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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 02/114

10:00 a.m., November 18, 2002

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Decisions Taken Since Previous Board Meeting

Executive Board Attendance
S. Sugisaki, Acting Chair

Executive Directors	**Alternate Executive Directors**
	A.S. Alazzaz
	L. Rutayisire
	N. O'Murchú
M.J. Callaghan	D.C. Guinigundo
	I. Alowi
	H.E. Phang, Temporary
	R. von Kleist
	H. Fabig, Temporary
P.C. Padoan	A. Lanza, Temporary
F. Zurbrügg	O. Steudler
Y.V. Reddy	
	J. Prader
	M. Marques, Temporary
Ó. Ísleifsson	B. Andersen
	A. Baukol, Temporary
	J.W. Ralyea III, Temporary
	S. Boitreaud
	S. Boucher, Temporary
A. Mirakhor	S. Rouai, Temporary
	A. Lushin
	I. Zakharchenkov, Temporary
	M. Beauregard
	S. Alcaide, Temporary
	M.A. Brooke
	R. Steiner
	A. Rambarran, Temporary
I. Usman	P. Ngumbullu
A.S. Shaalan	S.A. Bakhache, Temporary
Wei Benhua	
	P.A. Nijsse, Temporary
	D. Radev, Temporary
	T. Miyoshi, Temporary
	T. Komatsuzaki, Temporary
	C.E. Pereyra, Temporary
	R. Maino, Temporary

A. Linde, Acting Secretary
B. Esdar, Acting Secretary
Y. Chia, Assistant
S. Soromenho-Ramos, Assistant

Also Present
IBRD:J. Wilton, Director/ Chief Credit Officer; R. Brigish, Acting Country Director. African Department: J. Fajgenbaum, Deputy Director; D. Andrews, K. Nassar, J. Reitmaier, M. Tjirongo, V. Treichel. Asia and Pacific Department: T. Rumbaugh. External Relations Department: D. Hawley, W. Murray. Fiscal Affairs Department: A. Fedelino, A. Pivovarsky. Human Resources Department: U. Baumgartner. International Capital Markets Department: K. Srinivasan. Legal Department: H. Elizalde, M. Federici, D. Siegel. Monetary and Exchange Affairs Department: A. Bhundia. Policy Development and Review Department: M. Hadjimichael, M. Hussain, R. Kincaid, A. Tiffin, M. Walsh. Secretary's Department: M. Da Costa, P. Ramlogan. Treasurer's Department: E. Brau, Treasurer; B. Christensen, Deputy Treasurer; M.G. Kuhn, Deputy Treasurer; D. Gershenson, H. Hatanpaa, B. Keuppens, F. Lakwijk, A. Ter Martirosyan, P. Ross, H. Trines. Western Hemisphere Department: A.M. Jul, J. Prat. Office of the Managing Director: A. Tweedie. Advisors to Executive Directors: A.S.F. Atoloye, E. Azoulay, S. Çakir, B. Couillault, J. Gallardo, O.E. Garner, K. Kpetigo, S. Le Gal, Liu F., N. Mensah-Zekpa, J. Milton, A. Monajemi, A. Muganda, K. Sakr, Å. Törnqvist. Assistants to Executive Directors: V. Bhaskar, T. Belay, X. Bonnet, M. Di Maio, C.J. Faircloth, R. Gauba, E. González-Sánchez, T. Hadded, C. Harzer, C. Josz, D. Lombardi, R. Manivat, B. Mellor, P. Moreno, D. Merotto, T. Moser, T.P. Nguema-Affane, M.L. Nikitin, P.R.D. Prasad, Y. Saito, K. Sazanov, B. Siegenthaler, A. Stuart, S. Urinbaev, D.B. Waluyo, N. Watanabe, N. Yeritsyan, Yu J.

1. FUND POLICY ON PRECAUTIONARY FINANCIAL BALANCES

Document: The Fund’s Policy on Precautionary Financial Balances (EBS/02/185, 11/1/02)

Staff: Brau, TRE; Keuppens, TRE

Length: 2 hours, 40 minutes

Mr. Padoan and Mr. Lombardi submitted the following statement:

Introduction

We strongly welcome this paper on precautionary financial balances in light of the importance of the Fund’s financial position for the international monetary system.

Since the last Board discussion on this issue in the mid-1990s, the environment in which the Fund operates has changed significantly. In a framework of capital account crisis, the Fund’s resources have been made available in relatively large amounts and with little advance notice. In the current setting marked by greater downside risks, the increased concentration and the rising volatility associated with the use of Fund resources may become a distinctive feature of Fund activities in the near future.

How Much is Enough?

Against this background, we believe that a pragmatic approach regarding the determination of the precautionary financial balances, while apparently useful and simple to implement, presents clear limitations. We strongly encourage the staff to develop a more systematic approach with reference to the determination of precautionary balances, in line with recent developments in the theory and practice of risk management.

Obviously, this does not imply that the outcome from risk management models should be taken for granted. Certainly, it will have to be evaluated in light of the unique nature of the Fund. Such a nature, however, should not preclude our ability to better assess the risk profile of the Fund’s financial position with the help of new analytic tools.

A unique nature was also advocated some time ago with reference to central banks. Currently, several central banks have in place a more comprehensive system for assessing the risk of their financial position.

As a result, we cannot share a position whereby a pragmatic approach is a priori believed to be more reliable than a more structured and systematic framework. A judgmental approach, in our view, should be able to assess the relative importance of different indicators, rather than confining itself to some predetermined percentages. Such percentages come often from previous experience and do have merits; however, they might be a poor guide when applied to new situations.

Along these lines, we find it awkward that, in order to assess whether the Fund’s reserves are appropriate, the staff refers to the resources provisioned by other financial institutions that rely on risk management models.

In addition, even within a pragmatic approach, we would have liked to see more forward-looking considerations, along the lines of the recent discussions on the new liquidity indicator.

In the present circumstances, current precautionary balances more than cover existing protracted arrears. However, failure by a large borrower to meet its repurchase obligations could not be met through the current level of precautionary balances. Just as the Fund has implemented and strengthened its strategy for preventing and reducing arrears at times when they were threatening its financial position, we should now consider the most appropriate ways of managing the rising concentration and volatility of our loan portfolio. This is all the more important because the Fund, in light of its unique nature, cannot choose the degree of diversification of its portfolio or the timing of its engagement independently of the evolution of the global environment.

This, among other considerations, calls for further strengthening of surveillance mechanisms, along with heavier reliance on vulnerability assessments. Indeed, risk management at the Fund should exploit to the fullest the indications from surveillance exercises. The staff comments would be welcomed in this regard.

Conclusion

While we encourage the staff to further develop their risk management strategies in the current setting, we are asked to decide on the basis of a pragmatic approach, and should, therefore, be conservative and err on the cautionary side. Accordingly, we support the proposal of at least doubling the current level of precautionary balances.

Mr. Mirakhor submitted the following statement:

We thank the staff for the well-written paper, which assesses the financial risks confronting the Fund and the adequacy of precautionary balances. The large increase in the volume and concentration of Fund financing has raised legitimate questions about the risk of impairment of a significant portion of its credit. Moreover, the international environment, in which the institution and its member countries are operating, has become more uncertain and this could adversely affect the Fund's financial indicators and its exposure to risks, including those unrelated to credit. As a financial institution, the Fund needs to protect itself against risks. Because of the institution's cooperative character, the membership has always shown willingness to support and safeguard its financial integrity. Toward these objectives, the membership has supported, in the past, the establishment of the burden sharing mechanism, the Special Contingent Accounts (SCAs), and the design and implementation of the arrears strategy. No doubt, our authorities will continue to support strengthening of the Fund's financial position and will participate in any cooperative scheme to deal with specific and/or unforeseen risks. In relation to paragraph 36 of the paper, we agree that a prudent amount of reserves should cover self-insurance expenses against events unrelated to credit risks so long as insurance is not available. However, the situation should be monitored closely and appropriate level of insurance to cover such risks purchased at the earliest opportunity.

The staff paper proposes a doubling of the present size of precautionary balances on the basis of the increase in credit risk associated with the Fund's role in resolving financial crises, the rise in the concentration of credit to a few members, and the volatility of the pace of accumulation of precautionary balances. However, as indicated in the paper, these risks are mitigated by the preferred creditor status enjoyed by the Fund, the success of the arrears strategy, and the quality of programs, reinforced by the recent streamlining of conditionality and strengthening of ownership, which will enhance debt servicing capacity of Fund members. Moreover, the potential for Fund's undervalued and non-interest generating assets, i.e. gold, in strengthening the institution's balance sheet and income position should not be overlooked. Indeed, some of the extreme risks mentioned in the staff paper could well qualify under unforeseen contingencies, referred to in paragraph 23, and justify the use of gold. Additionally, due emphasis should be placed on the positive impact of recent policies on early repurchase and the extension of surcharges to purchases under the credit tranches and under the EFF on the Fund's financial position. Finally, the recent increase in the volume and concentration of Fund credit should be regarded as exceptional and should be reversed if the work on crisis prevention and resolution, including on orderly sovereign debt restructuring, is carried out successfully.

Turning to the issues for discussion, we have the following comments:

First, we have reservations regarding the introduction of "the credit capacity" indicator in assessing precautionary balances. Use of Fund resources beyond the reserve tranche position is not automatic but subject to conditionality and tranching, which tend to limit, over time, full utilization of the credit capacity.

Second, while the risk of unpaid charges associated with cases of large arrears should not be minimized, policies in place already offer a number of remedies. Such large unpaid charges could be covered by the burden sharing mechanism, the annual income, an adjustment in the rate of charge at mid-year, and recovery of any shortfall in the income target in the next financial year through an increase in the rate of charge. In exceptional circumstances, part of the accumulated precautionary balances could also be used.

Third, the staff paper raises the issue of large arrears combined with a decline in credit outstanding. While a decline in credit outstanding leads to a reduction in the burden sharing capacity to cover unpaid charges, the staff paper assumes unchanged policies. It is simply unrealistic to assume that the Board would see arrears grow to SDR 5 billion or SDR 20 billion, as shown in Table 3, without taking early action. Moreover, since increased likelihood of arrears has been explained by the large increase and concentration in Fund credit, a significant decline in its volume would reduce the need for reserve accumulation.

Fourth, the staff paper considers the case of low levels of credit and their impact on income and administrative expenses. In view of recent efforts by the Board to ensure better budgetary operations, monitoring, and control within a medium-term framework, it is reasonable to expect that the likelihood to occurrence of severe and unpredictable overruns in the administrative expenditure in any given year would be reduced considerably. However, if the membership at large could substantially reduce, on a sustainable basis, its use of Fund resources, a very positive achievement, it would lead to a reduction in the use of staff resources and in administrative expenses.

Finally, while Fund income has become subject to volatility in recent years, this resulted from the recent introduction of surcharges and the greater incentives to early repurchases. While it may be preferable for the Fund to rely on a predictable stream of income from surcharge, it would be a desirable outcome if borrowing countries were in a position to repay their obligation to the Fund early even if this leads to greater income volatility. The pace of accumulation of precautionary balances should by necessity fluctuate in response to this volatility.

Despite all of the above considerations, and to err on the side of caution, we can support continuation of the consolidation of precautionary balances and believe that current policies and the pace of accumulation of precautionary balances remain appropriate.

Mr. Shaalan and Mr. Bakhache submitted the following statement:

We welcome the opportunity to discuss what is considered to be a critical aspect of the Fund's financial operations. Like any other lending institution, the Fund has to have in place a set of mechanisms aimed at ensuring the institution's financial viability and soundness and protecting it and its creditors in the event of defaults by debtor countries. These considerations are all the more important for the Fund, which not only uses public monies, but also plays an indispensable role in the international financial markets.

Precautionary balances are one of many elements in the Fund's arsenal of safeguards. In fact, the Articles of Agreement and the Fund's financial operations are designed in such a way as to protect the institution's financial integrity from the variety of risks associated mainly with credit and unpaid charges risks. These safeguards include program conditionality, safeguard assessments of borrowing countries' central banks, the arrears strategy, the burden sharing mechanism, hidden reserves (notwithstanding the difficulty of putting the gold reserves into use), and last, but perhaps most important, the preferred creditor status of the Fund. It is, therefore, important that the adequacy of precautionary balances is judged in the context of the unique nature of the Fund operations, and that our policies for determining the appropriate level of reserves, as well as the means of accumulating these reserves take full account of the other safeguards we have at our disposal.

Against this background, we will address the questions raised in the issues for discussion in the staff paper. Our comments will focus on the issues of credit and unpaid charges risks. While we do recognize that there are other risks involved in the work of the Fund, we are somewhat less concerned about them than the staff appears to be in the paper and will, therefore, not address them here.

A snap shot look at precautionary balances in the GRA, as given in Table 1 of the report, suggests that the Fund has a reasonably adequate level of reserves. In fact, some ratios, particularly free reserves to credit capacity and to credit in good standing, have improved compared to previous years. However, the staff is correct to point out that in light of the evolving nature of the Fund's lending practices and its role in resolving financial crises, as well as the increasing credit concentration in a few members, these ratios may well be insufficient on their own to judge the adequacy of reserves. The illustrative example given in Box 4 is quite revealing and gives a sense of urgency with regard to the need to increase our precautionary balances.

Having said that, however, we believe that the burden of safeguarding Fund resources in high access cases should not fall primarily on precautionary balances. In fact, it would be too costly to provide full protection a priori for large access cases. The level of free reserves accumulated to provide a margin for the potential exposure to risk related to credit in good standing is not meant and should not be expected to fully address risks associated with high concentration of credit. As we mentioned earlier, there are other means at the Fund's disposal in extreme cases of default by a member country. It is also to be noted that realizing the loss of principal after arrears start accumulating can only take place after we have exhausted all the elements of our arrears strategy and the progressive steps cited in the Articles of Agreement on this matter and the member has withdrawn.

Still, we note that the surcharge system we have in place for high access cases provides us with a sizeable source of income to add to our precautionary balances. The resulting cushion in our reserve position presents an indirect link between reserves and the high concentration of credit. Given that surcharge income has become a major source of additions to precautionary balances, it is expected that the pace of accumulation of these balances would vary significantly. To the extent that additional precautionary balances are needed to address risks associated with large packages, a decline in the pace of accumulation when large packages are paid back quickly would be commensurate with a decline in the need for such balances. Viewed in this manner, the variability in the pace of accumulation of precautionary balances appears to be in accord with the associated risk variability.

With regard to the risk of income loss that result from nonpayment of charges, we believe there is ample room in the burden sharing mechanism to absorb these losses. In paragraph 14 of the report, in making the case for the use of precautionary balances to absorb the income loss, the staff argues that the capacity of burden sharing could be exceeded in the case of large arrears to the Fund because of the floor on the rate of remuneration of 80 percent of the SDR rate. While it is possible that the Board decides against large increases in the rate of charge to cover the income loss, we believe this is not a likely event as the Board's primary responsibility includes protecting the financial integrity of the Fund. Furthermore, in the event that this happens and precautionary balances are drawn down to cover income losses, the rate of charge will have to be raised to compensate for lower income on reserves. In this sense, both avenues of covering income loss would eventually have to be borne by borrowing countries.

That said, we do concur with the staff that at their current level precautionary balances do seem to be somewhat on the low side. To our mind, and given the other existing and potential safeguards(gold), an important issue here that should guide us is the views of the Fund's independent external auditors. It is important that the Fund maintains the unqualified opinion on the GRA financial statements it gets from the auditors. In this regard, prudence calls for continuing the increase in the level of precautionary balances given the large gap that could potentially exist between arrears and reserves in the event that a large debtor country starts accumulating arrears to the Fund. Based on the pace of accumulation projected under the current system, which will imply a doubling of precautionary balances in 5 to 10 years, we can support the staff's recommendation to maintain the system.

Needless to say, we need to keep the pace of accumulation under close review given the risks facing the Fund in the period ahead and the uncertainties related to the income from surcharges. We are open-minded on the options to increase the rate of accumulation if a need for higher precautionary balances materializes.

