the report, my authorities wish to state that they have not concluded internal consultations on the report and would request that the report not be published at this stage.

The Acting Chair (Mr. Zhang) noted that the State of Eritrea is an Article XIV member and maintained exchange restrictions and multiple currency practices subject to Article VIII that are identified in the staff report. It was not recommended to approve these measures and, hence, there was no proposed decision.

The following summing up was issued:

Executive Directors broadly agreed with the thrust of the staff appraisal. They welcomed the authorities' efforts to reengage with the international community and notably with the Fund through the Article IV consultation process. Directors noted that prolonged conflict had exacerbated Eritrea's economic difficulties and that the macroeconomic situation and near-term growth prospects are challenging. They underscored the importance of securing macro-financial stability, addressing the unsustainable debt burden, and removing impediments to private sector-led growth. Directors emphasized the important role of technical assistance in supporting the country's development and encouraged close cooperation with the Fund.

Directors noted that the peace agreement and removal of international sanctions provide an opportunity for Eritrea to build an impetus for development and bring vital aid and investment resources to the country. They encouraged the authorities to begin implementing reforms to accelerate the development process, and welcomed the authorities' intention to pursue an economic development strategy that envisages a strong role for the private sector. Directors underscored that significant reforms and investment, public and private, are necessary to diversify the economy and reduce its dependence on agriculture and mining.

Directors welcomed the authorities' recent efforts to adjust the fiscal position and their intention to limit budget financing and focus on securing grants and concessional loans. Nonetheless, they stressed that continued fiscal pressures could complicate macroeconomic management and warranted continued vigilance. Directors encouraged the authorities to pursue fiscal restraint not only by spending cuts, but also by improving tax collection and broadening the revenue base, while making room for social spending.

Directors noted that Eritrea remains in debt distress with a weak external position. They noted that arrears accumulation, weak debt-servicing capacity, and relatively low foreign exchange reserves call for strong measures to put debt back on a sustainable path. Accordingly, they called on the authorities to develop a comprehensive debt resolution strategy, including regularizing arrears to unlock external support and ease macroeconomic adjustment efforts.

Directors noted that financial sector stability is crucial to establish the basis for banks to engage in financial intermediation and for the Bank of Eritrea (BOE) to conduct monetary policy. They advised the authorities to update holistically the legal framework, including to restate the BOE's independence. Directors also encouraged steps to align the AML/CFT framework with international standards.

Directors emphasized that restrictions impeding the private sector should be eliminated and recommended that the authorities reduce state monopolies, impose hard budget constraints on public enterprises and banks, ease foreign exchange restrictions, improve access to financial services, and strengthen property rights. They underscored that actions to improve governance and reduce vulnerabilities to corruption would also be important.

Directors stressed the need for capacity building tailored to country circumstances, particularly the production and analysis of data. They encouraged the authorities to make use of technical assistance from the IMF and other partners in a well sequenced and coordinated manner.

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

APPROVAL: October 6, 2021

CEDA OGADA
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook/ growth

1. The favorable growth forecasts are predicated on strong investments, development of the mining sector and coastal tourism, and activity in the fisheries and agriculture sectors. Therefore, we encourage the authorities to smoothly implement their Minimum Integrated Household Agricultural Package (MIHAP) initiative, pursue the development of infrastructure projects and make utmost efforts to improve the business environment. That said, we wonder if the projected growth rates, ranging from 3 to 4 percent, will be sufficient to increase per capita income and begin reducing poverty. Staff's elaboration will be appreciated.

- Current growth projections are based on a "no policy change" scenario. Under current policies, growth is expected to remain below its potential and also lower than what is needed to significantly increase per capita incomes and reduce poverty. As noted in the staff report, wide-ranging reforms are required to spur private sector growth. The importance of such reforms are also emphasized in Annex IV: "Lessons from Transition."

