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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 02/46

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Executive Board Attendance

S. Sugisaki, Acting Chair

Executive Directors

A. Mirakhor

A.S. Shaalan
Wei Benhua

Alternate Executive Directors

A.S. Alosaimi
N. Guetat, Temporary
P.H. Whitehall, Temporary
H.-H. Jang, Temporary
F. Zurbrügg, Temporary
F. Haupt, Temporary
C.A.E. Sdrilevich, Temporary
H.E. Phang, Temporary
P.R.D. Prasad, Temporary
I. Abel, Temporary
M.L. Nikitin, Temporary
N. Epstein, Temporary
S. Boitreaud

I. Zakharchenkov, Temporary
O.E. Garner, Temporary
M.A. Brooke
V. de los Santos, Temporary
A. Muganda, Temporary
M.B. Chatah

N. Yeritsyan, Temporary
T. Komatsuzaki, Temporary
D. Vogel, Temporary

A. Mountford, Acting Secretary
T. Davidson, Assistant

Also Present

IBRD: A.A. Attiga, Assistant to Executive Director. Middle Eastern Department: P. Chabrier, Director; D. Burton, Deputy Director; S. Creane, M. Elhage, A. Jbili, N. Ltaifa, M. Lazare, S. Mahyoub, G. Shabsigh. Policy Development and Review Department: S. Kashiwagi. Secretary's Department: P. Ramlogan. Advisors to Executive Directors: S.A. Bakhache, S.S. Farid, S. Rouai. Assistants to Executive Directors: N.H. Farhan, T. Koranchelian, K. Sazanov, K.S. Oo, A. Lanza.

1. SOCIALIST PEOPLE'S LIBYAN ARAB JAMAHIRIYA—2002 ARTICLE IV CONSULTATION

Documents: Staff Report for the 2002 Article IV Consultation (SM/02/118, 4/19/02; and Cor. 1, 5/3/02); and Statistical Appendix (SM/02/120, 4/19/02; and Cor. 1, 5/3/02)

Staff: Elhage, MED; Kashiwagi, PDR

Length: 1 hour, 30 minutes

Mr. Shaalan submitted the following statement:

We would like to thank the staff for preparing a well-written and comprehensive report on recent developments in the Libyan economy. The authorities are also grateful to the staff for their excellent collaboration and advice and look forward to a continuation of their close policy dialogue.

The overall macroeconomic situation in Libya has continued to improve since the U.N. sanctions were lifted in 1999. The more improved economic environment of the past two years permitted the pursuit of prudent macroeconomic policies, which, combined with a rise in oil prices, led to substantial fiscal and current account surpluses, and significant build-up in foreign exchange reserves. These developments were accompanied by a growth rate of 4.4 percent in 2000, which slowed down to about 1.0 percent in 2001, largely due to a 4.0 percent decline in oil production and the understandable uncertainties surrounding the exchange rate unification during the year. Inflation has been virtually absent.

A major milestone in economic reform was achieved with the completion of exchange rate unification, which was accompanied by supportive policies aimed primarily at price and trade liberalization, including, following the return of the Fund mission, the removal of import license requirements. The challenge facing the authorities now is to build on this important success by broadening the reform agenda to attain sustainable high growth rates that would provide sufficient employment opportunities for the growing labor force. To this end, the authorities envisage to:

Gradually liberalize the economy by progressively eliminating price and trade controls after ensuring that suitable measures to protect vulnerable groups are put in place.

Increasingly diversify the economy's productive base away from oil, and rationalize further the role of the state and its intervention in the economy in order to absorb the growing labor force.

Promote an environment conducive to enhancing private sector economic activity through undertaking structural reforms, upgrading the

productive sectors, and achieving a greater degree of openness of the economy.

Improve resource allocation through ameliorating health and education services and achieving more balanced regional development.

The authorities intend to pursue their policies in a gradual manner and over a medium-term horizon, taking into account their social and political system, and the need to achieve consensus on the reform strategy.

Exchange rate policy

The successful unification of the dual exchange rate system was a major achievement in 2001, and represents a crucial step forward in the liberalization of the economy. As planned, the policy of convergence of the official and special rates continued through 2001, culminating on January 1, 2002, with the one-step devaluation of the official exchange rate, bringing it to the unified rate of SDR 0.608 per LD.

The unification of the exchange rate was accompanied by other supportive reform measures to ease trade and exchange restrictions and support public enterprises. These measures included:

The gradual adjustment of relative prices, except for subsidized goods and government services.

The abolition of foreign exchange rationing through the foreign exchange budget.

The elimination of import licensing requirements, which took place recently.

The reduction of tariff rates across the board by an average of 50.0 percent.

The progressive cutback of list of prohibited imports.

To mitigate the impact of the devaluation on public enterprises, the latter were allowed to provision themselves with foreign exchange ahead of the unification to cover outstanding letters of credit. Budget allocations were also provided to absorb the price increases of imports for enterprises involved in new projects, and to cover the increased cost of subsidized essential goods.

In the period ahead, the CBL expects to maintain a fixed but adjustable exchange rate peg. The authorities are confident that the level of the unified rate remains appropriate at this time, in view of the fact that a parallel rate has

not emerged and there appear to be no tensions in the foreign exchange rate market. Given their limited administrative capacity, the authorities believe that a fixed rate system is appropriate at this stage. They are aware of the need to maintain strong financial policies to avoid a real appreciation of the rate and/or a sustained loss in reserves.

Fiscal policy and public enterprise reform

Although the fiscal surplus was lower than in 2000, the fiscal position remained strong in 2001, with a surplus of 6.4 percent of GDP. While budgetary revenues remained at broadly the same level as 2000, development expenditures increased and were directed at upgrading the country's infrastructure, which had suffered due to the imposition of sanctions. Additionally, due to the fiscal decentralization effort, the need to upgrade the administrative capacities of the local governments also resulted in an increase in employment expenditures at the regional level. In spite of these new demands and an increase in development expenditures on both human and physical infrastructure, a fiscal surplus of about 5.0 percent is projected for 2002.

Looking ahead, the authorities are aware of the need to formulate a medium-term fiscal policy, which takes into consideration the exhaustible nature of hydrocarbon resources. They hope to reduce dependence on oil revenues through a reform of the tax and customs systems that would aim at upgrading the tax administration and broadening the tax base. A revision of tax laws is already underway, and the authorities intend to draw on Fund technical assistance in this area. The authorities are also keen to maintain effective macroeconomic management by continuing to set expenditure allocations, including for administrative and development budgets at the national level.

In order to reduce the need for budgetary support and enhance the overall economic efficiency, the authorities have established sectoral committees to assess the viability of commercial public enterprises (textiles, electronics, and food). These committees will soon make recommendations about the restructuring, liquidation, or privatization of those public enterprises.

Monetary policy and financial sector development

In order to support the unified exchange rate and bolster financial stability, the authorities foresee a strengthening of the monetary policy framework and central bank supervision and regulation. To these ends, the CBL has formed a Monetary Policy Committee of experts whose first task is to improve the operations of the CBL. The committee has prepared a report to

serve as basis for discussion for monetary policy analysis and to formulate a market-based monetary policy.

To enhance competition in the banking sector, the authorities have allowed the establishment of two new private commercial banks in 2001, and are currently considering applications for two more banking licenses. Preparations are also underway for the privatization of one public bank. The privatization of other public sector commercial banks is also being considered.

As part of the effort to strengthen bank supervision and improve prudential requirements, the central bank has stepped up its efforts to raise the capital adequacy ratio and to improve bank loan quality by arranging workouts for non-performing loans. The CBL is grateful for the very useful technical assistance provided by MAE, and is giving serious considerations to the mission's recommendations to reform and modernize the banking sector.