Mr. Le Fort and Mr. Zoccali submitted the following statement:

We thank the staff for a well-written paper, in which a clear case is made for at least doubling the present size of the Fund's precautionary financial balances, while maintaining the present cost distribution and pace of accumulation. In doing so, a number of important questions are implicitly raised, underscoring the complexity of the issues affecting the Fund's financial integrity.

In the first place, the ongoing discussion of the role of the Fund in capital account crises has stressed the limitations of the available instruments to help restore confidence in members affected by major and protracted dislocation costs and the risks faced by the Fund, despite its privileged creditor status. The possibility of a more adverse default scenario comes across almost as inevitable in the staff paper, for example, in the situation described in Box 4. While recognizing the role of such scenarios, the Fund's prudential policies should be judged also in terms of their dynamic effects on the risks they are intended to mitigate. We see clear limits in a strategy that seeks to ensure the Fund's financial integrity by focusing only on the reserves or the ratio of precautionary balances, considering that the Fund is a cooperative and universal institution, created to preserve or facilitate the rebuilding of the creditworthiness of its members.

The staff's assertion that credit risk to the Fund is now fundamentally different since it derives primarily from large arrangements with middle-income countries, should be complemented with the fact that capital account crises involving sizeable amounts of resources have become quite frequent. The Fund has a central role in providing members with financing and technical advice in order to allow them to correct the resulting maladjustments in their balance of payments under adequate conditionality. Experience shows that in almost all cases the Fund has been effective and thus repaid on time. Even in most cases in which large and protracted arrears arose, they were eventually reverted—among those, Peru, a middle-income country in our constituency—albeit at significant costs for the countries affected. These considerations suggest the importance of appropriately weighing in all the factors, noted in paragraph 28 of the staff report, that contribute to mitigating the credit risk facing the Fund, keeping in mind the common understanding of the obligations of the membership as a whole.

We welcome the detailed operational history of the Fund's policy on precautionary balances provided in the staff report. At the same time, some important aspects impacting on the significance of the current level of precautionary balances and the pace of future accumulation deserve a deeper discussion:

The valuation of the Fund's gold holdings and the opportunity cost of the policy limiting its mobilization should be analyzed. In particular, the current size of the "hidden" reserves implicit in the differences between the market and accounting price of holdings, as well as that of any contingent liability associated with the Fund's gold deserve examination.

We would appreciate comments on the cumulative extent to which surcharge income, originally justified as a hedge against risk related to large credit concentration (as in the SRF), was channeled to alternative uses in recent years, i.e. the administration costs of the PRGF Trust.

We wonder if the pace of dollar increases in the level of administrative and capital expenses is deemed sustainable and consistent with the criteria of efficiency and equity used to assess the financial integrity of the Fund.

We would like to ask the staff whether the current gamut of constraints may suggest that in the eventuality that a new amendment to the Articles of Agreements is pursued, proposals to allow for income generation by means other than changes in the rates of charge and remuneration, such as the "variable uniform norm", should also be revisited.

The above aspects, in our view, have a bearing on the issues for discussion and certainly for the consideration of a more integral response to the current uncertainties. On the issues raised for discussion in EBS/02/185, we generally concur with the staff that the determination of the optimal size of precautionary balances is ultimately a matter of judgment, that some further strengthening is desirable, that the adequacy of the pace of accumulation needs to be kept under review in light of the risks confronting the Fund in the coming years, and that the current distribution of costs in the accumulation of precautionary balances appears broadly appropriate on efficiency and equity grounds. In this regard, we value the attempt made to build on the burden sharing mechanism to cover the loss of income from unpaid charges and repurchases, as well to respect existing agreements pertaining to surcharges and the implementation of maximum exposure limits.

More specifically, regarding the adequacy of GRA precautionary balances, we agree with the continued application of the general principles for the assessment contained in Box 3, namely, that precautionary balances fully cover credit outstanding to members in protracted arrears; that they include a margin for the potential exposure to risk related to credit in good standing; and that the determination of the adequacy of precautionary balances is judgmental, hence all relevant factors should be taken into account.

Mr. Brooke and Ms. Stuart submitted the following statement:

Summary

We agree with the staff that, given the recent increases in the concentration of the Fund's outstanding credit, the current target level of precautionary financial balances looks too low. Consequently, we believe that the existing framework for determining the target level of precautionary balances should be revised to more explicitly account for concentration risk. While we can go along with the proposal to double target precautionary balances, we would like the staff to give further consideration to providing an explicit allowance for concentration risk in the framework and to provide more information about the treatment of gold. We can go along with the staff's proposal for no change in the system for accumulating reserves.

The Target Level for Precautionary Balances

We agree with the staff that the most important purpose for the Fund's precautionary balances is to protect the IMF in the event of losses resulting from non-repayment of Fund credit and from unpaid charges. In this regard, we agree that the Fund should maintain precautionary balances to fully cover credit outstanding to members in protracted arrears and an additional margin for the potential exposure to risk related to the credit that is in good standing.

We are concerned, however, that the 3–5 percent target for the free reserves to non-arrears credit is focused only on the scale of the Fund's total exposure and does not explicitly allow for concentration risk considerations. In addition, we recognize that the Fund has found it difficult to build up precautionary balances rapidly when new large programs are approved.

To address these problems, the staff propose doubling the level of the target for our precautionary balances and switching the focus of attention away from credit in good standing in favor of a ratio related to credit capacity. The main advantage of the new target ratio is that it would provide greater stability to our precautionary balances. In addition, the increase in the level of the new target will, of course, provide greater protection for the Fund's balance sheet and help to offset credit concentration risks.

However, we are concerned that the proposed new approach is not firmly anchored with sound principals and appears to have been arrived at in a somewhat ad hoc manner. In particular, it breaks the important link to existing exposure and could lead to some perverse results. For example, if a country's position weakened to such an extent that they decided to withdraw from the Financial Transactions Plan and request a Fund program, then, intuitively, one might wish to see an increase in precautionary balances. However, the staff's proposal would result in a decline in the precautionary balances target.

We, therefore, see merits and drawbacks in ratios based on credit outstanding and credit capacity. Consequently, we feel that the Board should pause for more reflection before deciding to switch away from the existing link to credit outstanding. Perhaps the staff could consider a hybrid approach incorporating both credit outstanding and credit capacity.

The main weakness of both the existing framework and staff's proposed new framework is that neither of the target ratios is sensitive to changes in credit concentration. This would not be a problem if our normal access policy limits were adhered to without exception or if a large exposure limit were in place. As we know, however, the normal access limits are often not respected in capital account crises and we do not have a large exposure limit. As a result, increased recourse to exceptional access in recent years has led to a higher concentration of Fund lending. We feel that this concentration risk should be explicitly recognized in the Fund's approach to precautionary balances. There are a number of ways in which this could be achieved and we have suggested a few possibilities in an annex to this statement.

Turning to the other considerations for which precautionary balances are meant to protect the Fund's balance sheet, we were disappointed that paragraph 36 provided no details about the scope and potential size of the events for which we are now self-insuring against. Without such information, it is impossible to know what the appropriate provisioning level for these considerations is. While we recognize that the potential losses in this area are likely to be significantly smaller than the Fund's credit risk exposures, we still feel it is important that staff provides the Board with all relevant information to make an informed judgment about the risks to which the institution is exposed. It seems hard to believe that our external auditors will not also want to know this information.

Reflecting the above concerns, we would like the staff to come up with revised proposals for the framework for the precautionary balances target that: (a) are more firmly anchored in sound principles; (b) provide an explicit link with concentration risk; and (c) include an explicit allowance for self-insurance risks.

What is the size of our precautionary balances?

Although it sounds a simple question, we are still uncertain about what is the size of our precautionary balances. The key consideration here is the treatment of the gold on the Fund's balance sheet. As noted in the Treasurer's Department's excellent booklet, "Financial Organization and Operations of the IMF", gold provides "fundamental strength to the IMF's balance sheet." It seems odd, therefore, to have included such a short discussion of this topic in the staff paper.

The current balance sheet valuation of the Fund's gold holdings is SDR 5.9 billion. This is significantly below the market value of the gold, which stood at SDR24.5 billion at the end of June 2002. Even allowing for some difference in treatment of income losses and capital losses on outstanding Fund credit, it is hard to deny that the unrealized (but uncertain) gains the Fund could derive from its gold holdings provides added security for the IMF, effectively bolstering its precautionary balances. We would, therefore, like to request that the External Audit Committee make a definitive ruling on whether or not any part of the Fund's gold holdings could be considered to be a part of the Fund's precautionary balances.

Speed of Accumulation of Precautionary Balances

The appropriate pace of accumulation of precautionary balances should be determined by two factors: first, the difference between the target and actual levels of precautionary balances; and second, some consideration of what the Fund membership is prepared to accept. As we noted above, we agree that the target level of precautionary balances needs to be higher to take account of greater concentration risk. In this regard, a doubling of the target is probably reasonable. However, it is difficult to make a judgment about the appropriate pace of accumulation of precautionary balances in the absence of a ruling from the External Audit Committee on the appropriate treatment of gold.

If the auditors were to decide that we should take no account of our gold holdings, there would be a strong case to be made in favor of accelerating the pace of accumulation of precautionary balances through adjustments to the burden sharing mechanism and the rate of charge. However, if some allowance were to be made for gold, a slower pace of accumulation might be warranted. While we wait for the views of the auditors, we are willing to accept the staff's recommendation that there be no change in the current system of accumulating precautionary balances.

Annex: Possible ways to account for concentration risk

Option 1: The precautionary balances framework could be revised to include a link to the credit outstanding of the largest IMF debtor.

Option 2: As an alternative to Option 1, one could include a buffer to cover the risk that an "average" large borrower goes into arrears.

Option 3: The target ratio of free reserves to credit in good standing could be compiled on an individual creditor position basis, with the target ratio increasing in size in line with higher relative Fund exposures to each member.

Option 4: As an alternative to Option 3, the target ratio of free reserves to credit in good standing could be increased as the concentration of the lending to the top three members increased.

Mr. Bennett submitted the following statement:

Key Points:

- The staff paper provides much useful information, but it could have been enhanced by relating the policy on precautionary balances more clearly to other policies, such as access policy and to the work on debt sustainability.

- In the recent discussion of debt sustainability analysis, a number of Executive Directors suggested that alternative scenarios with the staff's assessment of probabilities should be used. Could such scenarios and probabilities be helpful in assessing the optimal level of precautionary balances?

- There will always be a need for judgment in determining how much prudential balance to hold, but this judgment would be improved by basing it in a well-articulated analytical framework.

- Given the current level of knowledge, I agree that a doubling of the precautionary balances to SDR 10 billion seems broadly appropriate in the current context of increased financial risk. But I encourage the staff to pursue analytical work on a credit risk management framework and to report to the Board on this issue.

- The pace of accumulation will need to be monitored closely, and the IMF will need to respond decisively to adverse developments to preserve the balance sheet and safeguard the Fund's credibility as a prudential international financial manager.

Assessing the Adequacy of Prudential Balances—An Analytical Framework is Needed

Precautionary balances have an important role in protecting the Fund's balance sheet from a variety of potential income losses, most notably those arising from overdue obligations and the risk that creditors in good standing may fall into arrears. The staff have prepared a reasonably informative review of the IMF's policy on these balances, though it would have been more powerful if it related the discussion more clearly to other policies, such as access policy, and other IMF work. This wider perspective would take into account the evolving nature of the Fund and the role it is to play in the international monetary system in the period ahead. In doing so, it would lay a firmer foundation upon which to consider the adequacy of existing precautionary balances.

There is no question that the IMF should be vigilant in protecting itself against the risk of future operational deficits and general credit risk. The evolution of the IMF's portfolio has significantly increased the Fund's exposure to the latter risk such that if a high access country failed to meet its repayment obligations in the next year, arrears would likely exceed existing precautionary balances and the IMF's external auditors would no longer be able to give the Fund an unqualified opinion of its financial statements.

The emergence of this risk underscores a basic yet fundamental point—that precautionary balances are only one aspect of credit risk management. Effective risk management also depends, to a large extent, on making prudent lending decisions on the basis of well-designed programs that promote a high degree of policy commitment by members. With this in mind, there should be a relationship between precautionary balances and lending policies.

This is touched upon in the staff paper on Access Policy in Capital Account Crises (SM/02/246) and, in my view, the proposal to manage credit risk by linking the accumulation of precautionary balances to a measure of credit concentration in any single member country should be considered further. At a minimum, I think there is merit to the idea of linking a review of the adequacy and pace of accumulation of the precautionary balance more explicitly to some measure of credit concentration, given that the Fund's balance sheet risks over the near to medium term reflect decisions to lend exceptionally large amounts of IMF resources to a few countries.

Assessing the optimal size of precautionary balances will inevitably involve making judgments. And, while I recognize that, as a financial institution, the IMF is unique in character even among international financial institutions, I am not convinced that this weakens the desirability of basing our risk management decisions, at least to some extent, on a better articulated analytical framework. The overarching objective should be to make informed judgments on managing precautionary balances. The report relates the size of the precautionary balance to the IMF's current credit outstanding and its credit capacity. But it is far from clear whether these simple measures are sufficient to make informed judgments. For instance, does the concentration of lending not matter?

In previous discussions, a number of Directors suggested that alternative debt sustainability analysis (DSA) scenarios with the staff's assessment of the associated probabilities should be used. Rather than considering the level of precautionary balances in isolation, the DSA probabilities might be incorporated into a credit risk model for assessing the possibility of arrears. This would constitute a more integrated Fund-wide framework since DSAs are a key feature in guiding IMF lending decisions, particularly in exceptional access cases.

I encourage staff to pursue analytical work on a credit management framework and report back to the Board on this issue.

Addressing Increased Financial Risks

As regards the staff's proposal to significantly increase the Fund's precautionary balances, I share the view that the IMF faces increased financial risks owing to the level and concentration of outstanding credit. Given the current level of knowledge and in keeping with the IMF's role as a prudential financial manager, a doubling of these balances to SDR 10 billion seems appropriate.

Moreover, the pace of accumulation of prudential balances must be kept under close review in light of a number of uncertainties. Key among these is the volatile nature of surcharge income, which has accounted for nearly two-thirds of the accumulation of prudential balances on average in recent fiscal years. Nor can we overlook the heightened risk of arrears among certain large users of IMF resources in the near term.

The staff should, therefore, consider a range of options to achieve a faster pace of accumulation, so that it can present the Board with concrete proposals if an acceleration is required. Options might include raising the rates of surcharge that apply to large borrowers, which is consistent with efficiency considerations, as well as increasing the general rate of charge for all users of Fund resources.

I would add that it will be important for the IMF to take decisive and early action should adverse developments threaten the Fund's compliance with international accounting standards. Indeed, while it may be that the IMF maintains a strong balance sheet under these adverse circumstances, there is no question that a “qualified” assessment by external auditors would undermine the credibility of the institution as a prudential international financial manager. It is important that the IMF “lead by example” in this respect, as high standards of prudential economic management are expected from member countries.

Ms. Lundsager and Mr. Baukol submitted the following statement:

Key Points

- Precautionary balances appear too low to comfortably protect the Fund from credit risk, particularly given the high concentration of IMF purchases. We support the proposal to build precautionary balances to about twice their current level.
- We would prefer a relatively rapid build-up of precautionary balances. Given the constraints on achieving this, however, the staff’s proposal to build balances through existing procedures may be the best feasible option in the circumstances.
- This course heavily depends on volatile surcharge income. If surcharges are less than anticipated, the Board should revisit this issue to consider building reserves more rapidly through a higher target for net income.

Rationale for Precautionary Balances

The paper describes several reasons why the Fund needs some level of precautionary balances. Of these, we think that credit risk is the most important, since the size of purchases outstanding can be quite large, and there are few other mechanisms available in the Fund’s procedures to deal with arrears on purchases. That said, it is also important not to overstate the dangers associated with arrears. Arrears exceeded total precautionary balances in the 1980s and the early 1990s without an overwhelming impact on the Fund’s financial health or operations.