Public finances

2. Concerning the Asmara Project, we take note of the social and environmental challenges with regard to its implementation and wonder if authorities have shared with staff any cost-benefit analyses conducted that take into account externalities on environmental and health outcomes.

- The team understands that the Canadian mining company that was the original partner in the Asmara project had commissioned a Social and Environmental Impact Assessment (SEIA) for the project, to be prepared by an international consulting firm and submitted to the Ministry of Energy and Mines in January 2015, prior to obtaining its production license. In discussions, the authorities noted that the social and environmental concerns highlighted there were being carefully addressed. The team does not possess this report.

3. We would welcome staff comments on the current size of military expenditure and the potential to reduce it, considering the 2018 peace agreement with Ethiopia.

4. With the peace agreement reached and ending of embargoes, are there prospects for a shift from spending on the military to other areas, including health and education?

- Staff does not have full information on aggregate military spending, but spending on military salaries, allowances, supplies and retirement benefits has more than halved since 2010. It may be expected that going ahead a further reduction in military spending will be one of the peace dividends, but staff has no information on the pace of such a reduction.

5. We agree with staff on the need for the authorities to consider state-owned enterprise (SOE) reform to reduce fiscal costs and improve competitiveness. We also urge the authorities to consolidate public spending into a single set of accounts. Does staff have a sense of the scale of off-budget financing and whether this financing extends beyond the mining sector?

- Determining the precise scale of off-budget financing is difficult. It appears to only involve the mining and petroleum sectors.

Debt management

6. On the external front, we agree with staff that the authorities could consider requesting debt relief under the Heavily Indebted Poor Country (HIPC) Initiative to restore external debt sustainability. At the same time, we welcome the authorities' effort to seek debt relief bilaterally from key creditors. Staff's comments are welcome on the authorities' immediate focus at the bilateral level vis-à-vis the HIPC Initiative.

7. Developing a comprehensive strategy to address Eritrea's unsustainable debt is key to macroeconomic stability. We recognize that this will not be an easy process but encourage the authorities to continue their engagement with the World Bank to reduce the stock of IDA arrears. We also agree with staff on the need to reach out to non-Paris Club creditors who hold the bulk of Eritrea's bilateral debt. Given its debt distress we would urge the authorities to rely solely on grant financing. We would welcome staff comments on the status of any bilateral debt discussions.

- The authorities' immediate focus is on the clearance of outstanding external arrears. Here, with arrears to IDA accounting for about one third of total arrears, ongoing discussions with the World Bank on a development policy operation, are of high priority. Debt restructuring discussions with some bilateral partners are also ongoing but are less advanced. Pursuit of the HIPC initiative requires a number of conditions to be in place, including a track record of macroeconomic policy implementation established under a UCT-standard program with the IMF, and is therefore a more medium-term consideration.

8. ***We positively note that the authorities have acknowledged the need for a proactive debt-management and resolution strategy, will seek debt relief bilaterally from key creditors and intend to look into the possibility to receive debt relief under the Heavily Indebted Poor Country (HIPC) Initiative and the Multilateral Debt Relief Initiative. We encourage the authorities to draw on support from the Fund and World Bank to pursue these aims. We agree with staff that reaching out to non-Paris Club members in this context will be critical. What can the IFIs do to support the Government of Eritrea in this non-Paris Club outreach?***

- IFIs, including the IMF, can help in the process through data analysis and dissemination of assessments of the economic situation, such as through the current Article IV consultation. In addition, they can provide best practices, policy advice and technical assistance on debt restructuring and a medium-term debt strategy that would reassure bilateral partners.
- In previous cases, IMF Executive Directors' roles in facilitating communication have been very welcome.