Trade and external sector

Trade liberalization continues to be at the forefront of the authorities' reform agenda. A number of important actions have already been taken to reform the trade system and increase the openness of the economy. In particular, the import ban of some food items has been removed and replaced by tariffs. Also, Libya has applied to join the World Trade Organization (WTO), which would help the country benefit from further integration into the world economy and modernize its trade and customs regulations. Libya also intends to establish a free-trade area with Arab countries in order to increase the Libyan economy's regional integration, as a first step towards its integration into the global economy. Finally, the authorities are promoting foreign direct investment by opening up the oil and gas sector to investment from international oil companies.

The authorities agree with the staff that ensuring successful trade reform requires sequencing it with macroeconomic and structural reforms in the context of a medium-term framework. They will, therefore, take into consideration the comprehensive two-stage approach suggested by staff, when formulating their own strategy in the future.

Statistical issues

Progress on strengthening Libya's macroeconomic database has continued. In particular, the authorities revised the historical data series in monetary and real sectors in order to improve their quality and usefulness. They also addressed inconsistencies between monetary and balance of payments data. The authorities are determined to continue their efforts to improve their statistical database, particularly in fiscal area, and they would be

happy to receive Fund technical assistance to help them strengthen the quality of their macroeconomic data.

Conclusion

It is fair to conclude that while challenges remain for policy makers, much has been accomplished over the past two years. Though gradual in phasing, taken together, the reforms that have been implemented and those at the planning stage represent an important step toward reforming and opening-up the economy. The authorities are fully committed to continuing to implement their reform agenda and look forward to working closely with the Fund.

Mr. Rustomjee submitted the following statement:

Key Points

We commend the authorities for pursuing prudent macroeconomic policies and for ensuring favorable social indicators.

We recognize steps taken by authorities toward reforming the economy including the unification of the dual exchange rate system and a number of other measures taken to ease trade and exchange restrictions. Implementation of these measures sets the stage for future economic reforms.

We note the authorities concern regarding ability to absorb its growing labor force. In this regard, we encourage the authorities to pursue measures that would facilitate diversification of the economy and urge the Fund to provide the requisite technical assistance to help realize the envisioned reform agenda.

Introduction

The staff's assessment of the 2002 Article IV Consultation underlines prudent fiscal policy pursued by the authorities partly facilitated by the strong rebound in oil prices, while the favorable social indicators are a testimony to the authorities' commitment toward reducing poverty and improving the social well being of the country. We thank Mr. Shaalan for his comprehensive and informative preliminary statement, providing insight as to the authorities' intent on a number of policy areas including liberalization, tax reforms, and the need for diversification of the economy. We commend the authorities for their foresight in managing the economy and for focusing on social goals, as reflected in favorable social indicators. We broadly agree with the thrust of staff's assessment and wish to focus on a few selected areas.

Overview

Libya's economic performance has improved considerably since the 1990's given the authorities' prudent macroeconomic management. Real GDP growth recovered from a decline of 3.6 percent in 1998 to 4.4 percent growth in 2002, partly due to a rebound in oil prices. The average consumer price inflation fell from 3.7 percent in 1998 to a negative inflation of 2.9 percent in 2002, while gross official reserves almost doubled from US\$6.7 billion in 1998 to \$12.1 billion in 2002. The current account balance as well as the fiscal account were both in surplus during this period. In this regard, we commend the authorities for maintaining sound economic management.

While the authorities have pursued prudent economic management, we note that Libya remains vulnerable in view of its dependency on oil. To this end, it would be useful for the authorities to consider introducing measures that would facilitate diversification of the economy, with a view to expanding the productive base. This would in turn lead to higher rates of economic growth. A diversified productive base would engender employment opportunities that could absorb some of the rapidly growing labor force. In this context we encourage the authorities to examine the overall investment climate with a view to promoting private sector development. In this regard, the authorities may wish to revisit labor market practices, ensure policy predictability, and institute, selectively, investment incentives geared to attracting foreign direct investment in non-hydrocarbon sectors.

While we support the authorities view of a gradual approach to the reform process in order to foster ownership, we agree with the staff that a set of measures aimed at liberalizing domestic prices, eliminating trade and exchange restrictions may be able to be implemented at an early stage. To this end, we are pleased to note that a number of actions have already been taken to reform the trade system and to increase openness of the economy including removal of the import ban of some food items. We are further encouraged by the authorities application to join the World Trade Organization (WTO) and to establish a free trade area with Arab countries; these measures would facilitate Libya's further integration into the global economy. We encourage the authorities to consider going further by setting up a comprehensive trade liberalization timetable.

Fiscal policy

While the fiscal position has remained strong due to high oil prices in 2000 and 2002, the overall budget surplus has continued to diminish relative to GDP due to extra-budgetary expenditures including the hiring of additional workers by the local government, in the context of fiscal decentralization. We also note from the staff report that expenditures are foreseen to increase significantly, including discretionary expenditures as well as subsidization of

essential goods. Given the dependence on oil revenue, we would caution against a significant increase in expenditure. While we are pleased to note in Mr. Shaalan's preliminary statement that the authorities are taking numerous tax measures to reduce dependence on oil revenues, we nonetheless encourage the authorities to maintain fiscal prudence and effective macroeconomic management.

Monetary Policy

We agree with the staff that the authorities need to strengthen the monetary policy framework in order to bolster financial stability and to underpin the unified exchange rate system. In addition, we endorse the staff's call for removal of direct credit controls, flexibility in interest rate setting and creation of market-based instruments in order to enhance monetary policy. Moreover, we view the setting up a Monetary Policy Committee an important step and encourage the authorities to consider implementation of the recommendations of the 2001 MAE technical assistance mission.

Financial sector

We are pleased to note that the authorities have set in motion the process of enhancing competition and efficiency in the financial sector through establishment of two private commercial banks and the preparation for privatizing one public bank. These actions reflect the authorities commitment to pursue a robust package of the reforms. We view these measures as steps in the right direction and encourage the authorities to institute measures that would improve banking supervision, including uniform accounting and reporting standards based on international best practices.

HIPC-Related Issues

As a creditor to some of the Highly-Indebted Poor Countries (HIPC), we would encourage the authorities to consider providing debt relief to those countries at comparable terms to the enhanced HIPC Initiative.

Conclusion

We commend the authorities for their good management of the economy and welcome the authorities' reform process, which is being conducted at a pace commensurate with domestic priorities and capacity constraints. We support the gradual approach to the reform process given the importance of underpinning ownership of the process and the need to minimize disruptions in society. We urge the authorities to take advantage of the Fund's technical assistance to help address various policy issues with a view to facilitating institutional capacity and the process of reform.

Mr. Mirakhor submitted the following statement:

Key Points

The economy's strong external position can provide the springboard to further reforms and faster growth.

A gradualist approach to reform can still yield positive results if it is based on a comprehensive and well-sequenced set of policy actions and is implemented with diligence and conviction.

A prudent fiscal policy, implemented in a medium-term framework, is the key to policy credibility and financial stability. We welcome the review of the tax system and encourage reconsideration of the 70/30 rule.

The present level of the exchange rate and the exchange rate arrangement appear to be appropriate. Greater flexibility could be considered as a medium-term objective if conditions permit.

The framework of monetary policy needs to be strengthened. There is an urgent need to reform the banking sector and to improve bank supervision in line with the recommendations of the MAE technical assistance mission.

The authorities' plans to improve the performance of public enterprises and to liberalize the trade system could benefit from greater specificity.

We thank the staff for a clear and well-written paper, and Mr. Shaalan for his lucid statement. Recent economic performance in Libya has been on an improving trend. Helped by high oil prices and generally prudent policies, the economy grew at a reasonably satisfactory pace, the fiscal and external accounts have recorded significant surpluses, there are no inflationary pressures, and reserves have been built up to comfortable levels. At the end of 2001, the authorities took the bold action of unifying the dual exchange rate system through a one-step devaluation supplemented with a number of measures to ease trade and exchange restrictions, including the recent decision to remove import license requirements.

With a strengthened external position, the key challenge is how to fashion policies that will durably raise the rate of economic growth to a level that will create job opportunities to the rapidly growing labor force. Staff projections show that absent a concerted effort to accelerate and deepen the pace of structural reforms and foster private sector development, economic growth is likely to remain quite modest, weighed down by excessive controls and restrictions that impinge on efficient resource allocation and inhibit productive efficiency.