In our view, the other reasons cited to justify precautionary balances are relevant, but less critical. Arrears on charges, for example, can be made up in most cases through existing procedures of burden sharing and adjusting the rate of charge. The paper also cites the risk that charges on credit outstanding may not be enough to cover administrative expenses if credit outstanding is low, as was the case in the 1950s and 1970s. Frankly, we look forward to the day when the biggest problem facing the Fund is that credit outstanding is too low.

Size of Precautionary Balances

We concur with the staff's view (para 29) that quantitative risk assessment techniques used by other financial institutions are not mechanistically or fully applicable to the Fund. Moreover, while we welcome the information regarding the procedures of other IFIs, we would put less weight than the staff does regarding the relevance of MDB policies for the IMF. There are several reasons why the IMF's policy on precautionary balances may be different than the other IFIs, including that:

- The Fund neither lends to nor borrows from the private sector, unlike some MDBs, and
- The maturity of Fund lending is generally shorter than maturities of MDB lending. (Rough calculations suggest that the average maturity of loans outstanding from the Fund is about 3 years, compared with about 5.5 years for the IBRD, 6.4 years for IDB, and about 10 years for ADB).

Of course, as a financial institution with important systemic responsibilities and with creditors who are accountable to their taxpayers, the Fund must pursue high financial standards, even if the Fund's financial structure is not strictly comparable to MDBs or private banks.

In the end, it is mainly a matter of judgment to try to set an ideal size for precautionary balances. Looking at a variety of indicators, the staff suggests that doubling precautionary balances to about SDR 10 billion would "appear reasonable." We are comfortable with this numeric goal.

Method and Pace of Accumulation

The pace and method of accumulation of precautionary balances is the most important practical issue. We concur with the staff's argument that most of surcharge income should continue to go to build reserves, since such income is associated with loans that add to the concentration of Fund lending and thus risk.

In terms of other options to build reserves, increasing net income and the rate of charge would be a reasonable step, particularly given the very low rate of charge currently in place (based on the three-month borrowing rate of the world's most creditworthy countries) and in light of the large amount of interest free resources that help reduce the rate of charge. But, like the staff, we do not wish to reopen the Board's agreement on facilities now, given current circumstances.

In this context, we support the staff's suggestion to continue the current method of building reserves, acknowledging that it will likely take 5 to 10 years to double balances from their current level, depending on the amount of surcharge income. However, the Board and staff should keep this issue under close review and be prepared to take additional steps if surcharge income falls short of current expectations in order to meet the goal toward the lower end of the 5- to 10-year range.

Mr. Reddy submitted the following statement:

We thank the staff for the informative paper which analyzes issues relating to the level of precautionary balances required to maintain the credibility of the Fund's balance sheet, when faced with arrears. Even though precautionary balances are presently well above the volume of arrears, such a discussion is topical in view of the marked change in credit concentration since 1995. With larger portions of the total credit being confined to fewer members, the distribution of credit risk has correspondingly narrowed, making this exercise of evaluating the appropriate level of precautionary balances extremely relevant. During such an exercise, if the increased risk perception is to be balanced against the need to eschew proposals for increase in charges, and given the judgmental nature of the issue, the status quo probably represents the feasible middle ground.

Our views on the four issues for discussion are outlined below.

Size of the Precautionary Balances.

At the present juncture, given that the precautionary balances are well above the level of protracted arrears, the question seems to be: what should be the level of free reserves—the amount available to meet possible fresh arrears? Clearly the concentration of credit amongst the large borrowers and the impact of this on the level of precautionary balances is the main source of concern. Should provision be made keeping the credit outstanding of the largest user in mind, or based upon a proportion of the credit provided to some of the large users? In this connection, we are not clear what is the basis on which the staff feel that the present level of precautionary balances should be doubled, apart of course from a comparison with other institutions. With a greater credit concentration in the Fund portfolio being a relatively recent phenomenon, it may be difficult to justify such a recommendation. More work may be required before an objective view of the size of the precautionary balances can be taken, specially in view of the other safeguards the Fund has in place.

Pace of Accumulation of Precautionary Balances

We feel that the proposed pace of accumulation must be pragmatic and consistent with the earlier understanding that there would be no review of charges till 2004. The staff points out that the level of precautionary balances can be doubled over the next 5–10 years, at the present pace of accumulation. This may perhaps be adequate to cover most possible risks, specially as large borrowers may technically not come into full default at the time when they fail to meet their first obligation, unless a major part of their credit outstanding is due within the next year. In such a case, even if the precautionary balances are doubled, we are not sure whether this would be adequate to meet a "large" default.

Implications of volatility of surcharge income on pace of accumulation

The surcharge income is proportional to the number of large volume creditors and this is also related to the occurrence of crises amongst the membership. The volatility of surcharge income can thus be correlated to the efficacy of the Fund's crisis prevention measures. A larger surcharge income may imply a further focusing of Fund credit amongst fewer members, pointing at a higher credit risk. Conversely, a lower surcharge income may imply a less disparate distribution of Fund credit amongst the membership and thus a lower credit risk.

Distribution of cost of accumulating precautionary balances between equity and efficiency considerations.

Assuming that burden sharing income reflect equity considerations and the surcharge income represents efficiency considerations, the income from the latter is significantly more than the former. We are not sure whether this situation represents the right balance. In any case, given the understanding not to review charges at present, and if this is the only way to do so, we are not in favor of increasing the present pace of accumulation of precautionary balances.

For the above reasons, we are inclined to agree with the staff that, while the position should be kept under review, the present distribution and pace of accumulation of precautionary balances appear broadly appropriate.

Mr. Yagi and Mr. Miyoshi submitted the following statement:

Key Points

- We share the staff's view that the credit risk facing the Fund has increased substantially and that there is an increasing concentration of credit to a few countries, owing to a series of large arrangements for middle-income countries in recent years. The rapid expansion of international capital flows and the outbreak of capital account crises that this has caused have greatly changed both the magnitude and the character of the credit risk.

- Even with the Fund's preferred creditor status and adequate safeguards, such as conditionality, the risks still remain. As the "provider of confidence" to the international financial system, the Fund needs to ensure its financial prudence. The Fund needs to be sufficiently prepared for the increasing risks, so that it can take risks in extending assistance to members when their adjustment policies have a reasonable chance of success.

- We agree with the staff that using quantitative risk assessment models would not be appropriate in making judgments on the appropriate size of the Fund's precautionary balances, and that decisions on the appropriate level of precautionary balances have to come down to a matter of judgment. Although we are not fully convinced by the staff's considerations in making their judgement, we are prepared to accept their proposal for doubling the amount of precautionary balances.

- The prospect that the Fund's finances will remain exposed to a substantial degree of risk for several years is a matter of concern, but this chair believes that the current system of accumulating precautionary balances is appropriate, as is the pace of accumulation, at least for now. However, as the staff points out, the pace of accumulation should be reviewed closely because of the volatility of surcharge income. We should also bear in mind the possibility that we will have to examine alternative measures to maintain or accelerate the pace of accumulation of precautionary balances, depending on the Fund's income position and risks in the future.

We would like to thank the staff for the clear explanation of the current situation of the Fund's precautionary balances and the candid assessment of the risks to which the Fund is now exposed.

We share the staff's view that the credit risk facing the Fund has increased substantially and that credit is now concentrated to a few countries, owing to a series of large arrangements for middle-income countries in recent years. As the staff paper points out, the credit risk since the middle of the 1990s differs, both in magnitude and character, from the risk of protracted arrears in low income countries, which was the main risk facing the Fund before that time. The rapid expansion of international capital flows and the outbreak of capital account crises that this has caused have contributed to this development.

The Fund has preferred creditor status vis-à-vis other creditors. Also, as long as the conditionality for the use of Fund resources is established appropriately, and the adjustment policies of debtor countries include such conditionality and are implemented steadily, there is a high probability that the Fund's resources will be repaid. Even under such a framework, however, the risk still remains that repurchases will not be made. In some cases, the Fund decides to provide large-scale assistance recognizing that substantial risks are involved, following the Fund's basic principle of cooperation among member countries. Moreover, as the staff points out, in quite a few cases the Fund lends to countries that private creditors have reduced their exposure to, or have withdrawn from.

It is extremely important that the Fund, which is the "provider of confidence" to the international financial system, ensure its financial prudence. This chair supports the staff's view that the level of precautionary balances should be high enough to cope with the consequences of extreme but plausible adverse scenarios. It is our view that the Fund should take risks involved in lending to members whose adjustment policies have a reasonable chance of success. The Fund needs to be sufficiently financially solid against the increasing risks precisely because it should continue to extend its hand to such members.

We agree with the staff that using quantitative risk assessment such as value-at-risk models would not be appropriate in making judgments on the appropriate size of precautionary balances because past historical experience provides too few cases of nonpayment of obligations to the Fund, while the size and characteristics of the arrangements that currently pose the greatest risk to the Fund's finances are very different from those in the past. Furthermore, the probability analysis of default would be of little use in estimating the Fund's credit risk because that probability would be crucially affected by actions taken by the Fund itself. In this sense, we think, like the staff, that decisions on the appropriate level of precautionary balances have to come down to a matter of judgment, taking into account the various relevant factors.

The staff proposes a doubling of precautionary balances, citing the similarities in the risks between the Fund and other IFIs, as well as the fact that, unlike other IFIs, the Fund imposes no maximum exposure limit on access to Fund resources for any single member. The Fund's facilities are significantly different from those of the MDBs in maturity, the rate at which the resources revolve, terms and charges, and degree of concessionality. It is, therefore, not clear what sort of "credit risk considerations" (paragraph 31) were taken into account by the staff in making such a proposal. That said, we are prepared to accept the proposal that the amount of precautionary balances should at least be doubled in the present circumstances, which would bring them more in line with those of other IFIs, given the scale of Fund arrangements and the concentration of credit since the mid-1990s.

Concerning the current system and pace of accumulation of precautionary balances, the staff paper projects that it will take the Fund 5 to 10 years to double the amount of the balances. In light of recent developments, the materialization of credit risk with large arrangements may not be a hypothetical question, and this chair cannot, therefore, help being concerned about the prospect that the Fund's finances will remain exposed to a substantial degree of risk for several years. However, at least for now, we believe that it is appropriate for the Fund to accumulate its precautionary balances steadily under the current system, since a significant amount of surcharge income is projected for the coming years.

The current situation of increasing credit risk and the concentration of credit to a few countries is closely related to the practice of allowing access to Fund resources in excess of normal limits. In this sense, accumulating precautionary balances through surcharge income is broadly appropriate. However, as the staff rightly points out, the pace of accumulation should be reviewed closely because of the volatility of surcharge income. We should also bear in mind the possibility that, depending on the future income position and the risks confronting the Fund, we will have to examine alternative measures to maintain or accelerate the pace of accumulation of precautionary balances in order to safeguard the Fund's financial position.

Mr. Usman submitted the following statement:

Introduction

We commend the staff for a well-written paper on the subject for today's discussion. The paper has sought to put some light on the inadequacy of the Fund's current precautionary balances, and has made some useful recommendations on the steps forward, as well as the modalities to be adopted for enhancing the provisions under the different reserves, in order to meet the challenges and avoid possible uncertainties of the future. We want to especially acknowledge the benefits to the paper of the analysis on the risk management practices of other international financial institutions, which the staff provided as an appendix to the paper. It has not only enriched our perception of the practices in these institutions, but has also helped in forming an opinion on some of the issues raised in the paper for discussion.

For a start, we believe that the standard practice of hedging against risk in any organization, especially in a financial institution such as the Fund, is to make provisions for unforeseen and unavoidable losses and retain the organization's financial integrity as an ongoing concern. The risks to hedge against include, bad and irrecoverable debts, temporary default in loan, or credit payment schedules that could jeopardize its credit capacity, as well as the possible loss of regular income to cover its operations. The staff have successfully analyzed these similarities with regard to the Fund's policy on precautionary balance. While the chances of not recovering debts are very remote in the Fund's peculiar case (as acknowledged in the paper that this can happen only if a member withdraws its membership of the institution), in the other two risk areas, we believe that the Fund's financial soundness may be called to question if adequate provisions are not made to hedge against them.

Adequacy of Precautionary Balances to Credit Capacity

A simple calculation of the relationships between credit capacity, credit outstanding, and credit in good standing in Table 1 of the paper could give the impression that the Fund is not in any way subjected to serious financial risks, as good prudential ratios can be analyzed between those indicators. For instance, we observe that credit in good standing is a high proportion of credit outstanding, which from the analyses of the figures in Table 1 leaves doubtful or bad debts as only 1.3 per cent. Also, credit outstanding is a small proportion of credit capacity (about 38.7 per cent).

However, as the staff pointed out in the paper, there are other unforeseen factors, which make a judgmental approach, beyond the quantitative or mechanistic measures, imperative. These include potential exposure to risk of some credits in good standing, including non-payment by one or more large borrowers; large arrangements, and concentration of credit beyond the access limits for some members; as well as the possibility of the repurchases of some members lapsing into protracted arrears. All of these will, no doubt, affect both the Fund's credit capacity and credit in good standing. More important, credit outstanding becomes a poor measure of the Fund's credit risk exposure considering the need by the institution to make large commitments to some members that may find themselves in financial crises, and at very short notice, in order to avert contagion effects of the crises.

In this regard, the most recent situations in which two large users of Fund resources have obtained large exceptional access, amounting to some $30 billion (about half of credit outstanding), and have on occasions rolled over their repurchases—although the repurchases have not lapsed into protracted arrears—makes the need to set aside large precautionary balances, than are currently available, very pertinent. We also agree with the staff that potential non-payment or protracted arrears of such large users may call to question the integrity of the Fund as the central international financial institution, especially in the event that current annual incomes and investment of gold profits, which are the only other supplemental resources, are not sufficient to finance these arrears.

Furthermore, it is necessary to give serious consideration to the Fund's need to hedge against increased lending requirements in an uncertain world where the institution has the unique responsibility to provide funds at short notice to tackle possible future crisis in the international financial system. In addition to this uncertainty is the fact that the Fund is obligated to make funds available to repay lenders under the NAB and GAB within five years, regardless of whether the beneficiary repays or not.

In the same vein, future large lending arrangements under the exceptional circumstances to few members, may not be ruled out in the light of recent experiences, coupled with the fact that the share of the Fund in financing members in capital account crises has been increasing recently due to the poor participation of the private sector and bilateral financing arrangements in resolving sovereign debt and capital account crises. All these factors lend themselves to a plausible argument for increased reserve provisions and accumulation of precautionary balances by the Fund against such potential risks.

The pace of accumulation for precautionary balances should be accelerated but kept under constant review for some important reasons

While we can support a more rapid pace of accumulation for precautionary balances than currently obtains because of the present financial risks faced by the Fund, we wonder if the method of its financing, which substantially depend on surcharge income could be sustained into the future. This fear arises from the fact that surcharge income currently accounts for two-thirds of precautionary balances, and as the staff admitted, they are variable and are largely earned from programs with members facing capital account crises. Meanwhile, capital account crises programs are expected to be less frequent and less volatile in the future if all the policies and efforts of the Fund, including good macroeconomic performance of the affected countries, were to be effectively implemented.

A very similar example is the success of the Fund's strengthened strategy since 1990, to prevent and reduce protracted arrears by adopting conditionalities, which helped to enhance the debt servicing capacity of borrowing members, thus leaving only a few countries now in protracted arrears. In addition, the Fund's repayment risk is being mitigated by the preferred creditor status that is accorded the institution. To that extent, we feel that any new policy to increase the accumulation of precautionary balances should not be a strategy for all times, but should rather reflect changing circumstances appropriately. Therefore, we feel that the pace of accumulation may increase initially to meet the desired level, but should decline over time, especially if prevailing circumstances and projections so suggest.