9. ***The domestic debt burden is a larger problem, which HIPC or other external debt relief would not address. Given this high public debt level, what support can the IMF offer of the Eritrean authorities' in developing a 'comprehensive strategy to address the domestic debt burden'? Are there lessons from elsewhere?***

- The Fund stands ready to support the authorities with overall policy advice on the sequencing of reforms to address the domestic debt burden and targeted TA on auditing and restructuring domestic debt, bearing in mind the implications for financial stability. There are some useful broad lessons from other countries dealing with high levels of domestic debt for example from the central and eastern European countries and some Caribbean countries. These include; ensuring fiscal policies are sufficiently tight over a sustained period as it is one of the most direct policy tools by which a government can reduce its debt, growth-enhancing policies to boost potential, and the importance of evaluating the impact of debt restructuring proposals to assess the impact on debt sustainability and the broader financial sector, including the central bank. However, each situation is country specific and any policy advice would have to be tailored to Eritrea's unique situation.

10. ***We encourage progress in discussions to obtain debt relief from bilateral creditors, including non-Paris Club partners, which account for more than 30 percent of the total external debt. Could staff elaborate on the steps taken by the authorities in this regard? Additionally, details on the ongoing discussions with the World Bank for***

the repayment of IDA arrears would be appreciated. We have the sense from the report that the authorities do not seem to seek for a debt relief under the HIPC Initiative and the Multilateral Debt Relief Initiative (MDRI). Staff's comments on this matter would also be welcomed.

11. More information on whether Eritrea plans to request debt relief under HIPC and MDRI and how the rules and processes would be applied today is needed. In particular, we wonder (i) whether staff has already determined with management what would be the length of time required for Eritrea to establish a track record under a program; (ii) if a PRSP would still be requested; and (iii) what is expected from discussions with the World Bank to "regularize" arrears?

- The government is discussing an arrears clearance DPO with the World Bank, which is expected to result in clearance of arrears to IDA and open up grant financing from IDA's side and be a step forward towards debt relief under HIPC/MDRI should the authorities wish to consider it in the future.

- At this stage a decision to pursue HIPC/MDRI has not been made, the authorities are not considering a Fund-supported program at present, and there were no discussions about the length of a track record and the requirement of the PRSP (or development paper). Staff has, however, shared and discussed with the authorities the requirements of the HIPC/MDRI process. The authorities are not considering an IMF program at present.

12. As underscored in the staff report, "efforts to achieve fiscal sustainability should encompass increasing revenues and reorienting spending to growth-enhancing areas". While we concur that the authorities should focus on identifying grant financing, we wonder how much grant resources are effectively available in the short term and what would be the prerequisites for tapping into substantial concessional and grant financing?

- The government is discussing an arrears clearance DPO with the World Bank, which would pave the way for grant financing from IDA's side and from the AfDB.

- In the current debt sustainability analysis, World Bank and IMF staff take a conservative approach on the availability of grant financing. However, under a shift in policies and further normalization of relationships with the international community, the potential for increasing concessional financing is large.

13. Eritrea is considered in debt distress, while important data is missing on both domestic and external debt, and BOP data, even if incomplete, portrays a worrisome picture. We note that an internal investigation is being undertaken to

determine the nature of the long-standing advance by the Central Bank to a state-owned enterprise that represents about a quarter of the domestic debt. Also, the maturity of foreign currency loans by commercial banks is unknown. In addition, we learn from the report that 28 percent of total external debt, as well as a large portion of the arrears are to IDA. Could staff explain more in detail the debt situation towards IDA, for which arrears in 2015 were estimated to be at US$55 million and increasing by US$12 million every year? Information on prospects for IFC and MIGA support to private sector initiatives would also be useful.

- At the end of March 2019, debt (excluding arrears) to IDA amounted to US$359 million. In addition, arrears to IDA accounted for US$97 million, about one-third of total external arrears.

- Staff has no information of near-term prospects for financing by IFC/MIGA.

Monetary and exchange rate policies

14. We note that the economy could potentially benefit from greater exchange rate flexibility to help the economy absorb shocks as well as to improve economic competitiveness. Given Eritrea's high external debt and its limited monetary and exchange rate toolkit, it would be prudent to proceed with caution and in a gradual and measured manner. We welcome staff's views on the potential risks through the balance sheet channel and further elaboration on feasible measures to smooth out the transition period.