The authorities recognize the need for a step-up in the pace of adjustment and reform but are concerned that too fast a pace could prove to be socially disruptive. This is a concern that we share. Nevertheless, even a gradualist approach to reform can yield important benefits if it is implemented within a coherent and well-sequenced policy framework. The five-point reform agenda outlined in Mr. Shaalan's statement and the staff's two-stage adjustment strategy offer a clear road-map of the way forward. We encourage the authorities to pursue this agenda with diligence and conviction.

As the staff underscore, adopting a prudent fiscal policy stance will be key to ensuring lasting financial stability. The 2002 budget embodies a relatively expansionary stance, and its impact on domestic demand growth should be monitored closely. We join the staff in calling for a review of the 70/30 rule which appears to impart an undesirable procyclicality to expenditure policies and risks undermining the quality of development projects. The ongoing fiscal decentralization initiative holds the promise of improving service delivery in the regions and ensuring a better alignment of expenditures with local needs. It will, however, be important to guard against undermining fiscal discipline and macroeconomic management. This could be achieved, inter alia, by setting limits on the level and composition of regions' expenditures and better coordination between the central and regional governments, especially with regards to social expenditures. On the revenue side, we are pleased to note that the authorities are presently working on a revision of the tax laws aimed at streamlining the system and broadening the base in parallel with efforts to strengthen administration. Of particular importance is the removal of numerous and discretionary tax and customs tariff exemptions and reducing marginal personal and corporate income tax rates. Formulating fiscal policy in a medium-term framework will help focus on smoothing expenditures in the face of volatile oil prices and reviewing the effectiveness of the operations of the Oil Reserve Fund.

We commend the authorities for the unification of the exchange rate and the accompanying reforms. The absence of a parallel market rate or tensions in the foreign exchange market seems to suggest that the present level of the exchange rate is appropriate. Nevertheless, avoiding the re-emergence of the parallel market and responding to shocks will require that the authorities show flexibility in how they conduct exchange rate policy. Over the medium term, as reforms are implemented and indirect monetary instruments are developed, consideration could be given to moving towards a more flexible exchange rate arrangement.

The task of monetary policy is well-defined—strengthening financial stability and supporting the exchange system—and would be facilitated by phasing out the present system of directed credit and controls and allowing a more flexible interest rate structure. We are pleased to note that the authorities are looking into the feasibility of implementing a more market-based

monetary system. We welcome the establishment of two new private commercial banks and the favorable prospects for the privatization of a public bank. This would send an important signal to markets of the authorities' intention to foster private sector development. Much remains to be done in the area of bank supervision and prudential requirements, and we welcome the authorities' intention to give serious consideration to the recommendations of the MAE technical assistance mission.

The authorities' plans to improve the operations of public enterprises are welcome. Meaningful progress in this area will need to include restructuring and greater management autonomy in price and wage-setting decisions, and we look forward to the recommendations of the three sectoral committees. While the recent decision to remove import licensing is to be welcomed, a clear timetable for more comprehensive trade liberalization should be established. Libya's application to the WTO should help further integration into the world economy. We commend the authorities' plan to establish a free-trade area with its Arab neighbors.

The authorities have made notable efforts to clear external arrears and regularize relations with all creditors. Further efforts in this area would bolster confidence and attract foreign investment in the Libyan economy.

The staff representative from the Middle Eastern Department (Mr. Elhage) stated that since the staff report was issued, the authorities had informed the staff that import licenses had been eliminated. In the staff's view, this measure would simplify import transactions and increase transparency. However, importers still had to be registered with the import office, and could only import goods that are related to their line of work and that are not included on the negative list. The elimination of import licenses was not expected to have a significant impact on the level and composition of imports.

Mr. Guetat made the following statement:

Since the suspension of UN sanctions, the overall macroeconomic situation in Libya has improved with a very low inflation and a significant build-up of foreign exchange reserves. Libya's social indicators are also favorable by regional standards.

The unification of the exchange rate early this year, has been a major achievement for which the authorities are to be commended. Still, major challenges remain and the Libyan authorities need to diversify their economy so as to foster growth for the non-hydrocarbon sector and create an environment conducive to private business growth.

Since we broadly share the staff's appraisal and we are reassured by Mr. Shaalan's helpful preliminary statement, we will concentrate our remarks on the following areas: fiscal, monetary, structural and statistical issues.

Fiscal policy

Despite the fiscal surplus of 5.0 percent of GDP projected for 2002, we encourage the authorities to keep their prudent fiscal stance. The medium-term outlook with lower oil price appears less favorable for the budget. Indeed, more emphasis should be put on non-petroleum tax revenue collection and a continuation of the current gradual and cautious pace of reforms of the subsidy system, and relative restraint on extra-budgetary and capital expenditures. To this end, it is also important to reinforce the tax administration and broaden the tax base. We are reassured by Mr. Shaalan that a revision of tax laws is underway and that the authorities intend to draw on Fund technical assistance in this area.

Turning to the Oil Reserve Fund, we encourage the authorities to introduce more transparency in the use of resources. As regards fiscal decentralization, there are still some concerns on regional budgets. We encourage the authorities to put in place adequate control procedures and adequately staff the local agencies. Like the staff, we call for improved coordination between the central and regional governments, particularly in areas such as health and education.

While a number of measures were taken to cushion the adverse measures of the devaluation, early this year, we also note that the prices of domestic petroleum products were raised by 7 percent. We would like to know what impact the price hike has had on the population. Staff clarification is welcome.

Monetary and exchange rate policy

We welcome the unification of the dual exchange rate system in January, 2002 and the elimination of the exchange rationing. We agree with the authorities' prudence stance too keep a fixed exchange rate but adjustable peg to the SDR.

On monetary policy, we urge the authorities to press ahead on the remaining reform agenda and we encourage them to use more indirect instruments to conduct monetary policy. We also encourage the authorities to implement the recommendations of the MAE technical assistance mission as laid out in Appendix VI.

Structural and financial sector reforms

The authorities should focus on creating an environment conducive to the private sector development mainly in the non-hydrocarbon sector that will create job opportunities for the growing number of newcomers in the job market. To this end, they need to introduce more flexibility and deregulate the

labor market as well as the product and service market. Deregulation should also go hand in hand with the restructuring of the state-owned companies before envisaging their privatization.

Turning to the banking sector, non-performing loans standing at 29.0 percent of total loans is a major concern. Indeed, there is a need to reinforce banking regulation and supervision. To this end, we encourage the authorities to implement the recommendations of the August 2001 MAE technical assistance mission. The authorities should also press ahead with the privatization of state-owned commercial banks.

Trade policy

The authorities should push ahead with the external trade liberalization agenda, that include the elimination of non-tariff barriers on imports, mainly import licenses. We are reassured by Mr. Shaalan that his authorities will follow the two steps trade liberalization approach proposed by the staff. We also welcome Libya's application to the WTO. While we support the objective of establishing free-trade arrangements with Arab countries, we also encourage the Libyan authorities to work on a free trade agreement with the African countries.

Statistical and data Issues

Despite some progress, Libya's database still suffers from shortcomings that seriously affect the capacity of staff to conduct effective surveillance. We note from the appendix III that there are a lot of weaknesses in this area. It is also regrettable that on fiscal data, none of the recommendations of the 1998 STA mission has been implemented. We encourage the authorities to allocate more resources to capacity building and we also call for Fund technical assistance. We encourage the Libyan authorities to participate in the GDDS.

Finally, we encourage the Libyan authorities to make effective their pledge to the PRGF-HIPC Trust effective and wish them every success in their endeavors.

Mr. Whitehall made the following statement:

We commend the authorities for their commitment to prudent economic policies, which, after the lifting of sanctions in 1999, have led to an improvement of the macroeconomic performance. Against this background, the authorities now have greater confidence to pursue a broad range of needed reform measures. These have included, notably, the removal of import licensing, unification of the exchange rate, allowing the establishment of the first two private banks, and recent efforts to regularize arrears with creditors.