The strategy of accumulation should also make allowance for the Fund to sustain its income losses in order to cover its administrative expenses in the event that credit outstanding declines and incomes fall where the Fund is unable to increase the rate of charge to cover regular expenses, and in view of the fact that earlier methods of financing past deficits, including the sale of gold, are no longer available. Similarly, increase in the accumulation of precautionary balances should consider that other income losses may arise from potential accumulation of large arrears, faster payment of Fund credit (surcharges and repurchase expectations) by members, and possible loss of surcharge income from fewer cases of exceptional access arrangements. For these reasons, we will support the need to subject the policy of the pace of the accumulation of precautionary balances to constant review in order to, among other considerations, reduce the charges and interest forgone for members, as well as avoid carrying a high opportunity cost of holding idle balances.

Appropriateness of the current distribution of the cost of accumulation in terms of efficiency and equity

We agree with the staff that equity considerations should argue for costs of accumulating precautionary balances to be distributed fairly among all users to the same degree. In the first instance, the whole idea of financial risks discussed in the paper, which gave rise to the need to increase the Fund's precautionary balances, centered substantially around the risks which users of Fund resources pose to the institution's financial integrity in terms of its credit capacity, credit in good standing, and the ability to meet financial needs of members in crises at short notice. In this regard, we believe that for equity, if it were desired to increase the pace of accumulation of precautionary balances, we will support raising the rate of charge.

There is need to adopt some of the strategies of other IFIs shown in the appendix

In the paper, the staff stated that during the last discussion of the current guidelines, the formula and strategies of the financial risks of other international financial institutions were excluded for some plausible reasons. However, we feel that the current facts on the guidelines and strategies of the institutions given by the staff in the appendix to the paper calls for a second and critical look. Indeed, from the analysis of the staff on the multilateral institutions, we believe that there are some good and unique guidelines which are peculiar to each, even if these are strictly judgmental ones, which the Fund could adopt to make a unique set of guidelines that will serve the Fund's strategy and objective. This is especially so because there are some semblance in the operations and outlook of the Fund and the multilateral development banks, especially in the area of direct lending to the government, as well as in their preferred creditor status.

Mr. O'Murchú supported Mr. Bennett's and Mr. Brooke's comments on the need to link the analysis of the adequacy of precautionary balances to credit concentration, and, in that regard, welcomed the suggestions contained in the annex to Mr. Brooke's statement. In addition, Mr. Brooke's concern about the possible perverse effects of using solely credit capacity as an indicator to assess the adequacy of precautionary balances was justified. Perhaps a hybrid approach for assessing the desired level of precautionary balances, incorporating both credit outstanding and credit capacity, might be more appropriate.

The Treasurer (Mr. Brau), in response to questions and comments by Directors, made the following statement:

> Based on my reading of the ten preliminary statements submitted, these Directors agreed with the staff that an approximate doubling of the current level of precautionary balances is appropriate, particularly in light of the increased financial risk to the Fund owing to higher credit concentration. At the same time, they also concurred that the current method of accumulation of the balances is appropriate, but that it should be kept under close review. A few Directors stressed that if an adequate pace of accumulation were not achieved, then the Board should be prepared to consider options to increase it.
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> There were a number of Directors who, while agreeing with these conclusions, said that they would prefer that the staff elaborate an explicit quantitative risk assessment framework for the Fund. All the Directors who suggested that this framework be developed also recognized that judgments are inevitable and unavoidable in these matters, however, they hoped that such a framework would possibly give more structure to the judgments that need to be made. I agree that it would be desirable to have such a framework, and the staff will work on developing one. However, there are significant difficulties in constructing such a framework, and it is difficult to assess at present whether the staff can develop one that will have sufficient robustness and credibility.
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> Some of the Directors who suggested that the staff develop an explicit quantitative risk assessment framework also spoke about the need for a closer integration of the risk assessment framework with access policy. The Board has had a discussion on access policy and has agreed that there would be no absolute exposure limit on any one borrower. This point is a given, therefore, for today's discussion. I agree with the Board that in considering exceptional access cases, it is particularly important that the burden of proof be very high, through rigorous debt sustainability analysis. Accordingly, if such access policy is consistently implemented, the financial risk to the Fund is commensurately reduced.

Mr. Brooke proposed making explicit allowance for credit concentration in the quantitative risk assessment framework, while Mr. Padoan and others suggested the inclusion of vulnerability assessments and debt sustainability analysis. These are good suggestions, but there are significant difficulties in arriving at such a framework. Part of the reason is that Board decisions on policy conditionality affect the probability of whether or not a borrower might face debt servicing difficulties vis-à-vis the Fund.

There is also the difficult matter that the Fund's credit outstanding is highly volatile. Indeed, the Fund wishes its credit outstanding to be volatile, as it desires for its exposure to be reduced as quickly as possible. Moreover, the Fund also needs to stand ready to assist its members, potentially with large commitments, when they meet the requirements set out for that assistance. Therefore, this makes it difficult to use as a yardstick for assessing the adequacy of precautionary balances credit outstanding at any moment in time. This is different from the situation of institutions that are perhaps the most comparable to the Fund—the multilateral development banks (MDBs). Their credit outstanding moves smoothly and gradually over time by the nature of their credit. For these institutions, credit outstanding is a stable value for measurement, whereas for the Fund, it is a much more unreliable indicator. One could take an average of credit outstanding, but from the staff's point of view, it is more important to look at the Fund's overall lending capacity after all, the Fund is ready at any point in time—and we should certainly be prepared—to extend credit to members, if the conditions are met, up to our lending capacity. Therefore, the Fund's lending capacity to feature in judgments about the adequacy of precautionary balances.

As said earlier, the staff will try to work on developing a more explicit quantitative risk assessment framework. However, I feel that it is probable that, at the end of the day, we would arrive at similar conclusions as we do now, which is that the Fund would be well advised to be prepared to absorb the financial risk arising from non-payment by a large borrower. It is an extremely adverse, but possible, scenario. The recommendations that the staff has put forward in the paper, and which the ten preliminary statements have endorsed, go in that direction.

The second point I would like to react to is to the inferences that we have drawn in the staff paper for the adequacy of the precautionary balances of the Fund from the policies of MDBs, in particular of the World Bank. We said in the staff paper that we see no reason why the Fund should hold precautionary balances that are less than half as large as those of the World Bank. We recognize that there are substantial important between both the functions and the financial structures of the World Bank and other MDBs and the Fund. We believe, however, that when allowing for these differences, one can still draw certain implications and conclusions, which, in our view, are relatively insightful. A key difference—and one or two Directors pointed this out—is that the average maturities of outstanding claims of the World Bank on borrowers are considerably longer than those of the Fund. Therefore, for a given borrower, the World Bank faces the credit risk for a considerably longer time period than the Fund. This is a fundamental difference. The Bank also has a larger pool of borrowers than the Fund, including many borrowers that are not in crisis situations, and who have quite well-managed economies. Furthermore, the World Bank operates with an explicit exposure limit, whereas the Fund does not. As a result, the World Bank is prepared, particularly for the well-managed economies, to increase its exposure up to the exposure limit. An important point of similarity, however, is that, for sovereign borrowers that the Fund has joint exposure to with the World Bank, the covariance of arrears is very high—between 80 and 90 percent. This is true for both the incidence of arrears by sovereign borrowers, and for the clearance of arrears, as the Fund closely cooperates with the World Bank and other MDBs in the process of clearing arrears.

Given these factors, the World Bank's precautionary balances, relative to credit outstanding, are more than two times larger than the Fund's. Therefore, we draw the reasonably powerful implication that the Fund needs to accumulate larger precautionary balances. In addition, in the event that the precautionary balances are not adequate to cover the credit risks, the World Bank can rely on callable capital, which is provided by its member countries to strengthen its balance sheet in the event of an adverse risk. However precisely because the World Bank's precautionary balances are high the probability of having to call on callable capital is low. This is the fundamental strength of the World Bank's balance sheet and, as a result of this, its ability to access capital markets on AAA credit rating terms. One can draw a certain analogy of the World Bank's callable capital with the Fund's gold holdings, which provide fundamental strength to our balance sheet under certain circumstances. The uses of the Fund's gold, however, are fairly restrictive, and I will elaborate on that later. The objective is to accumulate sufficient precautionary balances to minimize the possibility that these fundamental backings—the callable capital or the gold—would need to be drawn upon, reserving them for extreme events.

On the pace of accumulation, the ten preliminary statements agreed with the staff's conclusion that, for the time being, the current system of accumulating precautionary balances should be maintained. In this regard, our view has been fairly strongly influenced by the fact that, for the next one or two years, the pace of accumulation will be high because of the high level of income from surcharges, and I believe many Directors were influenced by this as well. We concur that it is important to keep the pace of accumulation under annual review, as we do in the annual Board discussions on the net income target and on the setting of the rate of charge in April of each year. We also agree with the one or two Directors who said that the Fund should stand ready with options on what to do if the current pace of accumulation were not maintained.

Mr. Brooke asked for the views of the External Audit Committee on the role of the Fund's gold holdings and the extent that they could be considered as part of the precautionary balances; we will pass on the request to the committee. As said earlier, the gold holdings of the Fund are a fundamental strength to our balance sheet. The gold kept in the GRA is valued at SDR 35 per ounce, against a market price that is almost ten times that value. Therefore, we have an undervalued asset on our books. The external auditors were well aware of this situation when they advised, in their last briefing in June 2002, that the Board, in making judgments on the adequacy of precautionary balances, should take account of the risk of much higher credit concentration. Therefore, the external auditors made the recommendation on the need for higher precautionary balances knowing that the Fund has substantial gold holdings.

The usability of gold is highly restricted; an 85 percent majority of votes, as well as the concurrence of the legislatures of some countries, such as the United States, are needed before it can be used. The Fund's gold is, therefore, not liquid, but that does not mean that, in the case of ultimate need it could not be made liquid. The Board in 1995 established certain policies on the use of gold: (i) that it should be retained; (ii) that if it is used, as we did for the financing of PRGF and HIPC, only the income from realized profits of its sale should be used, and not its principal value; and (iii) that it should be relied upon as the ultimate resort in the event of unforeseeable contingencies. Gold should also remain available as backing for potential borrowing, in particular from official sources. Therefore, while gold is clearly an undervalued asset on the Fund's balance sheet compared to its market value and is available only in case of extreme need, its use is quite uncertain and subject to many safeguards. Correspondingly, the staff has refrained from putting a monetary value on gold for the purposes of including it in the precautionary balances.

On Mr. Le Fort's and Mr. Zoccali's question on how much surcharge income has been made available to the PRGF Trust, the Board decided in 1998 that the General Resources Account would not be reimbursed by the PRGF Trust for the expenses of administering the work of the PRGF. The amount involved recently is about SDR 67 million, while the total sum involved since 1998 through this year is approximately SDR 300 million. This decision by the Board is valid through financial year 2004, after which it will need to be reviewed.

Last, on the point of self-insurance by the Fund, we mentioned in the staff paper that either annual income or reserves—in case of large needs—could be made available for losses potentially incurred through self-insurance.

It has become either impossible or highly costly for the Fund to insure against property losses, casualty losses, and loss of lives resulting from acts of terrorism. Therefore, the Fund has decided to self-insure, for a large extent, against property, casualty, business travel, and workers compensation until the insurance companies again provide such insurance at reasonable cost. It is anybody's guess as to what the potential liabilities could be. The estimates, however, are not of the same magnitude as the credit risk faced by the Fund. There are certain scenarios—and one can assume a wide spectrum of terrible events—that, in case of one terrible event, liabilities to the Fund of approximately $1 billion cannot be ruled out. As said, the risk associated with self-insurance is of this kind of magnitude, and is thus not on the same scale as the credit risk faced by the Fund.

Mr. Brooke made the following statement:

I thank the Treasurer for his answers. Just a few follow-up points from me. The Treasurer characterized all preliminary statements from Directors as endorsing the staff's view on precautionary balances. I would like to state for the record that we endorse the staff's view on a doubling of the target for precautionary balances. That is not quite the same as the actual level of precautionary balances. That is why we asked for more clarity about the role of gold in the precautionary balances and for a definitive view from the External Audit Committee. Clearly, if the Audit Committee took a different view to the staff, then it would not necessarily be the case that one would want to double the actual level of precautionary balances.

Second, on credit concentration, I was a little bit disappointed by the Treasurer's answer that he did not think that any of the suggestions that we had proposed would change the staff's thinking. I did not think that the ideas we put forward were particularly complicated. I thought they had merit in simplicity and clearly moved in the direction that many Directors were calling for, which was a more explicit account of the risks of credit concentration. This was also what the staff paper pointed to. Clearly, judgment is a key issue here, but I do not think that the existing approach is satisfactory, and as it is not providing the Board with a clear sense of what judgment we have actually taken, let alone thinking about what the judgment should be, I would like to have a framework that is somewhat more explicit. I fully accept the possibility that the suggestions we made may not be the best, but they should at least initiate further discussions. I hope the staff could take a slightly more positive attitude toward thinking about these ideas rather than just dismissing them, saying that we will arrive at exactly where we are now.

On the point on credit outstanding, I totally take the comments raised by the Treasurer. The issue here has much to do with the timing with which we can increase our precautionary balances following a large credit approval by the Fund. Therefore, I would approach the issue more from a timing point of view rather than necessarily changing the fundamental basis upon which we use the ratio in our target for precautionary balances. I would welcome more thinking on this point, but I obviously need to listen to the views of other Directors through the remainder of the discussion.

Finally, on self-insurance, I welcome the extra information provided by the Treasurer, but I was still a little bit frustrated by the lack of details. If we previously had insurance policies, then we must have had maximum payouts for particular type scenarios, and insurance companies must have priced that with some account for risks, and we should be presented with similar information if we are now going to self-sure for these risks. It is a reasonable minimum amount of information that the Board should be expected to be provided with if we are going to try to make an assessments on these issues. To try to say that it is difficult and the exposure might be at $1 billion, I personally do not find it a satisfactory answer. We should have more information. I would be surprised if the external auditors did not ask the same questions if they were reviewing our procedures and asking how we arrive at the appropriate precautionary balances to offset these risks.

The Acting Chair (Mr. Sugisaki), in response to Mr. Brooke's comments, made the following statement:

The decision to self-insure against some risks is a recent development. We had asked the insurance companies to give us proposals, but they were not satisfactory. Therefore, we decided for self-insurance to some extent, but not entirely—we still keep the insurance to protect against possible human casualties, as well as physical damage to the building. However, beyond a certain limit, the insurance companies' proposals were simply outrageously expensive, so we decided not to accept their offers. We could provide some more information on this issue, and the Deputy Director from the Human Resources Department is available to provide an oral explanation. However, I would like to emphasize this point, namely, that there is no change as far as compensation policy is concerned. In other words, if there is a casualty, the staff is assured to get the same compensation as before under the entire insurance coverage.

Therefore, we should give full assurance to the Board and staff, including visitors, that they are fully covered by our insurance policy. The question is how to finance the compensation in the case that an adverse event materializes. We are saying that the Fund's current insurance policy will be adequate to cover such a risk, but under the very unlikely event that we may have to use Fund income and possibly part of the precautionary balance in a most case scenario, we may have to ask the membership to provide the Fund with more resources in terms of higher charges and so forth. This is why the staff included only one paragraph on the risk of self-insurance in the staff paper—I do not want terrorists to know that the Fund is entirely self-insured

> and not vulnerable. In this sense, I would suggest that we should approach this issue with caution, but I can provide, for the information of Directors, a short note on this matter. That is all we need for the moment because we should not create unnecessary anxiety among the staff working in this building.

Mr. Beauregard agreed with Mr. Brooke and Ms. Stuart that the role of the Fund's gold holdings was an important issue in the discussion on precautionary balances. The problem was that the pace of the deterioration of the Fund's finances had occurred quickly, while the pace of accumulation of precautionary balances had not been as fast. The important question to consider was what the Fund would do regarding its income position. Perhaps part of the gold holdings could be used in case of an adverse event. As Mr. Brooke had mentioned, the External Audit Committee should be asked to give a view on whether part of the Fund's gold could be used with less restrictive rules, should an adverse event occur.