15. Does staff agree with the authorities' assessment made in the buff statement that multiple currency practices no longer exist in Eritrea?

16. Given capacity constraints and remaining vulnerabilities, prioritization and sequencing of reforms will be critical. Given this, we note the authorities' concern that the greater flexibility of the exchange rate recommended by staff would have negative consequences on the already very high level of external debt (65 percent of GDP and 308.5 million USD of arrears). In addition, given the current lack of tools to conduct active monetary and exchange rate policy, we believe a more sequenced approach could be considered with the use of technical assistance in this field. Staff comments on the appropriate sequencing and plausible timing of relevant technical assistance, a decrease of the level of external debt, and moves towards a more flexible exchange rate system would be appreciated.

- Introducing a more flexible exchange rate will have to be preceded by institutional reforms at the central bank.

- Strengthening the monetary policy framework and operations, including through regular compilation of a monetary survey and monitoring of key aggregates, will be an important step to allow a smooth functioning of foreign exchange operations and removal of foreign exchange controls. IMF technical assistance can be leveraged in this regard. Good policies, in turn, would help attract foreign inflows (aid, investment) that would mitigate pressures on external accounts.

- Separately, as depreciation would feed into inflation, it would lower the domestic debt burden, offsetting some of the increase in the external debt-to-GDP ratio from revaluation effects.

- The impact of the exchange rate on debt would need to be carefully monitored, including to reassess debt levels in any debt restructuring negotiations. Of note, however, is that, as a depreciation would feed into inflation, it would lower the domestic debt burden, offsetting some of the increase to the external debt-to-GDP ratio from revaluation effects.

17. Does staff agree with the authorities' assessment made in the buff statement that multiple currency practices no longer exist in Eritrea?

18. Exchange rate remains fixed and several exchange restrictions persist. Authorities emphasize that multiple currency practices (MCPs) no longer exist but the staff report mentions on page 7, ¶8 that Eritrea maintains several exchange restrictions and multiple currency practices (MCPs) and does not recommend approval for the maintenance of those exchange restrictions and MCPs. Could staff clarify?

19. Could staff comment further on the multiple currency practices (MCPs), given the differences in view with the authorities mentioned in the buff?

20. Can staff comment on the information in the buff that, contrary to its views, Eritrea no longer maintain MCP?

21. Regarding multiple currency practices, can staff comment on the different view with the authorities, who emphasize they no longer exist?

- During the Article IV mission to Asmara, staff endeavored to assess the status of the exchange measures described in the Informational Annex. Following a number of discussions and request for supporting data it was assessed that there was insufficient corroborating evidence, likely on account of the authorities' capacity constraints and also the lack of clarity on some of their procedures. Since the elimination of findings of exchange restrictions and MCPs have to be substantiated by the relevant supporting evidence and given that staff has not received the necessary information to conclude that the restrictions and MCPs identified in 2009 have been actually removed, the jurisdictional findings made in the past by the Fund remain as set forth in the Informational Annex. Staff will continue to work closely with the authorities on this matter and will engage in further discussions with them.

22. The Central Bank is the lender of last resort of the government given the limited access to external financing, and the highly vulnerable domestic banking sector. Could staff comment on the health of the central bank balance sheet?

23. It is notable that against this background the country has recently suffered a sizable deflation. Can staff further elaborate on the reasons to such developments and link them to imbalances in the monetary market?

- Following a period of extensive central bank financing of the government and other public sector related entities, it is estimated that the central bank is holding public debt of 135 percent of GDP. This puts the central bank balance sheet in an extremely vulnerable position.

- As expected, extensive monetary financing until 2015 created inflationary pressures. At end-2015, steps by the government to significantly reduce the amount of cash in circulation and fiscal restraint resulted in deflation. The opening of the border with Ethiopia and the influx of goods exacerbated deflationary pressures.