We are heartened by the level of commitment to future reforms, as expressed in Mr. Shaalan's preliminary statement. What is needed now is for the authorities to follow through with the implementation of these policies, and generally strengthen the pace of reform and build on the achievements of the past. This will include strengthening monetary policy, gradual liberalization of exchange policies, reform of the civil service, and establishing a timetable for comprehensive trade liberalization. In this regard, we agree with the comments of Mr. Mirakhor on these points.

Nevertheless, we are mindful of the social and political realities of the Arab context, which will limit reform to a gradual pace. While there are no major significant risks to medium-term stability, like Mr. Rustomjee, we do have concerns about the recent worsening of the fiscal situation. We would caution that the ratio of expenditure to GDP has risen significantly faster than the ratio of revenue to GDP. Revenue has been a little sluggish in light of the weaker growth prospects expected for this year. Thus, the overall fiscal surplus is projected to decline from 10 percent to about 5 percent in the coming year. It is heartening also that the authorities are engaged in diversifying the economy away from oil, taking into account the exhaustible nature of hydrocarbon resources.

Finally, we consider that Libya still has a long way to go, and it will be important to follow through on stated policies while economic conditions remain favorable and oil prices are reasonably buoyant. With these remarks, we wish the authorities success in their endeavors.

Mr. Sdralevich made the following statement:

I agree with the staff's judgment that the current macroeconomic outlook is broadly favorable, with positive current account and fiscal budget balances and low (or indeed non-existent) inflation. In this generally positive picture, there are, however, some worrying signs. As the staff and other speakers have noted, the Libyan economy is heavily dependent on oil, and the non-oil economy, and particularly the private sector, are seriously undersized. Incidentally, I wonder whether the staff has carried out sensitivity analysis to study the impact of oil prices on macroeconomic variables. Maybe for the next Article IV consultations a small box on scenarios could be useful. The most worrying implication of this situation of dependency is that the long-term non-oil GDP rates are lower than the labor force growth. By consequence, in the long run the level of unemployment may increase to unsustainable levels, and I think that this danger, more than any immediate problems, confirms the importance of the comprehensive reform plans advocated by the staff.

In this light, we invite the authorities to proceed along a path of reform aimed at decreasing the role of the government and increasing the role of the

private sector, and at opening the economy to external investors. The intentions and the recent actions of the authorities described in Mr. Shaalan's informative preliminary statement, and the staff's update today, are encouraging in this regard.

As to the reform strategy, a gradual program is probably the most realistic option, given that there is so much to do to transform the economy into a market based system. The authorities should therefore start addressing the most relevant economic distortions before moving on to more sophisticated reforms. For example, as first and urgent steps, the removal of the remaining price controls, the rationalization, simplification, and reduction of trade barriers, and the corporatization of public sector enterprises and banks could be addressed. Without the completion of these basic steps to liberalize markets, it is not very realistic to think about implementing other, relatively more advanced reforms, namely full privatization of public enterprises, or the implementation of market based monetary policy, to name a few. In other terms, sequencing is important. But I think this is what the staff have in mind with their two stages of reforms. Regarding privatizations, I find interesting the authorities' intention to move the public enterprises' ownership to their employees. I would appreciate some clarification from the staff or Mr. Shaalan to which extent control would also be transferred to employees.

In monetary and exchange rate policy, a very important result has been obtained with the unification of the exchange rate system, a difficult task that the authorities have accomplished with determination and speed. Now it will be important to avoid the resurgence of a parallel market, and in this regard the measures advocated by the staff to further liberalize foreign exchange transactions and to eliminate exchange and trade restrictions will be essential. A realistic exchange rate level will also discourage the return of a parallel market. For this reason, and not least to help the economy absorb the shocks from the fluctuations in the oil prices, we agree with the staff that the authorities must be ready to adjust the exchange rate peg, and in the longer run, should move to a flexible exchange rate system.

In the fiscal domain, the oil-related revenues allow for a comfortable budget surplus, so again there is no immediate risk. This does not mean however that no improvement is needed, and indeed, besides the issue of raising revenues noted by other speakers, two issues come to mind. In the first place, the 70/30 rule, while certainly having the merit of setting apart resources for capital investment, does not allow for any tuning of such expenditures over the cycle, and should therefore be reformed or, probably better, eliminated. Second, transparency and rationalization could be improved, especially with regard to the Oil Reserve Fund (ORF), the operations of which should be carried out according to clear guidelines, and integrated in the fiscal budget.

Lastly, I would like to encourage the authorities to address the deficiencies in the statistical sector, that at the moment make proper surveillance very difficult to carry out. Participation in the GDDS would help Libya to improve its performance in this field.

With these remarks I wish the authorities continued success.

Mr. Alosaimi made the following statement:

Let me first thank Mr. Elhage and his team for a well-prepared set of papers on the Libyan economy and Mr. Shaalan for his informative preliminary statement. The authorities' policy initiatives along with improved oil prices and the lifting of U.N. sanctions have strengthened economic performance in Libya over the past two years. Non-hydrocarbon GDP grew, both the fiscal and balance of payments accounts registered substantial surpluses, and reserves increased.

These welcome developments notwithstanding, much still needs to be done to reduce the economy's vulnerability and place it on a sustainable high growth path. The attainment of these objectives hinges, to a large extent, on enhancing the efficiency of public sector enterprises. In this regard, it is important to streamline those enterprises, accord them greater autonomy in setting prices and implementing employment policies, and subject them to hard budget constraints. This should improve their productivity and strengthen their finances.

A stronger investment effort by the private sector is also essential. In this regard, the Libyan authorities' intention to open-up a wide range of activities to the private sector is a step in the right direction. These efforts should be complemented by reforms in other areas, especially in the regulatory framework.

In the fiscal area, the focus should remain on strengthening the structure of the budget. In this connection, reforming the tax system and improving the tax and customs administrations are essential. Here, technical assistance from the Fund would be useful. On the expenditure side, it is important to pass through, at least partially, higher prices resulting from exchange rate unification while improving the targeting of subsidies. Moreover, projects should be carefully screened to achieve the full benefits of increased capital spending. The authorities should also remain vigilant to ensure that the fiscal decentralization process attains the desired objectives without undermining the expenditure stance.

Turning to monetary and financial sector policies, I welcome the authorities' cognizance that the policy framework needs to be strengthened to enhance financial stability and support the exchange rate system. Here, it is

important to implement the recommendations of the MAE technical assistance mission. It is also important to address the weaknesses identified in the staff report regarding the banking sector. The establishment of two private banks last year and the ongoing preparation to privatize a public bank are steps in the right direction. However, it is essential to increase the ability of commercial banks to assess risks and to recover bad loans. In this regard, I am encouraged by the central bank's efforts to arrange workouts for non-performing loans. The ongoing efforts to enhance supervision and prudential regulations should also be strengthened.

On the external sector, I welcome the unification of the exchange rate as well as the easing of restriction on international transactions. However, further efforts are still needed in these areas. Indeed, it is essential to sustain the unified exchange system and avoid the reemergence of a parallel market rate. It is also important that the unified exchange system does not lead over time to loss of competitiveness which could hinder efforts to increase diversification and private sector investment. Trade reform is another area that requires greater attention. In this regard, the tariff reductions already implemented and the planned liberalization of the import system are encouraging steps. Here, I welcome the authorities' move to eliminate the import licenses as just pointed out by the staff. I also welcome the objective of establishing free trade arrangements with other Arab countries.

With these remarks, I wish the authorities success in their efforts to adjust and transform the economy.

Mr. Epstein made the following statement:

We agree with the staff assessment that while the overall macroeconomic performance has improved over the past three years, growth and employment creation have remained moderate, reflecting the adverse effects from distortionary policies. Moreover, Libya's economic policies will not yield strong benefits as long as the government continues to deny its people universally recognized economic and political freedoms. We take this opportunity to address a few specific concerns.