The Treasurer (Mr. Brau) responded that the staff was grateful to Directors for their useful suggestions and would work on developing a quantitative risk assessment framework. However, all risk assessment frameworks were ultimately judgmental. The likelihood that the Fund's risk assessment framework would have an even higher judgmental element than those of other institutions was high. The staff would work on developing a quantitative risk assessment framework that would allow the Fund to make judgments on its precautionary balances in a more structural manner, but it would be difficult to achieve a comprehensive framework; it was important not to have unrealistic expectations.

On Mr. Beauregard's comments on the role of gold, the views of the external auditors were important, the Treasurer continued. However, they would need to be consistent with the views of the Board on the Fund's policy on gold. As had been previously explained, the Board had taken positions on the use of gold; it was for the external auditors to interpret the implications of those positions on the usability of gold, and not to make rulings on them.

Mr. Beauregard reiterated his view that it was important for the Board to reconsider the Fund's policies on the use of gold when discussing precautionary balances.

Mr. Brooke clarified that he agreed with the Treasurer that it was difficult to determine and design a new risk assessment framework that would comprehensively address all of the individual credit risks. The proposals from his chair were simply trying to make more transparent the actual judgments that had been taken by the staff. By having a framework that included different precautionary ratios, depending on credit concentration risks, the Board would be fully aware of the judgments that had been taken. At the moment, an extra amount of precautionary balances had been proposed to take into account credit concentration risk, but nobody was certain about the actual amount. By having a simple framework where the numbers were explicitly linked, and which would move in line with credit concentration, the Board could form that judgment and be convinced that it knew what had been agreed to reach that judgment. That was not quite the same as what the Treasurer had earlier explained.

Mr. Rutayisire asked whether it would be relevant to incorporate value-at-risk analysis in the proposed framework for assessing the appropriate level of precautionary balances. In other words, if every credit risk exposure that the Fund faced was assigned a value at risk, would it not help to determine the appropriate level of precautionary balances needed, and possibly answer some of the questions that had been raised with respect to developing a quantitative risk assessment framework?

The Treasurer (Mr. Brau) elaborated that the staff's view on the difficulties of developing a satisfactory quantitative risk assessment framework derived from comparison to the operations of a MDB. The credit portfolio of MDBs was normally quite stable, certainly in the case of the World Bank. The World Bank had had stable credit exposure to individual sovereign borrowers for a long period of time, possibly between 30 to 50 years. Therefore, in the long run, based on historical probabilities and assessments of the prospects for the economies of its borrowers, it was possible to take a view on the appropriate level of precautionary balances based on the explicit modeling of risk. However, for the Fund, owing to its policies and shorter loan maturities, the value at risk assessment was very different, and not analogous to the World Bank. According to Mr. Brooke, if the Fund's total credit risk was concentrated on a few large borrowers, then axiomatically, no matter how one assessed it, no one knew what that risk would be, but precautionary balances would still need to be provided for it. Therefore, if the Fund faced that risk in the future, then certain conclusions axiomatically followed. The staff implicitly may have the same view as Mr. Brooke. However, on the one hand, while the staff would try to develop a quantitative risk assessment framework, on the other hand, we were in a situation where—at least it seemed to the staff and many Directors—that the Fund's current precautionary balances were clearly too low, and should, therefore, be increased. The staff's view was that, due to the intrinsic differences between the Fund and either MDBs or commercial banks to estimate probabilities of default, the Fund faced greater difficulties in making those judgments based on historical experience, and, therefore, a more axiomatic approach may be necessary for the Fund. The staff would, however, report back to the Board on its work on developing a more explicit risk assessment framework.

Mr. Andersen made the following statement:

> I welcome the opportunity to discuss the Fund's precautionary balances—a topic very relevant for an institution that stresses financial soundness to its members. Let me also say at the outset, that I can support the staff's recommendations and that I think all relevant issues have been covered extensively in the very thoughtful statements issued by my colleagues, of which I can broadly associate myself with the views expressed in the statements by Mr. Bennett and Mr. Padoan and Mr. Lombardi. I would, nonetheless, like to make some points for emphasis.
>
> Building up an adequate level of reserves in an environment, where the credit risk facing the Fund has increased considerably, is a legitimate concern. Even though the Fund's role in the international financial system is unique and it does not operate like a bank in the conventional sense, it is important

that the Fund acts consistently with its own advice. The staff reaches a conclusion that a strong case exists to at least double the present size of the precautionary balances. The staff's recommendation is to maintain the present pace of accumulation, and the paper shows that a doubling of precautionary balances is then likely to be achieved in 5 to 10 years. I can support their recommendation, taking note of the fact that this is also in line with the decision made during the review of Fund facilities in 2000. I do also continue to believe that it is natural that the accumulation of reserves is financed at the source of the risks that is by surcharges on borrowing.

On both the level of the precautionary balances and the pace of their accumulation, I think it is fair to recognize that arguments can be made on both sides, but that the balances presently are clearly on the low side "on balance." On one hand, I join Mr. Mirakhor in his emphasis that the risks are somewhat mitigated by such factors as the Fund's preferred creditor status and the safeguards provided by the quality of our programs, underpinned by a well-designed and comprehensive system of conditionality. Furthermore, while it is appropriate for the Fund to bear some risks as part of its responsibility for the global system, any potential moral hazard that might stem from any overly large accumulation of reserves needs to be obviated. Needless to say, it is important that member countries do not relax their efforts to be current in their payments to the Fund. On the other hand, a relatively large proportion of the debt owed to the Fund is now concentrated on a few countries in a few regions incurring a regional risk factor in addition to an increased credit risk and high volatility of surcharge income. Thus, the present concentration of the Fund's outstanding credit with the standard access policy only applied to about one-sixth of the outstanding Fund credit without any significant change in the concentration of credit risks in sight in the foreseeable horizon must be taken seriously. Also, it is of utmost importance that the Fund is well prepared to meet any unexpected developments that may disturb payments due to the Fund, an issue which, unfortunately, needs increased attention following recent events, including Argentina's failure to fulfill its payment obligation to the World Bank falling due last week. Moreover, as emphasized by Mr. Bennett, a "qualified" assessment by our external auditors could seriously harm our credibility as a prudential international financial manager.

Finally, a few remarks on the analysis. Even though the level of precautionary balances is a matter of judgment, I agree with those of my colleagues—including Mr. Bennett, Mr. Padoan and Mr. Lombardi, and Mr. Brooke and Ms. Stuart—recommending a stronger analytical framework, which takes into account recent developments in the theory and practice of risk management. Thus, I am sympathetic to their various suggestions, which aims at developing a more systematic approach to the determination of precautionary balances, and I welcome Mr. Brau's assurance that the staff will work on it. Also in our analytical foundation for our provisioning policy, I think our shareholders should expect that we live up to the highest international standards. I also agree with Mr. Bennett that the policy on precautionary balances could have been related more clearly to other policies, including in the context of our work on crisis resolution and prevention. We are working hard, inter alia, on PSI, SDRM, collective action clauses, as well as access limits, and to enhance the effectiveness of our surveillance—all efforts that aim to reduce the risk of an overly large exposure of the Fund to single countries. A situation as the present one where about 85 percent of our outstanding credit has been granted on the basis of the exceptional circumstance clause, I would very much hope turns out being a real stress test of our lending relations with our members. In a not too distant future, we will hopefully have made significant progress in our crisis prevention and crisis resolution framework so that the risk concentration is reduced. This would, in turn, diminish pressures to increase the level of precautionary balances. In conclusion, I invite the staff to continue keeping the issues under close review, which I understand is also intended with at least an annual discussion of importance for our policy on precautionary balances, and, in parallel, make further efforts in strengthening the analytical work in this area.

Mr. Steiner made the following statement:

We join other Directors in praising the staff for an informative paper. We concur with the staff and certainly with all Directors that the Fund now confronts higher risks than in the past, and several factors support this claim, the most important being the fact that lending has been become more concentrated on a few large debtors.

The appropriate level of the Fund's precautionary balances is extremely difficult to determine, and, ultimately, judgmental concerns will have to play a role. If we accept that, in the past, the level of reserves was reasonably appropriate, then by acknowledging that the Fund's exposure to risk has increased, we are supporting the staff in that precautionary balances should be increased. Still, we would like to raise three points on which we have some concern.

First, we believe that the adequacy of precautionary balances is better understood in terms of credit outstanding rather than in terms of credit capacity. The staff correctly points out that credit outstanding could increase quite suddenly, and that precautionary balances should be available to withstand such an increase in exposure. But, as Mr. Shaalan points out in his statement, credit outstanding can also decrease quite suddenly, thereby limiting income from surcharges—the income currently generating precautionary balances—and diminishing the need for precautionary balances in the first place. In our opinion, and in line with Mr. Mirakhor, the relevant benchmark in determining the appropriate level of reserves should not be the level of credit capacity, but rather the level of credit outstanding, or perhaps a hybrid approach as suggested by Mr. Brooke and Ms. Stuart. We agree with the staff that the volatility of credit outstanding is an issue, but perhaps using some kind of average is the right way to go forward. In that case, we believe the average should make reference to credit outstanding rather than credit capacity.

Second, the Fund is different from other IFIs. In addition to the points highlighted by Ms. Lundsager and Mr. Baukol in their statement that the Fund does not lend to the private sector and that its loans are generally of a short-term maturity, it is also important to recall that World Bank and regional development banks borrow from the market, whereas the Fund works somewhat like a cooperative. While Fund soundness and solvency are issues of utmost importance which we obviously support, we do not believe that the stringent precautionary balances that might be deemed appropriate for the World Bank and other IFIs should necessarily carry forward in an automatic fashion to the Fund. While we support the staff in proposing an increase in the Fund's precautionary balances, like Mr. Reddy, at this stage we do not feel entirely compelled by the argument that the current level should be doubled in order to put the Fund more in line with the World Bank and other IFIs. In addition, as pointed out by Mr. Brooke, a different treatment of gold might well change the target reserves that we should probably aim for.

Third, there is the issue of the distribution of an increase in precautionary balances. A trend seems to have emerged, according to which the bulk of the increase in precautionary balances is being generated from surcharges. This is evident in Figure 2 on page 27 of the staff paper. It appears that the efficiency element is clearly dominating considerations for equity. We believe that when the Board revisits the issue of charges in 2004, we should try and achieve a more equitable distribution between surcharges and burden sharing. If we take into account that the Fund provides different kinds of public goods, including technical assistance and global financial stability, and that the Fund faces risks that include several not associated with lending, then we believe it makes sense to strive for a more balanced distribution of the cost of accumulating precautionary balances.

Finally, like Mr. Bennett, Mr. Padoan, and Mr. Andersen, we look forward to a staff report that will complement the fact that while judgment is basically determining the appropriate level of precautionary balances, that judgment would be improved if it could eventually be based on a well-articulated analytical framework. The staff's acknowledgment that a paper will be forthcoming eventually in that regard is something that we appreciate.

Mr. Prader made the following statement:

We welcome today's timely discussion.

We are grateful to the staff for identifying challenges to the Fund's financial safety that did not exist when we last discussed precautionary balances a few years ago. The principal threat arises from the Fund's present engagement in resolving capital account crises in emerging markets, which has required lending ever larger amounts of money to only a few countries, creating a heavy concentration of risk. So far, problems of arrears accumulation by the poorest countries have been contained or brought under control, but it cannot be excluded that an emerging market country, where the Fund has a huge loan exposure, would incur arrears on its obligation to the Fund. We share the staff's view that this is an extreme scenario, but since its magnitude could make it much worse than previous arrears cases, we must carefully consider its implications for the Fund's policy on precautionary balances.

One factor contributing to the need for vigilance is the increasing incidence of extensions of repayments, even if this has so far been restricted to the extension of rather ambitious early repurchase expectations. Also, the sanctity of the preferred creditor status of the Bretton Woods institutions can no longer be taken for granted, as we learned last week and from the successful actions of vulture funds.

Fortunately, we are already following a prudent policy of reserve accumulation, which should allow us to reach the proposed doubling of the present level of precautionary balances to around SDR 10 billion within five or ten years. I realize that the objective of doubling the precautionary balances sounds quite dramatic, and perhaps we should not say it too loud for fear of creating an apprehensive mood. This being said, however, we support this objective for the following reasons:

(i) It is a reasonably conservative response to the possible problems at hand. A judgmental approach is appropriate. A more analytical approach, while welcome and desirable, would probably be fraught with the same limitations as the present one.

(ii) It can be handled within existing mechanisms. It continues our policy of a steady prudent accumulation of reserves, and does not lead to abrupt changes in the Fund's reserving policy. For us, what is important is a steady pace of accumulation, rather than abrupt changes in either direction, which could give rise to panic among the creditors or the markets.

(iii) This policy should be clearly explained to the external auditors and shareholders of the Fund who are worried about the above-mentioned recent changes in the Fund's lending policy.

(iv) While the level of the Fund's reserves would still be below the level maintained by other IFIs, it would, nonetheless, increase from some 3 percent of credit capacity to at least 6 percent. I am mindful of Mr. Brooke's and others' preference for using "credit outstanding," but such conceptual differences only make it clear that the real problem is to send the right message at the critical moment.

(v) Continuing the present policy simultaneously sends a reassuring message of calm to the financial community and a message reminding large borrowers that their failure to repay the Fund could have negative repercussions for other Fund members, and especially other borrowers.

I should also mention that we share the staff's view of the limited role that gold could and should play in the event of an arrears case involving a major Fund borrower.

The real problem is not that the staff is asking for a doubling of the Fund's precautionary balances—though this seems ambitious at first sight—but the source of the funding of this increase, namely the surcharge. Let me stress that we continue to support the policy of surcharges. What is troubling would be an over-reliance on surcharges as a means of financing the Fund and the build-up of its reserves. A situation where a few countries provide two-thirds of the reserve accumulation of the institution is clearly problematic in several ways, not only from the standpoint of equity, but also from the standpoint of the stability of the Fund's revenue base. The participants in the debate on surcharges could hardly have foreseen the Fund one day becoming almost totally dependent on them for its income, and a volatile income at that. It is, therefore, both worthwhile and fair to consider how we might put the Fund's income and reserving base on a broader and more stable footing, as mentioned in paragraph 43 of the staff paper. We do not wish to change the surcharge policy, but if the SDR interest rate continues to remain so low, we might need to act on the staff's implied suggestion of revisiting the system for setting the rate of charge when the agreement reached during the review of Fund facilities in 2000 expires two years from now.

The second problem with the surcharge policy is that unexpectedly large windfall revenues have facilitated a very strong increase in the administrative expenditures of the Fund. The sharp expansion of the administrative costs of the Fund in itself creates strong pressure on the rate of charge and results in dependence on surcharge income, and at current low SDR interest rates on extending large loans. We are grateful that the staff paper illuminates these developments and thereby increases our cost awareness. It would be interesting to obtain some more specific numbers about increases in the Fund's administrative expenses in the last five or ten years, since another possibility for reducing the Fund's dependence on surcharge income would be to contain the Fund's rising administrative costs.

An additional concern is that surcharge income is not only being used for its original purpose, which is to cover additional risks to the Fund, but also for other purposes—such as financing the administration of the HIPC trust, which costs some SDR 60 million a year and has cost some SDR 300 million since 1998. Again, it would seem fair and correct not to use the surcharge income coming from a few emerging market countries to pay for objectives belonging to the international community at large.

It also seems questionable to assume that the income from a few countries should be used to make provision for increases in the Fund's vulnerability stemming from the asset and liability risks (mentioned in paragraph 19), including the possibility that the international insurance industry is no longer willing to insure or will insure only at significantly higher premiums. Such risks as the potential additional liabilities created by a health disaster caused by terrorism, should be borne and covered by the entire membership rather than just a few unlucky borrowers. The same applies to the case of changes in the actuarial assumptions of pension plan. It is the obligation of the entire membership to guarantee and reinsure the staff retirement plan. By the same token, if the pension plan constitutes a potential risk to the Fund, the Management and Board should refrain from proposing amendments to the pension plan that would increase its cost.