24. On the financial sector, efforts to address high NPLs and improve the regulatory environment should be accelerated. As we have observed, some countries that have taken meaningful steps to improve their AML/CFT regimes still face challenges restoring CBRs. We welcome staff's elaboration on how Eritrea may overcome impediments to regain CBRs.

- The authorities are taking steps to regain CBRs by first joining the Eastern and Southern Africa Anti-Money Laundering Group (ESAAMLG). Depending on the outcome of the mutual evaluation of Eritrea's anti-money laundering and combating financing of terrorism (AML/CFT) framework under the Financial Action Task Force (FATF) Forty Recommendations, the authorities would need to then implement the necessary reforms, if any. It would be premature to specify what further steps are needed before completion of the mutual evaluation.

Financial sector

25. We note with concern that the banking system is vulnerable due to the high NPL and the large exposure to unsustainable government debt. Staff mentioned that

based on other countries' experiences, such problems may be managed through bank restructuring and supportive measures to strengthen the banking sector. We note staff's encouragement on seeking TA support and would appreciate further comments on their assessment of Eritrea's financial and institutional capacity to develop and implement such recommendations in the near-term.

- Eritrea faces significant institutional and policy implementation weaknesses, which create substantial challenges in the near term. The constraints are broad-based, ranging from there being limited trained staff to a very tight budget envelope to invest in training and physical equipment. The TA strategy is cognizant of the constraints and seeks to provide focused recommendations in a discreet number of priority areas.

26. Reducing bank exposure to the public sector can improve the health of the banking sector and increase private credit. Additional efforts to diversify and reform the banking sector beyond Eritrea's three publicly owned banks, including by easing restrictions on private sector banking activity and increasing private sector financial access, should be considered. Does staff have information on a breakdown on banks' sectoral exposure, particularly their vulnerability to a sudden fall in agriculture and metals prices?

- Staff received some data on the breakdown of banks' sectoral exposure, but it was difficult to assess its overall reliability and a large component was classified as "other." Based on the data, the exposure to the agricultural sector was very small and there was no specific data related to metals.

27. Improving the business environment would include taking adequate measures to promote financial intermediation. Unfortunately, the current concentration of the banking system in a failing public bank does not bode well. Could staff elaborate on the desirability and possibility of new private players entering the banking system and what role, if any, other financial institutions play in serving the population?

- There are potential benefits for new private players entering the banking sector as they could bring new technologies and more modernized systems. Moreover, there do not appear to be any legal barriers preventing the entry of new private players. However, given the broader constraints in the economy and the business climate, entry of new private players would be very challenging.

- In terms of other financial institutions, there is also a small microfinance institution that provides microcredit to primarily micro-businesses in rural areas.

Structural issues

28. Since Eritrea's economic activities are very volatile, structural reforms to reduce the heavy reliance on the primary sectors and diversify the economy should be expedited. We welcome staff's comments on the economic sectors that could potentially be targeted as quick wins for Eritrea's economy.

- With the Asmara and Colluli mining projects coming on stream and production set to start in 2020 and 2022, respectively, and with Colluli mining production expected to double in 2028, the mining sector is projected to grow fast in the short and medium run, and notwithstanding the volatility of mining contribute significantly to GDP. In addition to mining, other sectors that could potentially be targeted for quick wins for

- Eritrea's economy include agriculture, fishing, tourism, and trade and commerce. For example, wider implementation of the MIHAP initiative could significantly and rapidly boost agricultural productivity. With its vast coast, Eritrea is also strategically positioned to benefit from increased marine trade with Ethiopia since the recent opening of the border, as well as fishery and tourism, currently underexploited sectors, which require infrastructure investment.

29. Eritrea's strategic location in the Horn of Africa, including along the Bab el- Mandeb strait, could attract foreign investment in developing its maritime and port transportation and cargo logistic services. Could staff comment on the potential for developing this sector?