First, Libya's extreme dependence on the oil sector for revenue generation appears unsustainable, given projected lower oil prices over the medium term. The authorities' continued focus on the hydrocarbon sectors at the expense of developing other sectors in the economy risks dampening Libya's growth prospects and exacerbates its vulnerability to external shocks. A key step towards economic diversification is freeing up the constraints across the economy. The extent of governmental controls inhibits market-oriented economic reforms and hinders opportunities for increased efficiency, competitiveness, and job creation.

Second, private sector financing is very limited, given the underdeveloped financial sector, reflecting administratively-set interest rates, directed lending policies, and excessive regulations. Of particular importance in strengthening and building confidence in an efficient financial sector is developing an appropriate anti-money laundering and counter terrorism financing regime. Unless addressed, money laundering and terrorist financing issues may derail economic growth and increase the risks to domestic as well as international financial systems. We note that the authorities have not submitted notification of measures to combat the financing of terrorism following the invitation issued in the Secretary's March 12 memorandum nor have they expressed willingness to participate in the international coalition against terrorist financing. We urge the authorities to do so.

Third, we agree with the staff about the immediate need for data transparency. Without accurate and timely data, the authorities are not in a position to identify economic vulnerabilities or develop an adequate policy response.

Finally, while unification of the exchange rates and the accompanying measures are steps in the right direction, the authorities must move forward in a number of economic and structural reforms, such as the restructuring of public enterprises, in order to achieve growth rates strong enough to absorb the growing labor force and allow for more diversified economic development.

Mr. Wei made the following statement:

Let me first thank the staff for the well-prepared papers for today's discussion and Mr. Shaalan for his insightful preliminary statement. It is very encouraging to know that Libya's overall macroeconomic conditions have continued to improve since the lifting of the UN sanctions in 1999, due to the authorities' prudent macroeconomic management. A much-improved macroeconomic environment has provided breathing space for important fundamental reforms to take place over the past two years. I agree with Mr. Shaalan that these reforms and those in the pipeline represent a significant step toward reforming and opening up the economy. Since I am in broad agreement with the staff appraisal, I shall limit my remarks to only a few areas.

Given an oil-dependent economy, overall activity has generally rebounded along with oil prices since the second half of 1999. On the issue of inflation, while the staff's flat projections probably suggest that there is no pressure either way (upward or downward)—it would be useful if the staff could elaborate more on what has happened recently and going forward, especially against the background of further domestic price deregulation and trade liberalization. Staff comments are welcome.

Indeed, the authorities see this as an opportune time to build on the recent success by broadening the reform agenda. I believe that the authorities have a good grasp of what is most needed and pressing to pursue and consolidate gains. As highlighted in Mr. Shaalan's preliminary statement, the authorities envisage deregulating price controls and devising social safeguards; diversifying the productive base away from oil; engineering an environment conducive to private sector economic activity; and improving resource allocation. I fully agree with the authorities' visions and policy considerations.

On the fiscal side, the position has remained strong. Surpluses have been sustained at high levels. I commend the authorities for their forward-looking attitude and agree with them that a medium-term fiscal strategy has to be devised now, taking into account the exhaustible oil resources. In this connection, substantial reforms will need to take place both on the revenue and expenditure fronts. And these reforms will also have to be made consistent with the overall economic reform strategy, for example, the pace and extent of the measures to reinvigorate the economy through diversification, and also the pace and extent of the reforms to open the economy or liberalize trade. This is a very ambitious and comprehensive effort. I can therefore see why the authorities aim to pursue the agenda in a gradual manner and over the medium-term horizon. In my opinion, it is only prudent to do so. Thus, we support the authorities' gradual approach in pursuing their policy agenda.

On the monetary side, the unification of the exchange rates was a very courageous move and a major achievement, which provides an important foundation for reforms to accelerate, especially on the external front. I concur the view of the authorities that the fixed exchange rate is the most appropriate for the authorities while maintaining a certain degree of flexibility to make adjustments to absorb external shocks. I welcome the report prepared by the Monetary Policy Committee, which should form a useful basis for discussion for monetary policy analysis and formulation of a market-based monetary policy. It is also encouraging to see the commendable progress made in reforming the banking sector. I welcome the on-going efforts in facilitating the establishment of private banks and privatization of public banks.

On statistics, I join the staff and other Directors in commending the authorities for their considerable efforts in improving the quality of statistics in a number of important areas, including the balance of payments and monetary statistics. However, I agree with the staff that there is still room for further improvement and priority now should be given to the fiscal sector. I am sure that the authorities will find the Fund's technical assistance extremely useful in this regard.

Before concluding, I would like to join Mr. Mirakhor in encouraging the authorities to make further efforts in clearing external arrears and regularizing relations with all creditors to bolster confidence and attract foreign investment, while noticing that they have made notable efforts in these areas.

With these remarks, I wish the authorities full success in meeting future challenges.

The staff representative from the Middle Eastern Department (Mr. Elhage), in response to questions and comments from Executive Directors made the following statement:

Mr. Guetat asked about the impact of the recent increase in petroleum prices on the population. Currently, a gallon of gasoline costs around US\$0.38, still significantly below international prices. The increase was from slightly above US\$0.35 to 0.38. We do not expect such an increase to have a significant impact on the population. On the sensitivity analysis regarding a change in oil prices, the staff estimates that for a US\$1.0 change in oil prices, oil revenue will change by about 1.7 percent of GDP. In the current medium-term scenario as shown in Table 7 of the staff report, the staff takes into account an oil price of around US\$20.0 a barrel. Given that price, over the medium term there would still be current account surpluses, and the fiscal deficit, assuming no further reform measure, would be about 2.0 percent of GDP by 2007.

On structural reforms, privatization in Libya differs slightly from that pursued in a market economy. The authorities approach is to move both the ownership and control of companies to employees.

On the devaluation of the exchange rate, Mr. Wei asked a question regarding its impact on prices. On the basis of a 50.0 percent devaluation of the official rate, the staff determined the impact on prices by looking at the components of the CPI basket. The staff found that devaluation will not affect 20.0 percent of the basket which is made up of subsidized goods, basic services, and the part of the basket which had already been imported at the special rate. Accordingly, the staff projects that for 2002, prices will increase by about 6.0 percent, driven by the fact that rent and utilities prices will remain largely unchanged. In a recent discussion with the authorities as of last week, they informed the staff that they do not see any pressure on prices resulting from the unification of the exchange rate. Prices will move upward when the authorities start dealing with the subsidies issues until now they do not have a plan to reduce subsidies of essential goods.

During the mission, the staff discussed a package of reforms with regard to subsidies. As Directors indicated, subsidies cannot be addressed without addressing wages, which have not been adjusted since 1981. The

reform approach should be comprehensive and should address the low wages, which are significantly low even by regional standards, while at the same time liberalizing prices. For next year, the staff do not expect a significant upward change in prices.

Mr. Boitreaud made the following statement:

At the outset, I would like to thank the staff for this interesting report and Mr. Shaalan for his instructive statement, that provided us with the authorities' agenda to reform the Libyan economy in the coming years. At this stage of our discussion, I will make a few points for emphasis.

The improvement in the external environment, partly due to high oil prices and to the suspension of UN sanctions, can only be comforted by the authorities' determination to promote a more market-oriented economy. The most important step undertaken in that respect is the unification of the exchange rate. We commend the authorities for this well prepared and ambitious reform that sends a strong and positive message to the private investors. If the absence of tensions in the foreign exchange market suggests that the level of the exchange rate is appropriate, we share Mr. Mirakhor's remark that avoiding the re-emergence of the parallel market and responding to shocks will require that the authorities show flexibility in how they conduct exchange rate policy. This unification will indeed create new challenges for the authorities, especially concerning the conduct of the monetary policy and in the area of bank supervision, as underlined by Ms. Guetat.