In conclusion, let me say that significantly higher SDR interest rates could and should make the phenomenon of over-reliance on surcharges less relevant, because it would be only temporary. But a prolonged dependence on surcharges would compound the seriousness of a number of problems. For instance, it could conceivably lead to a discussion on finding a reserving mechanism which would eventually return the built-up reserves to the countries who originally paid the surcharge rather than to the membership as a whole.

Mr. Callaghan made the following statement:

We agree that there should be no change at this stage in the current system of accumulating precautionary balances. However, in many respects, we come to that conclusion by default in that we do not think a convincing case has yet been made for a change in the policy on precautionary balances. I think that there is a range of very important questions and queries that have been raised in the paper, in the statements, and the discussion so far, and I think these need to be pursued a bit further before signing off on any particular new target or level for precautionary balances. I think one of the issues that have been raised is this question of the role of the precautionary balances. Looking at the statements, I think there is a considerable divergence in Directors' views. The staff started by noting that the majority of Directors appear to endorse the proposal to double precautionary balances, but I think I was more concerned or interested in the differing views that have been raised and all the questions that have been raised today. I think that these need to be addressed before we come to just focusing on adopting a new target. So at this stage, I think it is premature to support a proposal that precautionary balances should be at least doubled their present size. I share the concern that Mr. Brooke notes in his statement that this proposal does not seem to be firmly anchored with sound principles and appears to be a bit ad hoc in nature.

The paper states that the overall size of precautionary balances is ultimately a matter of judgment. I certainly agree. And, we are always a strong advocate against forced precision and misplaced science, but it does not mean that you do not anchor your views, have as much rigor as possible in your analysis, and present as sound a reasoning as possible in support of any judgment that is formed. And I think Mr. Brooke has hit the nail on the head, so to speak, when it comes down to transparency and how are we coming to this judgment. And, I thought that the discussion earlier when the staff representative said that he agreed with Mr. Brooke that he was referring to some implicit assumptions as to how he came to his view is exactly what we need to flesh out; we need to know a bit more about those assumptions.

If I understood earlier, I thought the staff agreed to come back to the Board with some more detail on this, in terms of a bit more detail on how they came to those assumptions and they arrived at the judgments in the paper. I think that is probably what we need before we sign off on anything.

On the rationale for the doubling of the current level of precautionary balances, it does seem to be justified that the current level appears too low. I think it does appear too low; but why stop at doubling if we say we are going to increase it? Is it simply a case that that more is best when it comes to reserve accumulation? There is a cost in putting more and more resources on the shelf, so to speak. So I am not comfortable about adopting an imprecise way of saying let us double precautionary balances.

I would note, nevertheless, that there does appear to be logic in the SRF and the credit tranche surcharges being directed to precautionary balances. This is the type of lending, namely large amounts to individual countries, that could compromise the financial position of the Fund. But the paper raises concerns and Directors have raised this now, and uncertainties over the pace of accumulation of reserves through surcharges, and the prospect of early repurchases. However, as Mr. Shaalan and Mr. Bakhache have noted, to the extent additional precautionary balances are needed to address risks associated with large packages, a decline in the pace of accumulation when large packages are paid back quickly would be commensurate with the decline in the need for such balances. Through the surcharge mechanism there does appear to be some logical link between the accumulation of precautionary balances and the associated risks that they are covering. I agree with Mr. Brooke it would be preferable if we can try to get a bit of a closer link between concentration and Fund handing in the build up in precautionary balances. By way of a general comment, in focusing concerns over the pace of accumulation of precautionary balances, it does give the impression that we would be pleased if there were no early repurchases, and that there were a large number of capital account crises resulting in a heavy usage of the SRF facility for such an outcome would certainly assist in the pace of accumulation of precautionary balances. It is nonsensical to say that, but it does highlight that there needs to be a link between precautionary balances and the risk they are covering. This needs to be made.

Mr. Shaalan and Mr. Bakhache make the important point that precautionary balances are but one of the elements guarding the Fund's financial position. Ultimately, the first line of defense should be the existence of effective Fund programs. And as Mr. Bennett notes, there should always be, to quote him, prudent lending decisions on the basis of well-designed programs that promote a high degree of policy commitment by members.

There is a very fundamental problem if we have a situation where a number of large programs go into arrears. And, the problem extends well beyond whether the Fund's level of precautionary balances is adequate do cover such an extent. Like Mr. Shaalan and Mr. Bakhache, we think the main reason for holding precautionary balances is to guard against the loss of income or loss of principle when a country goes into arrears. The considerations cited in the paper regarding free resources to cover administrative costs and acts of God or self-insurance, I think they are a secondary consideration. And, I support the frustration again raised by Mr. Brooke on this matter, that it is still too vague, we have very limited information and I note your point, Mr. Chairman, about concerns about wanting to disclose this, but it is very limited information that is presented to the Board. I think as Ms. Lundsager and Mr. Baukol note, we should in fact look forward to the day when the biggest problem facing the Fund is that the credit outstanding is too low and that we may not be able to cover our administrative expenses.

The key issue is what would be the impact on the Fund's operations if a large debtor went into arrears. And such a situation would be a loss of income and potential loss of principle. On the first, the burden sharing mechanism exists to cover the loss of income. However, the staff emphasizes that the cost on the floor and rate of remuneration, there may be a situation where the loss occurred because the required interest rate charged to offset the loss would be considered excessive by the Board. There is, however, considerable scope to lift charges and while precautionary balances could be run down to smooth the required increase in the rate of charge, as Mr. Shaalan notes, the rate of charge would eventually have to increase to compensate for the lower income on reserves.

The second issue is the possible loss of principle when a borrower goes into arrears. And this seems to be the main risk we are attempting to cover with precautionary balances. There is the possibility of a loss of principle if a member in arrears withdraws from the Fund. However, we are yet to see such a loss being realized via the withdrawal of membership of a country in arrears. Yet, the need to have sufficient precautionary balances to fully cover credit outstanding to member in arrears seems to be driven mainly by the desire to comply with the international accounting standards rather than to guard against the prospect that a kiss may actually have to be written off. Yet it does not appear feasible nor necessary to have precautionary balances sufficient to guard against the possibility that a large fund borrower may go into arrears. Box 4 highlights how quickly arrears by a large borrower could exceed precautionary balances. The paper also notes the precautionary balances for this purpose have to be built up well before arrears occur because setting aside balances against potential nonpayment by a large user of Fund resources could not be financed in the income year of nonpayment—a point raised by Mr. Beauregard. While there is a concentration of large arrangements, I do not think it is realistic to aim to build up sufficient precautionary balances in advance against the prospect that some, if not all, of these arrangements may go into arrears. Even doubling the existing level of precautionary balances, which on the basis of current accumulation rates would take some ten years, would not provide sufficient coverage against the prospect that existing large arrangements may go into arrears. The approach taken in the paper is to propose very substantial general provisioning before any specific arrears event actually occurs. On its own, the fact that IMF credit is becoming too concentrated is too general a basis to justify provisioning at the level suggested in paper. It is impracticable to build up precautionary balances quickly enough to cover the possible default of a large borrower, I think we do have to look at the other options that are available.

And, as Ms. Lundsager and Mr. Baukol note, arrears have exceeded total precautionary balances in the 1980s and in the early 1990s without an overwhelming impact on the Fund's health or operations. A unique aspect of the Fund's balance sheet is the large asset of gold, which is currently undervalued. There has been some discussion on this already. One clear option seems to be to try and revalue the gold holdings in the event that extra provisioning was needed, assuming this could be negotiated through the articles. Alternatively, there is this question and the point Mr. Brooke raised, the question that should go to the external auditor committee about what should be the view taken on the undervaluation of gold, if they believe that the assets in arrears are overvalued. And I think that this is an important point that needs to be addressed before we can take any decision on what should be our target level of precautionary balances.

It is interesting to note that the Managing Director's statement in 1995 when he said, "The Fund's gold holdings provide operational maneuverability through adding credibility to the level of funds precautionary balances." The current staff paper notes that while policies governing the use of gold do not exclude mobilization of gold resources to cover losses, the intended purpose is to cover other unforeseen contingencies. Going back to the 1995 paper, one of those unforeseen contingencies raised was that if the GRA was to borrow from members. However, the need to borrow from members is also cited as a reason to build precautionary balances, and also to hold a minimum uncommitted level of reserves. This raises the question as to whether the gold holdings are effective in delivering their stated purpose, the operational maneuverability." In addition, there does seem to be duplication between some of the reasons for precautionary balances and a minimum uncommitted level of reserves. Despite the formal differences, both appear to be providing a buffer for borrowing under the NAB and the GAB.

On the question as to whether the target should be based on the Fund's lending capacity rather than a non-arrears credit, we have reservations similar to those raised by Mr. Mirakhor, Mr. Shaalan, and also Mr. Steiner earlier. We think the basis should be credit outstanding and not credit capacity.

There has been some discussion already about how we should compare the Fund with other multilateral development banks, and I think that we do dismiss too readily the differences between the Fund and these other organizations. The staff has referred to some of the differences between the institutions on the asset side, but I think Mr. Steiner has made that very important point that the multilateral development banks fund a bulk of their working capital from international capital markets and the level of reserves has a direct effect on the cost and ability of these institutions to borrow. This is not the case for the Fund where the primary source will continue to be member governments.

In conclusion, as noted at the outset, we would not propose a change at this stage to the way precautionary balances are being accumulated, but I think that there has been sufficient questions and queries raised on the whole role of precautionary balances, on how they are being accumulated, and a variety of other matters and also the important point of transparency that Mr. Brooke has raised, that these need to be addressed before we sign off on any particular policy regarding the target level for precautionary balances. Mr. Brooke refers in there about a number of Directors calling for more analytical framework. I think that as the staff representative pointed out—and he used the words of Mr. Zurbrügg—it would be good to make clear that what

Directors were calling for was more transparency on the assumptions underlying the proposed increase and a given level of precautionary balances.

Mr. Alowi made the following statement:

We thank the staff for the timely preparation of this review. We agree with the staff's view that these balances are insufficient to safeguard the financial integrity of the Fund, in the light of the increased financial risks faced by the Fund. Moreover, the financial soundness of the Fund should stand up to scrutiny, whether compared with other similar type of IFIs, or in complying with the International Accounting Standards. As such, we support the proposal to strengthen the Fund's precautionary balances.

Size of Precautionary Balances

However, while we agree with this increase in the balances, and we understand that its determination has been ultimately a matter of judgment, such a substantial increase in the balances would, we think, warrant a more careful look at the numbers, as many speakers have emphasized. It would not be possible to calculate the exact amount needed, but it would be useful to identify the specific credit risk considerations that led to the staff's recommended doubling of the balances.

Pace of Accumulation

On the pace of accumulation, we note that there is no guarantee that the current pace can be achieve in future, but, in principle, we agree that the pace under the current system is appropriate. Nevertheless, the pace of accumulation should be monitored closely and reviewed in view of the numerous uncertainties.

Mr. Boitreaud made the following statement:

At this stage of the discussion, it seems that a broad agreement has been reached on at least two points:

First, the credit risk facing the Fund has increased over the past years, owing to a series of large arrangements concentrated in a limited number of emerging economies. True, some argue that we should not overstate the risks associated with this development, and that we should not forget the several safeguard mechanisms that are in place but, by and large, it appears that there is a consensus on this increase in the credit risk.

Second, which is a consequence of the previous point, the current level of precautionary balances appears to be too low. It is very difficult to assess what the relevant level of precautionary balances should be, but, like many other speakers, I tend to agree with the staff's proposal to build them up to around twice their current level.

Having said this, I would like to stress three different issues that are less unanimous.

The first relates to the need to modify the existing framework for determining the target level of precautionary balances. As expressed by many colleagues, the determination of this target will remain a matter of judgment, given the unique nature of the Fund. The staff rightly insists that the incidence of nonpayment of obligations to the Fund is too small and diverse to derive reliable estimates of credit risk from historical experience. I agree with the staff and I do not believe that the elaboration of a value-at-risk model is feasible nor desirable in the IMF. However, like Mr. Bennett and others, I think that a better articulated analytical framework would help us make better informed judgments. Such a framework should not be based on one sophisticated risk assessment model, but on the list of different basic indicators and on the list of staff assumptions, as mentioned earlier by Mr. Callaghan. Such indicators would nurture our judgment. In that regard, the reference made by Messrs. Padoan and Lombardi to some forward-looking considerations is certainly worth examining.

A second issue concerns the role of the Fund's gold holdings in precautionary balances. Like Mr. Mirakhor, I think that the potential for gold in strengthening the IMF's balance sheet should not be overlooked and that some of the extreme risks mentioned by the staff could qualify under unforeseen contingencies. We should, of course, remain cautious as gold is certainly not the IMF's most liquid asset but I believe that this issue should deserve further attention.

The pace and method of accumulation of precautionary balances is a third issue. On the method, like Ms. Lundsager and Mr. Baukol, I concur with the staff that most surcharge income should continue to be earmarked for building reserves as such income is associated with the concentrated large arrangements that are at the origin of the increase in the Fund's credit risk. On the pace of accumulation, I tend to share the concern expressed by Messrs. Yagi and Miyoshi about the prospect that the Fund's finances could remain exposed to some degree of risk for several years. Recent developments prove that the rapid accumulation of a very large amount of arrears is not a totally unrealistic scenario for the near future. At the same time, I do not see many realistic venues for significantly increasing the pace of accumulation given the current level of reserves and the current amount of protracted arrears. We should, therefore, continue with the current method, but, as mentioned by many colleagues, the Board should be kept regularly informed so as to be ready to examine additional measures depending on the future evolution of income and of risks facing the Fund.

Mr. von Kleist made the following statement:

In an ideal world, we would not need any precautionary balances at all, since the Fund, as a monetary institution, should not extend any credits which carry a non-negligible default risk. However, we certainly do not live in an ideal world.

The staff paper, therefore, makes an overall convincing case for increasing the Fund's precautionary balances. Given the current high level of credit concentration and the prevailing uncertainties, the actual level of precautionary balances is clearly on the low side. In this context, it should not be overlooked that this situation is mainly due to the Fund's policy of granting exceptionally large credits to a few member countries with capital account problems.

As the staff paper mentions, in case one of those large Fund users would cease to honor its payment obligations, the Fund's external auditors would no longer be able to give the Fund an unqualified opinion on the GRA financial statements. In contrast to a commercial bank, this, as such, would not have direct dramatic consequences for the Fund and we should recall the situation in 1990 when accumulated arrears once exceeded the level of precautionary balances without impeding the Fund's liquidity, creditworthiness or its financing role. However, the Fund would certainly suffer a loss of credibility, particularly as it rightly advocates prudent financial policies in its member countries.

Against the background of increased credit, as well as income risks, I, therefore, very much support the staff's proposal to at least double the current level of precautionary balances.

That having been said, in our view, the staff's rather narrow focus on the appropriate relation between the Fund's credit capacity and its precautionary balances is somewhat misleading. As Mr. Bennett pointed out in his statement, it is not the mere size of the Fund but the credit concentration which led to the unsatisfactory situation we find ourselves in today. Therefore, not least for the sake of the Fund's financial integrity and notwithstanding its recent decision not to implement a maximum exposure limit for any one member, the Board should reconsider the policy of large financing packages by strictly adhering to normal access limits and by enforcing private sector involvement as a standard feature of crises resolution efforts, thereby reducing the risk of a repeat of the high increase in credit concentration in future, once the current high credit concentration has hopefully wound down.

Regarding the appropriate pace of accumulation of the precautionary balances, the very fact that a possible default of only one major creditor might already exhaust the cushion provided by the actual precautionary balances, would clearly warrant an acceleration of the current pace of accumulation. However, as pointed out in Mr. Brooke's and Ms. Stuart's statement, the pace of accumulation is not least determined by the cost the membership is prepared to accept. Assuming that, for the time being, there is neither a Board majority for increasing the rate of charge nor for alternatively larger additions to the SCA-1, the staff's proposal to stick to the current pace of accumulation seems reasonable.