- Eritrea is strategically located in the Horn of Africa, including along the Bab el- Mandeb strait, and spans over 1,000 km of coastline along the Red Sea, separating Ethiopia from the sea. In the past, transit trade through its two major ports, Massawa and Asseb, had been a major source of foreign exchange, especially for trade with Ethiopia, but had declined substantially thereafter. The recent opening of the border with Ethiopia and lifting of international sanctions, present an opportunity again to boost transit trade in the coming years. This would, however, require policy changes such as lifting trade restrictions and significant investments to rehabilitate infrastructure (ports, communication, energy, roads). The authorities envision that transit trade will become an important driver of economic growth in the short term.

Capacity development

30. We welcome the capacity development strategy outlined in Annex VIII of the staff report and support the top priorities: macroeconomic statistics, fiscal and debt sustainability, and strengthening the institutional framework of the Bank of

Eritrea. Could staff elaborate on to what extent this strategy has been developed in collaboration with other international organizations? And how do we best ensure that the authorities have the resources to absorb the proposed extensive volume of technical assistance?

31. Considering the immense challenges and the ambitious reform program, extensive TA, specifically related to the core fiscal functions, public financial management (PFM), banking, and statistics that comprehensively assess data availability, is urgently needed to support both surveillance and policy-making. We would therefore see value for resident advisors to assist in implementing reforms and are assured by staff's assertions that the capacity development delivery in the past was well-received and reasonably absorbed. Staff's comments on whether other development partners have already resumed the provision of TA are welcome.

- The medium-term capacity development strategy incorporates comments by Fund departments and has benefited from some discussions with other multilateral organizations, such as the World Bank and European Union. Eritrea is still in the

- Early stages on of reengaging with the international community; the Fund is advanced in identifying with the authorities the priority areas for support, due to East AFRITAC's ongoing involvement and the recent HQ missions. Despite the vast needs of the country, the strategy, cognizant of absorptive constraints, prioritizes a few key areas—macroeconomic statistics, fiscal and debt sustainability, and strengthening the institutional framework of the Bank of Eritrea.

Other

32. Apart from capacity development programs, given the many challenges facing Eritrea, were there any discussions on the possibility of a Fund support program to assist the authorities?

- At this early stage, the authorities' focus is on strengthening engagement with the Fund on policy implementation through the Article IV consultation process and on technical assistance. Discussions on program engagement at this stage would have been premature.

33. Given the data limitations, could staff inform on the extent to which Eritrea is currently fulfilling its obligations under Article VII, Section 5?

- All members are obliged to provide to the Fund the information listed in Article VIII, Section 5 of the Articles of Agreement and in Annex A to Executive Board Decision No.13183. However, such obligation is subject to each member's capacity to do so. In this case, Eritrea suffers severe capacity constraints, further details of which are provided in Box 1 of the Staff Report on page 5. As a result, it is the staff view that Eritrea is not failing to fulfill its obligations under Article VIII, Section 5.

34. Growth should not only be more sustainable but also more inclusive. We were somewhat surprised that no mention of social measures or social safety nets appear in the report itself and are only present in Annex IV "Lessons from Transition". Comments from staff are welcome.

- The report notes upfront Eritrea's progress on some social development outcomes and in detail in Annex I: "Progress Toward the Development Goals". The main body of the report and Annex V also point out that broad based private sector led growth is the way to achieve an inclusive development experience. As regards social safety nets explicitly, Eritrea's difficult debt and fiscal problems would preclude putting in place more robust social safety nets. Furthermore, in a primarily agricultural society, productivity gains in agriculture are an important, indeed probably the most important, social safety net. In this context, Annex V on "Prospects for the Agricultural Sector: The MIHAP Initiative" discusses how the MIHAP can improve social measures such as living conditions, nutrition, and incomes of rural subsistence households (60-70 percent of Eritrea's population).