We concur with the staff that fiscal policy is the key policy instrument for strengthening macro and financial stability. The strong fiscal position, due to high oil prices in 2000 and 2002, leaves however no room for complacency as public spending is clearly on the rise. As emphasized by the staff, the authorities would need to review the implementation of the 70/30 budget rule by devising a more flexible, transparent, and accountable process, that would smooth out expenditures and enhance efficiency. We also note that the ongoing fiscal decentralization is adding pressure on the expenditure. If we fully support the global objectives of this reform, that is to improve services in the regions and better tailor expenditures to local needs, we would like to stress the importance of establishing sound safeguard mechanisms to maintain fiscal discipline. We would like to hear from the staff on these mechanisms.

We also support the staff's recommendation that the authorities should clear remaining arrears and regularize their relations with external creditors, but we would emphasize the necessity to deal with debt treatment issues in a multilateral framework.

In the medium term, Libya remains vulnerable in view of its dependency on oil. Like Messrs. Rustomjee and Sdrlevich, we urge the

authorities to introduce measures that would facilitate diversification of the economy that would in turn lead to higher rates of economic growth. Disengaging the public sector from activities where the private sector can deliver goods and services in a more efficient manner and at competitive prices should also be considered.

We share Mr. Epstein's concerns regarding anti-money laundering and combating the financing of terrorism, and urge the authorities to make progress in this area.

Let me conclude by saying that we welcome the efforts taken by the authorities to revise and improve data. Nevertheless, a lot remains to be done in that area, especially concerning the fiscal area.

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

Mr. Komatsuzaki made the following statement:

Libya's economic developments since the last Article IV consultation have been encouraging. Real GDP was positive and the fiscal and current account balances were strong. There has also been some progress in policy implementation. This chair welcomes that the exchange rate system has been unified by end 2001. However, Libya is still a highly closed economy, with all goods and services being subject to official price controls and restrictions on payments and transfers for current international transactions having been maintained. Libya needs to address structural reforms vigorously to foster the development of private sector activities and maintain sound growth to support its rapidly growing labor force. I broadly agree with the staff appraisal, but will make a few remarks for emphasis.

Price liberalization, including both domestic price liberalization and trade liberalization, and elimination of foreign exchange restrictions need to be pushed forward. This will ensure better linkage between domestic and world prices in a more flexible domestic price setting, which would provide a fundamental element to foster private sector activities.

In the trade area, I encourage the authorities to formulate a medium-term framework to realize trade liberalization in a coherent manner and appropriate sequence. The authorities' intentions and actions toward a more liberalized trading system are welcome in this regard, including application to the World Trade Organization.

Regarding the free-trade arrangements with Arab countries, like the staff, I encourage the authorities to include a program for multilateral liberalization. I also urge the authorities to eliminate restrictions on payments and transfers for current international transactions. An adjustable exchange

rate regime appears to be pertinent to current circumstances, but I concur with Mr. Mirakhor that it is important to avoid a re-emergence of the parallel market. In any event, a continuous review is necessary as these restrictions on international transactions are going to be eliminated.

In the fiscal area, expenditures should be planned and implemented cautiously. The 70/30 rule seems to subject expenditure decisions dominantly to the availability of resources and to promote a procyclical expenditure stance. Expenditure decisions have to be made based on necessity, and I concur with the staff in calling for the review of the system to replace it with a more transparent and flexible framework. Separately, the Oil Reserve Fund is now operating in a transparent way, and its operations also have to be viewed in view of establishing a transparent operating rule.

On data issues, Libya's database suffers from significant deficiencies and needs improvement. While there has been some progress, developments in fiscal data are disappointing, with none of the recommendations of the 1998 statistics mission having been implemented. I urge the authorities to implement them as soon as possible. Participation in the GDDS would also be helpful to improve overall data quality. With these remarks, I wish the authorities success.

Mr. Zakharchenkov made the following statement:

At the outset, let me commend the staff for the balanced and concise report. I broadly share the staff's assessment of the economic developments in 2000-2001. Following the suspension of the UN sanctions in April 1999, the macroeconomic situation improved considerably, mainly on account of the oil sector performance, and remains broadly stable to this date. I agree with Mr. Shaalan that it is fair to say that a number of important steps have been accomplished over the past two years. Most notably, the authorities have unified the exchange rate and proceeded with a number of structural reforms in the areas of trade and price liberalization, to make the economy more open and flexible. However, many important challenges still remain and I will address some of them in the rest of my statement.

First, as a general observation, the Libyan economy remains largely state-controlled and relies heavily on the oil sector that accounts for 95.0 percent of exports and over 60.0 percent of budgetary revenue. At the same time, the authorities have to achieve nonhydrocarbon GDP growth rates around 5.0-6.0 percent annually in order to generate employment opportunities for the rapidly growing domestic labor force. From our point of view, the medium-term reform strategy of the development of the private sector should ideally include steps similar to those mentioned by the staff in paragraph 21. In this connection, I noted from paragraph 19 of the staff report that at this stage there are no concrete plans to dismantle the system of

subsidies and directed credits, ease labor market restrictions, or significantly reduce the role of the public sector in the economy.

Second, the unification of the exchange rates represents a major step forward, but it should be supported by second-tier reforms to eliminate remaining foreign exchange and trade restrictions in order to prevent the re-emergence of the parallel market. Several important steps have already been undertaken, but a comprehensive package of reforms is still to come.

Third, the authorities should pay close attention to fiscal developments. I agree with staff that the present fiscal position seems to be stable, but a number of issues give rise to some concerns: (a) The continued policy of fiscal decentralization has resulted in increased pressure on expenditures on behalf of the regional authorities; (b) The effect of the devaluation is not fully assessed at this stage and several public enterprises could face losses despite the provisioning of foreign exchange liabilities and pose an additional burden on the budget or on the balance sheets of the public banks; (c) The operations of the Oil Reserve Fund (ORF) and National Oil Company are not transparent and pose a threat to the overall budgetary discipline; (d) Finally on fiscal issues, we support the staff's view on the need to review the implementation of the so called 70/30 rule in order to make development expenditure more efficient and budgetary process more transparent.

Fourth, Libya is highly dependent on its oil and gas sector and, given the exhaustible nature of these resources, they should be managed well. In this connection, we noted that in its present form the ORF does not fulfill neither its role neither as a fund for future generations, nor as a stabilization fund. Even in the period of high oil prices in 2000-2001, the ORF reserves declined by US\$200 million. In this connection, we support the staff's call to review the operations of the ORF.

Finally, we support the authorities' request for technical assistance in the areas of statistics, financial programming, tax administration, and customs reform.

With these remarks we wish the Libyan authorities well.

Mr. Brooke made the following statement:

Like other Directors, I fully endorse the main messages of the staff report, and have only a few points to make. As the staff highlights, the Libyan economy continues to be hindered by extensive government controls on prices, external trade, banking sector, and labor market practices. In addition, the economy remains highly dependent on the hydrocarbon sector. Faced with these controls and the associated macroeconomic volatility and uncertainty, it

is little wonder that private sector investment outside of the hydrocarbon sector has been weak.

As the staff note, the authorities' main objective should be to formulate a comprehensive macroeconomic and structural reform program that would seek to liberalize domestic prices, eliminate trade and foreign exchange restrictions, significantly reduce the role of the state in the economy, and formulate improved frameworks for monetary and fiscal policies. As noted by Mr. Sdravovich, it will be crucially important in this regard to consider the appropriate sequencing of these reforms.

I welcome the indications in the report and in Mr. Shaalan's statement that the authorities recognize the need to adopt such strategy. Nevertheless, it is somewhat disappointing to learn that the authorities' plans for economic reforms will continue to be gradual and limited in scope. Given the significant costs associated with the existing combination of policies, I would urge the authorities to adopt a more ambitious approach. In this regard, I welcome the recent unification of the exchange rate as a significant step in the right direction, and hope that this will help the authorities to gain more confidence in tackling the other much-needed reforms.