For the same reason, striving for a generally preferable lower variability in the pace of accumulation by reducing the role of surcharge income may prove difficult under the present system, since it also presumes members' willingness to accept a higher rate of charge and/or increased provisions to the SCA-1. Moreover, for reasons of efficiency and appropriate incentive structures, we deem it crucial that borrowers that are most likely to face repayment difficulties should pay the most.

To conclude, while the current distribution of cost of accumulation appropriately reflects efficiency as well as equity considerations, the pace of accumulation must be kept under close review, given the uncertainties mentioned earlier. Echoing Mr. Shaalan's statement, in case a need for an accelerated pace of accumulation should arise, be it because of a default or due to lower than anticipated surcharge incomes, the Board should be prepared to consider the relevant options in a timely and open-minded manner. I thus support Mr. Bennett's proposal that—as a precaution—the staff should prepare in advance different options—including radical options—to achieve a faster pace of accumulation, for a speedy consideration by the Board if that should become necessary. However, already at this stage, it seems advisable to strongly caution against considering the Fund's gold holdings as part of its precautionary balances in the narrow sense. As the staff correctly notes, such a move away from the hitherto restrictive use of the gold holdings would certainly result in a number of alternative proposals for its use, which should clearly be avoided.

Mr. Zurbrügg made the following statement:

Today's discussion on the Fund's policy on precautionary balances is timely, in some aspects uncannily timely, and I thank the staff for the thorough review. The paper does an excellent job at highlighting the disconnect that currently exists between our strategy on precautionary balances and the Fund's role in the resolution of recent financial crises. The lending policy in general and access policy in particular over the past years raises serious questions about the appropriate level and pace of accumulation of precautionary balances. There is general agreement that the Fund's credit and income risk has risen due to the concentration of outstanding credit and the magnitude of lending arrangements. In light of these developments, I concur with the staff that the level of precautionary balances is low and support the proposal to increase precautionary balances to a level at least double the present size.

This being said, like several other speakers, I felt that the paper could have benefited from stressing the links between the precautionary balance and other policy issues. A major reason for the insufficient level of precautionary balances is the fact that the Fund's measures to address concentration risk and limit risk exposure have been limited in scope and application. First, access policy has not provided the desired safeguard, since exceptional cases have become more frequent. Adhering to our decision to allow for exceptional financing only under the condition that circumstances are truly exceptional and agreed procedures are followed strictly would greatly contribute to mitigate risk. Second, the facility designed for exceptional access cases, the Supplemental Reserve Facility (SRF), has often been circumvented. The higher surcharge income and shorter repurchase periods contribute importantly to accumulating adequate levels of precautionary balances and to limiting the duration of the exposure. An appropriate use of SRF in future arrangements would be a substantial step towards addressing the issue of precautionary balances. Third, the Fund has not been able to involve other relevant actors in resolving crisis situations and finds itself more and more often as the sole lender.

Another issue that would have increased the value of the paper is a stronger rationale for the extent and the time span of an increase in precautionary balances. I fully understand the difficulties involved in such an exercise and have taken note of the staff's initial comments. However, making the case for increasing precautionary balances to a level at least double its present size, mainly on the grounds of an inappropriate comparison with other IFIs, leaves me uncomfortable. I join Mr. Padoan and Mr. Lombardi and others in encouraging the staff to develop a more systematic approach. This does not necessarily imply a sophisticated risk model. In my view, it is more in the direction of making assumptions transparent. For example the staff noted in the paper that we should not merely target a level sufficient to deal with average credit risk, but also with extreme and plausible adverse scenarios, including nonpayment by one of the largest borrowers. In his comments, the staff representative mentioned that the new level of precautionary balances should cover the credit risk of an average large borrower. These are the kind of assumptions that need to be spelled out.

On the pace of accumulation: It is conceivable that due to the high credit concentration adverse scenarios as described by the staff could erode precautionary balances relatively quickly. The illustration in Box 4 is striking and, by design or coincidence, presents strong similarities with Argentina. Unfortunately, the real case makes the point even more forcefully, since expected repayments in 2003 are around SDR 8 billion. Given these numbers and the current situation, in my view, the Fund will probably have to increase the pace of accumulation sooner than later. For now, I agree not to reopen the compromise reached during the facilities discussion, and I consider the efficiency and equity considerations put forth by the staff as appropriate.

In support of a more systematic approach, I agree with the staff's proposal to replace credit outstanding with the Fund's credit capacity as the main reference point for determining the adequacy of precautionary balances. In doing so, precautionary balances would be geared to a more meaningful and more stable yardstick. The stabilization of the target level would also protect precautionary balances from being misappropriated for alternative uses in times of low levels of outstanding credit.

Such a switch should, however, by no means be misinterpreted as a call for higher lending. In this respect, caution is warranted with regard to the signaling effect an increase in precautionary balances might have, as the question of precautionary balances and access policy are inevitably linked. While I am strongly in favor of the Fund maintaining a strong balance sheet, higher precautionary balances should in no way reflect our willingness to increase or maintain high levels of lending in the future.

Mr. Wei made the following statement:

At the outset, let me thank the staff for the well-written paper that presents a thorough analysis of financial risk and precautionary balances of the Fund. The increasing role of the Fund in crisis resolution, as reflected partly in the amount of lending that concentrates on some large borrowers, has given rise to the financial vulnerability of the Fund. The recent volatility in the international financial system has further increased the Fund's risk exposure. In this connection, I would like to join others in emphasizing that the Fund as an institution should be well equipped in protecting itself against risks. However, a number of effective instruments have been developed to contain the risk of exhausting precautionary balance. The strengthened surveillance plays an important role in safeguarding the macroeconomic and financial stability of member countries. The arrear policies, burden sharing mechanism and the setting of rate of charge in response to the change in the Fund's financial situation, all serve to mitigate the risk to the Fund's financial integrity. Meanwhile, access to gold could be also considered if the Fund's financial integrity is actually under immediate threat.

Mr. Mirakhor has made a number of very useful comments on various aspects of the Fund's policy on precautionary financial balances. I fully share his comments as he struck a good balance in assessing the risks faced by our institution. I agree with him that it is unrealistic to overemphasize the risks.

Of course, even with these policy tools, risks remain. It is conducive to take a cautious attitude towards the financial integrity of the Fund. Hence, to increase the accumulated amount of precautionary balance could be a wise choice. However, like Mr. Padoan, we also find that the approach of assessing the adequacy of precautionary balance is not a systematic one. Though it is always difficult to quantify the risk, as responded comprehensively by Mr. Brau at the opening of today's meeting, we would like to encourage the staff to continue to make efforts in developing a more systematic framework of risk management that reflects the unique feature of the Fund responsibilities.

This being said, the present system of accumulating precautionary balances operates smoothly in covering the risks of the Fund. We share the staff's view that there is no need to change the current system of accumulating precautionary balances. Therefore, we can go along with the current pace of accumulation that will double the size of precautionary balance in five to ten years. Meanwhile, given the increased risk confronting the Fund, the system of accumulation should be kept under close monitoring.

Mr. Zakharchenkov made the following statement:

At the outset, let me say that it is not reasonable to determine the appropriate size of precautionary balances using strictly mechanistic approach. It is important to judge the adequacy of Fund's precautionary balances within the context of the unique nature of this institution and being mindful about many safeguard mechanisms that are already in place. Both the staff and the several Directors who have issued statements already extensively covered this issue and I will not elaborate on it any further. On balance, the staff's proposal to keep the present system of accumulation of precautionary balances unchanged is appropriate at this stage.

At the same time, the credit risk facing the Fund is increasing due to the Fund's growing role in resolving capital account crises experienced by member countries and the increasing concentration of credit to a few members. Besides, the present level of Fund's precautionary balances seems to be on the low side, especially if compared with other IFIs. Taking these factors into consideration, we can support the staff's call for the continuation of consolidation of precautionary balances with the objective of doubling their amount within 5 to 10 years.

We consider the current pace of accumulation to be broadly appropriate. It is true that under the present system it is hard to predict the exact pace of accumulation due to the volatility of the surcharge income. But we are not that much concerned about it since the variability in the pace of accumulation of precautionary balances appears to be in accord with the associated risk variability. This said, the level of precautionary balances needs to be kept under close review and we are prepared to revisit this issue, if warranted by future developments.

Mr. Alazzaz made the following statement:

I join other speakers in thanking the staff for a timely and informative paper for today's discussion. The paper details both the progress made in strengthening precautionary balances, as well as the increased risks. As shown in Table 1, there has been an impressive improvement in the Fund's precautionary balances since 1990. Indeed, arrears declined sharply and the ratio of free reserves to credit in good standing, which is the most relevant indication of the adequacy of precautionary balances, moved from -5 percent in 1990 to 6.7 percent in September 2002. Here, I am not convinced that the comparison between Fund precautionary balances and those of other IFIs is very meaningful in view of the Fund's conditionality that should reduce the risks, the differences in the maturity structure, and the need for the World Bank, for example, to raise money in financial markets.

That said, the increase in the concentration of the Fund's lending and the rise in the size of the financial packages, which are shown in Figure 1, pose risks. While the Fund's conditionality and preferred creditors status should limit these risks, it is prudent to not only continue to accumulate precautionary balances in line with current policies, but also to assess in more detail the impact of any future large lending package by the Fund on the risk profile of the Fund's portfolio. It was the appreciation of the increased risks that prompted the Board to agree on interest rate surcharges for large loans. These surcharges have provided a major boost to the Fund's precautionary balances and should continue to do so as long as those large loans are outstanding. Indeed, precautionary balances are expected to grow by about SDR 1 billion this year. If the large loans were to be paid off, the risk to the Fund would decrease, and, therefore, the need for accumulating precautionary balances at a fast pace would also diminish.

As to the other risks detailed in the paper, I am of the view that the risk of precautionary balances having to absorb income losses are minimal for the reasons mentioned in Mr. Mirakhor's statement, as well as the Board's proven commitment to the integrity of the Fund's finances.

Mr. Nijsse made the following statement:

As stressed by other Directors, it is clear that the risk for the financial position of the Fund has increased. It is, therefore, appropriate to build up adequate precautionary balances. Not only has the concentration on our credit portfolio increased, there has also occurred the novelty of default by a large middle-income country on its loans to the World Bank. In this context, I support the staff in its call for an increase in the precautionary balances. It is, however, difficult to quantify the precautionary balances necessary to cover concentration risk—to make reservation for default by the largest borrower, we may need a five-fold increase in Fund's reserves.

Given the judgmental nature of the staff's assessment, I would not be eager to introduce a new system of generating precautionary balances, and for now, the system of burden sharing and surcharge income will generate adequate addition to our precautionary balances. With regard to the use of surcharge income to generate precautionary balances, Mr. Beauregard was right in pointing to the fact that it was appropriate that those major debtors contribute to surcharge income as they are also the major contributors to the concentration risk in the first place.

While the comparison with MDBs does not seem to be totally appropriate, as those banks operate differently and may have different patterns of risk, the difference between the Fund and other IFIs in this area has become too large. Unlike the Fund's creditors, MDBs' creditors expect to be repaid on a set date. Thus Fund's debtors, like MDBs', cannot go bankrupt, while in the case of creditors, unlike MDBs', they do not usually expect to be repaid until the Fund has adequate resources to do so.

In conclusion, I support the continuation of the current system of generating precautionary balances. We should monitor the development of the coverage of our precautionary balances closely. If we have more information on the developments in some individual large program countries and on the development of the concentration of our credit portfolio, we might be able to make a better judgment about the quantified target value or ratio for the Fund's precautionary balances, and might have to discuss alternative methods for generating such balances.

Mr. Rutayisire made the following statement:

Assessing the adequacy and the financing of the precautionary balances in the Fund remains an important exercise, in order to safeguard the financial integrity of the Fund. We, therefore, welcome today's discussion which provides us with the opportunity to review the key issues related to the Fund's precautionary balances, following our April 2002 review of the Fund's income position. We thank the staff for the comprehensive report, which contains an in-depth analysis of the Fund's precautionary balances. On the issues proposed for the Board's consideration, we agree that future large lending arrangements to a few members under exceptional circumstances support the need for the increase in the reserve positions to address such potential risks. On the other hand, like Mr. Usman, we wonder whether the surcharge income, which accounts for two-thirds of precautionary balances, could be sustained in financing the precautionary balances.

First, on precautionary balances, we note that the level has fully covered credit outstanding to members in protracted arrears since 1993, due mainly to the successful implementation of the Fund's strengthened strategy for preventing and reducing arrears to the Fund. Moreover, free reserves have been accumulated and have exceeded the indicative target range of 3 to 5 percent of credit in good standing since 2000. Despite these encouraging developments, the increasing credit concentration to a few members with the large amounts of access, the significant impact of arrears on the Fund's income, as well as the risk of potential loss expected from the Fund's administrative expenses exceeding income all point to the need for caution, as the staff notes, for increasing precautionary balances relative to the credit capacity of the Fund. However, such an increase would have an adverse financial impact on those members that can least afford it. Moreover, as is well outlined in the staff report, the Fund is, in many ways, unlike other financial institutions. The credit risk that the Fund faces is difficult to quantify, and the risk assessment practices of other financial institutions do not apply to the Fund.

A number of other characteristics also reduce risks to the Fund and help to preserve its financial integrity. The most important one is the tool of conditionality, which helps to improve borrowers' financial position. The other one is the Fund's preferred creditor status. This latter one has helped the Fund well in the past, and will continue do so. Our strength and strategy to deal with countries that develop arrears has contributed significantly to a reduction of protracted arrears. All these are relevant factors that should be given adequate weight in our decision.

Therefore, while we understand the greater risks that the Fund faces, we do not think that they justify a doubling of the precautionary balances. The financial impact of any increase on the financial position of the membership should be carefully monitored and analyzed. In this regard, we would have liked to see some tables indicating the impact of an increase in reserves on the rate of charge. We wonder if the staff could give some indications on the impact on the five largest borrowers if their suggestion for doubling of reserves is implemented.

Overall, we see merit in maintaining the accumulation of precautionary balances at a moderate rate.

Second, we view the current pace of accumulation of precautionary balances as appropriate.

Finally, on efficiency and equity grounds, we are of the view that the current distribution of the accumulation of precautionary balances seems generally appropriate.

Mr. Beauregard made the following statement:

Safeguarding the financial integrity of the Fund is of paramount importance. Today's discussion calls for a close review of the adequate level of precautionary balances and of their pace of accumulation.

The staff underlines the reasons why the current level of precautionary balances ought to be increased. From all these reasons, I share other Directors' view that credit risk is the most important one. I also share the view that the staff paper could have included more information about the risks arising from self-insurance activities.

While I support the staff's arguments that judgment plays a key role in defining the adequate level of precautionary balances of the institution, I also share other Directors' views, especially those expressed in Mr. Padoan's and Mr. Lombardi's statement, that this evaluation warrants more analytical considerations. Simply speaking, I do not understand why the staff is recommending doubling the current size of precautionary balances. Why not tripling them or just increasing them by 50 percent from current levels? Mr. Zurbrügg's comments in this regard make it clear that we are not asking for the use of a sophisticated model, but for clearer assumptions.

The slow pace at which precautionary balances accumulate under current policies calls, at least, for additional reflection with regard to the financial risks the institution faces. In this regard, I do not share the staff's analysis based on the average risk of the large borrowers of the institution as presented in Box 4. I think that for prudential reasons an analysis based on a worst-case scenario is more appropriate. This is important should a large borrower enter into default with the Fund. The problem is that in this case the speed at which the financial situation of the Fund would deteriorate is significantly higher than what current policies would allow precautionary balances to grow in the short term. I note Ms. Lundsager's and Mr. Baukol's comment regarding past experiences of financial arrears exceeding total precautionary balances in the 1980s and early 1990s. However, I think that the current situation differs substantially from the one cited, in particular, the type of crises that some of our member countries confront today and the high concentration of the lending portfolio of the institution. In this regard, I share Mr. Brooke's and Ms. Stuart's comments regarding the possible use of the Fund's gold position. This is an issue that the Board needs to address, but it is also an issue that would involve the participation of the External Auditors.