On the question of privatization, in a number of other countries, it has been important that privatization is deemed to be politically acceptable. Some sections of the economy or some members of the population gain much more than others from the privatization process. I wonder whether the staff are concerned about equity issues in the way that the Libyan authorities are going about privatization, and whether they have discussed these issues with them.

On technical assistance, I welcome the authorities' improved dialogue with the Fund staff. In principle, I support the technical assistance requests. I note, however, as was pointed out by Mr. Komatsuzaki, that many of the actions identified by the 1998 statistics technical assistance mission have not yet been implemented by the authorities. I hope, therefore, that the staff will seek assurances of the authorities' genuine intention to implement reforms before sending the proposed technical assistance missions.

Finally, I agree with Mr. Epstein's comments on the authorities' actions in the areas of anti-money laundering and countering the financing of terrorism, and would encourage them to take steps to meet the UN's guidelines in these areas and those set out in the IMFC communiqué. I wish the authorities every success in their challenging reform agenda.

Mr. Mirakhor, in response to Mr. Brooke, remarked that it was dangerous to ask the staff to judge the intention of the authorities first before the Fund provided technical assistance to them. If the staff recognized that technical assistance was necessary, and the authorities were requesting it, the Fund was obligated to provide technical assistance because

Libya was a member country. The record should be checked to find out if the provision of technical assistance over a period of time indicated that implementation was not keeping up with recommendations. Only then could a point be reached where such judgments could be made.

Mr. Brooke replied that what he had said was in agreement with Mr. Mirakhor. The track record of implementation of the recommendations of the 1998 statistics mission was less than desirable. Thus, it should be a matter of concern to what effect future technical assistance missions would have. The staff had stated that the MAE technical assistance mission had gone well, and that the authorities had been receptive to the recommendations. Thus, while in support of the request for another technical assistance mission, caution was due given the past track record, as was pointed out by Mr. Mirakhor.

Mr. Shaalan said that it would not be fair to say that the authorities had not utilized past technical assistance. There had been some improvements in data, although there were still limitations, undoubtedly. Progress cannot obtain quickly when starting from a low level, but the authorities, take the advice seriously and act on it.

Extending his remarks, the staff representative from the Middle Eastern Department (Mr. Elhage), in response to questions and comments from Executive Directors, made the following statement:

There were few questions raised regarding privatization in Libya. The authorities are aware that public enterprises need to be reformed. Recently, they have established sectoral committees to look at public enterprises, and they have in mind three options: restructuring liquidation, and privatization. Privatization would take two forms. The first form is where enterprises would be sold completely to employees. The authorities want as broad-based ownership as possible, and have a strict policy about limited ownership. More than once the authorities have told the staff that they are a socialist country, and would like to have as many workers owning the companies they are working for. The second form of privatization would involve foreign partnership in those enterprises where the authorities think it would help. Recently, for example, the authorities offered several proposals regarding the tourism sector, where joint ventures would be allowed in the economy.

On the appropriateness of fiscal policy, the key issue in maintaining a prudent fiscal policy is the assumption of the budget oil price which determines how much will be spent on capital expenditure and how much will be spent on current expenditure. As long as the budget assumes a conservative oil price in comparison to international prices, the fiscal situation will not be in danger. For 2002 the authorities have adopted US\$18 dollars per barrel, which was very close to the international prices at the time of the consultation discussions. The authorities are aware that they were cutting it close, and assured the staff that if oil prices were to remain low, they would cut capital expenditure.

Capital expenditure has increased significantly. The authorities have quite a significant amount of catching-up to do in terms of investment in health and education. Also, over the medium term, there is a need to diversify the revenue base, and the authorities are looking at measures to do so. At present, they are looking at the fiscal outcome in conjunction with public enterprise reform.

On the Oil Reserve Fund (ORD), the authorities admit that its activities have not been transparent, and in the last meeting in September of the General People's Congress, which is the Libyan parliament, the authorities were critical of the operations of the ORD. They have established a small committee within the General People's Congress to look at the operations of the ORD. They know there is a problem, and they know that to maintain financial stability, it is important to bring the ORD's operations under control.

Ms. Phang commented that growth projections for Libya did not appear to be consistent with employment growth, which was fairly high at above 5.0 percent. Growth stood at 4.3 percent in 2000, 0.6 percent in 2001, and negative growth was expected for 2002. The rest of the medium-term projections on nonhydrocarbon GDP growth rates were low at less than 3 percent. She therefore wanted to know what was necessary to increase growth to a level that would be more sustainable.

The staff representative from the Middle Eastern Department (Mr. Elhage) replied that because Libya had excess labor and capital, it was important to improve the efficiency of the factors of production. To absorb the labor force, which was growing at around 3.3-3.5, non-oil GDP would have to grow, at a higher rate than currently projected. For Libya to achieve a higher non-oil GDP growth, they needed to have a comprehensive reform agenda. The authorities had agreed that the economy had a significant number of distortions. For the period ahead, the staff would be working with the authorities on how to improve the functioning of public enterprises and the banking sector. Libya had a lot of potential in tourism and manufacturing (in particular petrochemical industries) which could lead to growth, which was high in terms of value-added. Manufacturing, in particular petrochemical industries, could lead to higher growth. At this point, in order to achieve a higher growth rate, the authorities needed to improve the efficiency of the factors of production. When distortions were eliminated, the private sector would come on board.

Mr. Shaalan made the following concluding statement:

First, I wish to thank colleagues for their most interesting remarks, which I shall convey to the authorities. Before I begin to address some of the comments and observations on some of the views expressed, I would like to dispose of one issue, namely the question of money laundering and the financing of terrorism.

This morning, the Secretary's Department of the Fund received a communication from the Libyan authorities which specifically addresses these

issues, which will be circulated to colleagues possibly today. It refers to my communication with them on the subject, and information is provided on the country's progress in the implementation of the UN's Security Council Resolutions to counter terrorism. The authorities ascertain that the Libyan financial sector is totally clean of any terrorists and their activities. Second, Libya is in the process of establishing a financial intelligence unit to receive and process reports of suspicious transactions. Third, Libya is now working on issuing a law related to anti-money laundering. Fourth, Libya is ratifying and implementing the UN instruments to counter terrorism, particularly Security Council Resolution 1373. Fifth, Libya is ready within its jurisdiction to freeze the assets of terrorists and their associates once it finds any suspicious transaction in its financial sector. Finally, they would like to assure the Fund that Libya is fully cooperative regarding measures to counter any terrorism acts and are ready to share information in such fields and play its part in this process.

Turning to specific points that were raised, I must say I was heartened by the understanding of the Board of the strategy pursued currently by Libya, namely the gradual approach. Of course, the accelerated approach is probably viewed as more appropriate in the minds of many, but in the case of Libya, there are social and political realities that would make an overly accelerated approach to reform probably not workable. An accelerated approach might even backfire. The realities of the situation call for a gradual approach, and results can already be seen in a number of areas, in particular the unification of the exchange rate, exchange rate liberalization, the delineation of additional areas where the private sector can be involved, the current account surplus, and the absence of any inflation to speak of. However, Directors did note that the fiscal situation is a matter of concern.

Admittedly, Libya is highly dependent on oil revenues, and probably more so than many other oil-dependent countries. Oil revenues finance a good part of the budget, and account for a considerable part of the economy. Weakness in oil output has reduced a 10 percent surplus in 2001 by half over the past year. Nonetheless, with regard to the management of fiscal policy, when resources were abundant, Libya did not increase its oil revenue expenditures, but saved some of it, as reflected in the quite high surplus that was attained last year. Having said that, the authorities are fully aware that they need to have a medium-term strategy to even out the oil fluctuations as they diversify the sources of revenues to the budget.

With regard to the monetary sector and the exchange rate, nonperforming loans are at a relatively high level at about 29 percent. This is, as the authorities note, a cause for concern. To this end the authorities are in the process of addressing this high level of nonperforming loans with workouts that are ongoing at present. With regard to the exchange rate, unification has taken place; but, as many colleagues have remarked, care must

be given to the possibility that another parallel market rate may emerge. The authorities are fully aware of that. So far, the existing rate has cleared the market with some growth in reserves.

On the question of the transfer of enterprise ownership and control, there are many ways of privatization. One way which is being pursued by Libya is to give the ownership of a certain production unit to the workers in that unit. As of now, workers do not exercise full control, given that control is dependent upon the dismantling of price controls which is taking place gradually. The authorities are considering allowing majority control of enterprises by workers. For equity reasons, it may be the case that ownership should be open to everybody, but in any privatization process equity issues are never totally addressed. In the case of Libya, they have chosen this route; they believe it gives incentive to those who own the capital, and hopefully would result in increased efficiency.

On the PRGF/HIPC Trust, the remarks of colleagues on Libya shouldering its responsibilities in that area will be communicated very promptly to the authorities. Finally, on external arrears, there has been some progress, although there is much to be done. As some colleagues have mentioned, it would be better to address these arrears in a multilateral context.

Again, let me thank colleagues. Their views will be communicated promptly.

The Acting Chair made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They noted that higher oil prices and prudent fiscal policies have contributed to a considerable improvement in economic conditions in Libya during 2000–01, reflected in higher economic growth, falling inflation, and stronger external and fiscal positions. Directors welcomed the unification of the exchange rates and the supporting measures implemented, particularly the elimination of foreign exchange rationing and import licensing requirements.

Directors considered that the main issues facing the Libyan authorities are how to increase the rate of economic growth in order to create sufficient job opportunities for the rapidly growing labor force, and the need to diversify the economy to reduce its vulnerability to oil price fluctuations. Noting that projected economic growth under the current policy stance will not be sufficient in itself to provide the required number of jobs, they urged the authorities to widen and deepen their reform agenda to achieve higher growth rates in the non-oil sectors. Directors noted that the measures undertaken thus far represent a good base on which to build future reforms, but emphasized in particular the need to create a policy environment conducive to private sector development. Directors sympathized with the authorities' concern that too fast a pace of structural reform could be socially disruptive, but stressed that even

a gradualist approach could yield important benefits if it is implemented within a coherent and well-sequenced policy framework.

Directors considered that, in the short run, the reform agenda should aim at further liberalizing domestic prices, eliminating remaining trade and exchange restrictions, and addressing explicitly in the budget the impact of price adjustments on vulnerable groups. For the medium term, Directors underscored the need for far reaching reforms that will require significant technical preparation: these include public enterprise restructuring, reform of the subsidy system, civil service reform, tax and customs administration reforms, and the restructuring of public banks.

Directors agreed that fiscal policy remains the key to macroeconomic stability, and that it should be tightened to help contain domestic demand and strengthen the post-unification exchange rate policy framework. They advised against setting rigid budgetary rules that could weaken fiscal discipline. They called on the authorities to review the 70/30 fiscal rule, which appears to impart an undesirable pro-cyclicality to expenditures and risks undermining the quality of development projects, as well as the operations of the Oil Reserve Fund to smooth out expenditure and enhance efficiency and transparency. More generally, Directors stressed the need for stricter budget oversight of all extrabudgetary funds, and for limits on the level and composition of the regions' expenditures and their ability to raise taxes and fees. On the revenue side, they welcomed the efforts under way to rationalize the tax system, broaden the tax base, and strengthen tax administration.

Directors underscored the need for a comprehensive program to restructure public enterprises and provide them with greater management autonomy, including decision-making authority on product pricing and salary levels, in order to increase enterprise productivity and competitiveness. They stressed that the authorities should also consider disengaging the public sector from activities in which the private sector can play a leading role in a competitive environment.

Directors welcomed the authorities' intention to use a more market-based monetary policy framework to bolster financial stability and support the unified exchange rate system. In particular, Directors noted that the creation of a unit at the Central Bank of Libya responsible for developing a monetary analysis framework, and the introduction of effective instruments for liquidity management, are important prerequisites for an effective monetary policy. They called on the authorities to phase out direct credit controls and to allow flexibility in interest rate setting.

Directors expressed concern about the banking system, and emphasized the need for prompt action on this front. Noting the weak state of banking supervision, particularly in the context of sizable nonperforming

loans, they urged the authorities to improve banking supervision along the lines recommended by the MAE technical assistance mission of August 2001. Directors welcomed the establishment of two new private commercial banks and the planned privatization of a state-owned bank, which should help to increase competition within, and the efficiency of, the banking sector. They welcomed the steps taken by the Libyan authorities to support the cooperative international efforts to combat money laundering and the financing of terrorism.

Directors stressed the need to eliminate the remaining restrictions on current account transactions in order to support the unified exchange rate and avoid the re-emergence of a parallel exchange market. In this regard, though Directors agreed that the current exchange rate is appropriate, they urged the authorities to show flexibility and to stand ready to promptly adjust the rate as warranted by overall developments. Regarding the exchange rate system, Directors agreed that a pegged exchange rate system is appropriate provided that it is supported by well-coordinated demand management policies to keep inflation under control. They suggested that, as the Central Bank of Libya gains credibility in exchange rate and monetary policy management, the authorities could consider moving to a more flexible arrangement.

On external trade, Directors welcomed Libya's decision to apply to join the World Trade Organization, establish a free-trade area with Arab countries, and eliminate import licensing requirements. They encouraged the authorities to continue broadening trade liberalization by eliminating the remaining nontariff barriers to trade, and to set up a comprehensive trade liberalization timetable. Directors also encouraged the authorities to remove all remaining exchange restrictions and to consider accepting the obligations of Article VIII, Sections 2 and 3.

Directors welcomed the authorities' efforts to clear external arrears and regularize relations with creditors, and encouraged them to take advantage of Libya's improved financial position to expedite the clearing of remaining external arrears.

Directors observed that, despite progress achieved in data compilation and reporting to the Fund, serious weaknesses in the statistical system remain. This is particularly true of fiscal data and its consistency with monetary data, but Directors noted that expeditious efforts in other areas are also needed, such as real sector data, external debt, balance of payments and monetary statistics. They emphasized the need to develop a comprehensive and transparent budgetary presentation that integrates all extrabudgetary funds. Directors welcomed the authorities' stated intention to bring about major improvements in these areas, and encouraged them to participate in the Fund's GDDS.

Directors stressed the potential role technical assistance could play in helping the authorities address the wide-ranging challenges they face.

It is expected that the next Article IV consultation with the Socialist People's Libyan Arab Jamahiriya will be held on the standard 12-month cycle.

The Executive Board took the following decision:

1. The Fund takes this decision in concluding the 2002 Article XIV consultation with the Socialist People's Libyan Arab Jamahiriya, in light of the 2002 Article IV consultation with the Socialist People's Libyan Arab Jamahiriya conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. The Socialist People's Libyan Arab Jamahiriya continues to maintain restrictions on the making of payments and transfers for current international transactions in accordance with Article XIV, Section 2, as described in SM/02/118 (4/19/02). The Fund encourages the Socialist People's Socialist Libyan Arab Jamahiriya to eliminate these restrictions as soon as circumstances permit. (SM/02/118, 4/19/02).

Decision No. 12739-(02/46), adopted
May 6, 2002

2. EUROPEAN CENTRAL BANK—INVITATION TO ATTEND EXECUTIVE BOARD SEMINAR

The Executive Directors agreed to invite Mr. Grisse, permanent representative of the European Central Bank in Washington, to attend as an observer the Executive Board meetings on the 2001 Article for consultation with Denmark and the review of data provision to the Fund.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/02/45 (5/3/02) and EBM/02/46 (5/6/02).

3. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/02/58, Supplement 1 (5/2/02), EBAM/02/59 (4/30/02), and EBAM/02/60 (5/1/02) and by Assistants to Executive Directors as set forth in EBAM/02/59 (4/30/02) and EBAM/02/60 (5/1/02) is approved.

APPROVAL: July 29, 2002

SHAILENDRA J. ANJARIA
Secretary