The staff's suggestion to relate precautionary balances to credit capacity instead to credit outstanding is interesting, but like Mr. Brooke and Ms. Stuart, I think this criterion has also its drawbacks and we should analyze this issue more in depth before making a decision to switch to such criteria. In this regard, is this criterion consistent with International Accounting

Standards? Has the staff already consulted this issue with the External Audit Committee, and, if so, what is their opinion?

To conclude, we support the staff's proposal to continue increasing, under current policies, the precautionary balances of the Fund with the caveat that, from the staff's analysis, it is not clear to us what would be their most appropriate level. We strongly encourage the staff to develop an analytical framework to measure the financial risk of the Fund. This tool will serve us to complement our judgment on this issue and to make better decisions with regard to the correct level and pace of accumulation of precautionary balances under different circumstances. Finally, we would also encourage the staff to explore the possibilities to use the Fund's gold position should the need arise, and to present them to the Board for its evaluation.

The Treasurer (Mr. Brau), in response to further questions and comments by Directors, made the following statement:

On Mr. Beauregard's question if the international accounting standards offer a view on whether expressing a target for the level of precautionary balances as a ratio to credit capacity is permissible, I am told by the chief accountant that there is no precise method in international accounting standards to do that, and our approach is consistent with international accounting standards. What the international accounting standards require is that a credit asset that is impaired, as is evidenced by non-payment, has to be reflected in the balance sheet using its realizable value. The international accounting standards are not more specific, and permit, in our view, expressing a target level for precautionary balances as a ratio of credit capacity.

Mr. Rutayisire asked whether the staff's recommendation to at least double the level of precautionary balances would have an impact on the rate of charge. The present system would not imply a change in the rate of charge. We are not, at this time, suggesting a change in the system, neither of surcharges, which are governed by the decisions of the Board and are themselves not changeable from year to year, nor in the determination of the rate of charge. That system will stay unchanged and, therefore, our recommendation in and of itself has no impact on the determination of the rate of charge.

In conclusion, the message that I take from this discussion is that while there is broad support for the continuation of the present method of accumulating precautionary balances and for at least doubling the level of precautionary balances, many Directors would like for us to work on a framework that allows—and here I take the language from Mr. Zurbrügg in particular, and echoed by others—assumptions to be made as transparently as possible. We will certainly endeavor to do that. I promise due diligence and

> due speed on this work, but I do not want to promise right now when we would report back to the Board with such a framework. It would be some time next year, but most likely not in the first half of the year.

Mr. Baukol, on the concern of many Directors that a more analytical framework was needed to make the assumptions more transparent, said that he agreed with the staff that the new framework, when developed, might not produce overly insightful findings. It would be surprising if the staff would come up with new indicators that would suggest that the current staff recommendation was well out of bounds. It was also uncertain whether there would be much benefit to try and formalize some sort of link between the assumptions and the actual target for precautionary balances in the future. On the role of gold, while it was clearly an undervalued asset on the Fund's balance sheet, and the amount of its undervaluation could be calculated, Mr. von Kleist and Mr. Prader were correct to suggest that it might not benefit the Fund to try to define the potential effect of the undervaluation of the Fund's gold on the adequacy of precautionary balances.

Mr. Prader welcomed the staff's message that they would develop a more analytical framework, which would include more transparent assumptions, for assessing the adequacy of precautionary balances. On the issue of surcharges, as the Board had already approved decisions regarding the annual income targets, it would be important to gather support from all Directors to ensure that the Fund's finances were put on a secure and broader footing. While for the next two to three years the level of income from surcharges would be high to ensure generating an adequate level of precautionary balances, there might be difficulties further down the road. Therefore, the staff should consider a range of options to achieve a faster pace of accumulating precautionary balances and place the Fund's income base on a broader footing, even though not many Directors mentioned the issue.

Mr. Padoan said that Mr. Baukol should not to be overly pessimistic on the further insights on the appropriate level of precautionary balances that could be derived from developing a more explicit risk assessment framework, especially those related to the alternative paces of accumulation. The staff should consider not only whether the level of desired precautionary balances should be doubled, but also, especially given the time span, the appropriate time path to develop the optimal pace of accumulation. In that regard, more transparent assumptions about the need to increase the target level of precautionary balances and the ways of financing that increase could be improved by a more rigorous analysis of the matter.

The Acting Chair made the following summing up:

> Executive Directors had a wide-ranging and productive exchange of views today on the adequacy and accumulation of precautionary balances in the General Resources Account. They agreed that the present level of precautionary balances appears insufficient to ensure the financial integrity of the Fund, in view of the growing concentration and volatility of Fund credit, as well as the increased risks associated with the more uncertain international

environment, and the frequency with which the Fund is called on to assist members facing capital account crises.

Directors recognized that the credit risk to the Fund now derives primarily from large arrangements with middle-income countries, which is different from the experience the Fund has had so far with members in protracted arrears. In this connection, the Fund should be prepared for the possibility of disruptions of payments due to significantly increased and more concentrated credit outstanding. Directors also noted other potential risks that pointed to the need for higher precautionary balances, including the risk of income losses resulting from unpaid charges exceeding the capacity of the burden-sharing mechanism, and from the Fund's increased responsibilities and related growth in administrative expenses. In addition, recent developments in insurance markets have raised the degree to which the Fund relies on its reserves to cover potential losses for which it is self-insured. At the same time, a number of Directors pointed out that other existing safeguards, such as the preferred creditor status of the Fund, the success of the arrears strategy, the quality of Fund-supported programs, and the existence of important undervalued assets, serve to mitigate these risks.

Against this background, and the likely difficulty in raising the rate of charge rapidly and by a sufficient margin to compensate for large income shortfalls when they occur, Directors considered that the Fund should continue to build up adequate precautionary balances to cover possible overdue principal, absorb losses in income, and preserve the Fund's reputation as a prudent financial institution, given its global reach. A higher level of precautionary balances would also bring the Fund's prudential ratios closer in line with those of other international financial institutions, and maintain compliance with International Accounting Standards. Some Directors expressed the view, however, that the Fund's desired prudential ratios could differ from those of other international financial institutions, among other reasons, because the Fund does not lend to the private sector or borrow in the markets, and that its debt outstanding is generally of a shorter maturity.

In the discussion on the appropriate level of precautionary balances, there was broad agreement that the Fund should maintain such balances to fully cover credit outstanding that is in protracted arrears and provide a margin for the exposure to risk associated with credit in good standing. Directors underlined the need for judgment in determining the appropriate level of precautionary balances. Many Directors thought that the use of quantitative risk models was not fully applicable, given the cooperative nature of the Fund and its status as a preferred creditor. A number of Directors, however, considered that a more analytical approach would be useful, including through the incorporation of debt sustainability analyses and vulnerability assessments to anchor and facilitate judgment on the appropriate level of precautionary balances. Directors noted that an increasing concentration of risk called for a further strengthening of surveillance and prudent lending decisions based on a high degree of policy commitment. In this connection, the implications of the current discussion for the Board's deliberations on the Fund's exceptional access policy would also need to be kept in mind. A number of Directors also expressed a preference for using credit outstanding, rather than credit capacity, as an indicator for assessing the need for precautionary balances—because credit capacity does not capture factors such as credit concentration. In this regard, it was suggested that an approach incorporating both concepts could also be considered.

Regarding the role of the Fund's gold holdings, a number of Directors suggested that the External Audit Committee be asked for an opinion regarding the potential effect of the undervaluation of the Fund's gold and possible competing uses of gold on judgments regarding the adequacy of the precautionary balances.

Most Directors viewed as appropriate on efficiency and equity grounds, the present system of accumulating precautionary balances, in which surcharge income and regular net income are placed to reserves. However, they emphasized that the pace of accumulation, which relies heavily on surcharge income, should be kept under close annual review in light of the uncertainties regarding flows of surcharge income and the risks confronting the Fund. Some Directors stressed the importance of considering a range of options to achieve a faster pace of accumulation in the event that future surcharge income is less than anticipated. In this connection, a few Directors expressed concern about the heavy reliance on surcharges, and suggested that the Fund's income base should be placed on a broader footing.

To conclude, the Board generally supported a doubling of the target for precautionary balances, and the maintenance of the present system of accumulating these balances, under which surcharge income and regular net income is placed to reserves and SDR 94 million a year is financed through burden sharing. Directors urged the staff to develop a more comprehensive analytical framework for determining the target level of precautionary balances—including more transparent assumptions—that takes account of credit capacity, credit concentration, and credit outstanding.

2. TANZANIA—2002 ARTICLE IV CONSULTATION; POVERTY REDUCTION AND GROWTH FACILITY—REVIEW, EXTENSION, AND WAIVER OF PERFORMANCE CRITERIA

Documents: Staff Report for the 2002 Article IV Consultation, Fifth Review Under the Poverty Reduction and Growth Facility, and Requests for Extension of the Arrangement and Waiver of Performance Criteria (EBS/02/187, 11/4/02; Cor. 1, 11/14/02: and Sup. 1, 11/18/02); and Selected Issues and Statistical Appendix (SM/02/342, 11/6/02; and Cor. 1, 11/14/02)

Staff: Reitmaier, STA, Hadjimichael, PDR

Length: 2 hours, 25 minutes

Mr. Usman submitted the following statement:

Key Points

Tanzania continues to pursue sound macroeconomic policies and to implement structural reforms under the PRGF-supported program. The excellent performance is a reflection of the commitment and determination of my authorities, including at the highest political level, to move the country beyond the PRGF mode.

Macroeconomic performance under the program remained strong. Real GDP grew by 5.6 percent in 2001 and is expected to grow by 6 percent in 2002. Overall inflation rate continued to decline to 4.4 percent by September 2002, while international reserves are recorded at a comfortable level of seven months of import cover.

The Bank of Tanzania is intensifying sterilization of operations through additional sales of liquidity paper in the amount of TSH 80 billion, and securitization of government debt approximately TSH 180 billion, in order to stem the excess liquidity and monetary expansion.

Structural reforms are pursued with vigor, as demonstrated by government's continuous withdrawal from economic activities best led by the private sector, the establishment of market-oriented regulatory framework, as well as other efforts geared to improving the investment climate. Prudent financial policies have preserved macroeconomic stability, while emphasis on fiscal transparency has improved public sector accountability.

Implementation of the Poverty Reduction Strategy Paper (PRSP) is on target, as reflected in budgetary allocations and other policy interventions. The authorities expect to present the second annual PRSP progress report during November 2002, which provides a comprehensive poverty assessment.

Performance targets were broadly met. My authorities have taken measures to address nonobservance of quantitative benchmarks on the reserve money, extra budgetary expenditure and accumulation of domestic arrears and structural performance criterion relating to the amendment of legislation to tighten approval procedures for incurring or guaranteeing new foreign borrowing

Introduction

My authorities wish to express their appreciation to the Fund as well as other multilateral institutions and bilateral donors for their continued support. The strong support from the international community has played a catalytic role in ensuring a successful reform process and has truly underlined the concept of partnership in development. My authorities will continue to pursue sound macroeconomic policies and to push forward with implementation of the remaining structural reforms in order to enhance the investment climate, and to promote private sector development with a view to move the economy to a higher growth path.

Recent Economic Developments and Prospects

Macroeconomic program objectives were broadly met during the period under review. Despite delays in some areas, my authorities have persistently pursued structural reforms. Real GDP grew by 5.6 percent in 2001 and is expected to accelerate to almost 6 percent in 2002, notwithstanding a deterioration of the outlook for the terms of trade of traditional agricultural exports. The overall 2001/2002 fiscal deficit, before grants, was about 1.7 percent of GDP lower than programmed due to lower recurrent expenditures, without adverse impact on allocation of priority expenditures. The overall inflation rate declined, reaching 4.4 percent in September 2002.

The external sector has strengthened considerably. The current account deficit (including official transfers) narrowed sharply from the equivalent of 9.2 percent of GDP in 1999 to 5.4 percent in 2001, on account of growth in nontraditional exports and a steady flow of foreign assistance coupled with HIPC debt relief. Although traditional exports are expected to decline reflecting unfavorable terms of trade, particularly for coffee, cotton and cashew nuts, overall exports are projected to increase on account of continued strong growth in nontraditional exports, mainly gold, as well as improvement in tourism receipts. Imports of consumer goods declined significantly partly because of the recent depreciation of the shilling, while imports of capital goods remained strong as mining sector activity continues to grow. Meanwhile, gross official reserves of the Bank of Tanzania increased to US$1.3 billion at end-September 2002, equivalent to seven months of import cover.

Performance Under The Program

Tanzania's performance under the program remains on track. All quantitative performance criteria and quantitative benchmarks on central government revenue for end-June 2002 were observed. A structural performance criterion on submission to Parliament of amendments of legislation, relating to tightening approval procedures for incurring or guaranteeing new foreign borrowing, was not observed, as a Cabinet decision determined that the requisite measures should be implemented in the context of the revised National Debt Strategy (NDS). To this end, several amendments to the existing Loans, Guarantees and Grants Act of 1974 will be submitted to Parliament in February 2003, when Parliament will be in session. In the interim, measures have been implemented to strengthen the process. Nonobservance of the reserve money which led to higher-than-programmed expansion in monetary targets resulted from factors beyond the authorities' control as well as limited instruments available at the Bank of Tanzania and the economy to adequately mop up excess liquidity. The rapid increase in liquidity was attributable to a number of factors including the following: (i) transfer of government deposits from Bank of Tanzania to accounts of local governments in commercial banks; (ii) merging and subsequently conversion of two non-bank institutions to a fully fledged commercial bank, and as a consequence, deposits in this bank became part of money stock; (iii) establishment of a new international bank in Tanzania with a sizable capital investment; (iv) a large inflow of private capital for mining, other investment projects as well as a large amount of foreign exchange inflow related to construction of embassy buildings. In response to this unforeseen liquidity creation, the Bank of Tanzania has intensified securitization of government debt to ensure observance of the monetary targets. To address the extra budgetary expenditures related to the air control system, the authorities will regularize the transaction through a supplementary budget during 2002/2003. Regarding the accumulation of domestic budgetary arrears, the authorities have put in place a mechanism through the existing IFMS to prevent recurrence of such arrears.

Fiscal Policy and Budgetary Reform

My authorities remain committed to maintaining fiscal discipline and transparency, enhancing government revenue mobilization, and improving public expenditure management, in line with the poverty reduction strategy. They concur with the staff on the need to broaden the tax base, to strengthen revenue collection efforts, and to improve expenditure management. In this regard, my authorities have accorded top priority to enhancement of revenue mobilization and have set in motion a process of addressing revenue enhancement issues. This process includes a recent request for a Fund mission to examine the cause for VAT's weaknesses and the poor performance. Following the mission's recommendations, my authorities will implement measures to enhance its collection. In the same vein, as part of the restructuring effort of tax administration supported by the World Bank, my authorities have retained the services of a consulting firm to assist in strengthening of tax administration.

The 2002/03 budget targets an increase in revenue-to-GDP ratio of 12.3 percent. To reach this target, my authorities have identified a number of revenue enhancing measures [indicated on pages 53 and 54 of the Letter of Intent (LOI)] to be implemented in the course of the 2002/03 budget and beyond. The measures will include, among others, abolition of customs and excise duty exemptions, rationalization of tax rates, improvement in tax administration, simplification of tax collection, review of tax laws and amendment of some of the existing tax incentives.

With regard to the export processing zones (EPZ) and the EPZ Act, my authorities have noted the staff's concern pertaining to potential revenue leakage. To this end, my authorities are reviewing the legislation with a view to targeting benefits that focus on access to AGOA and EU's import policy only.

On expenditure management, my authorities will continue to strengthen public expenditure reform and transparency, including through the mechanism of Integrated Financial Management Systems (IFMS). Furthermore, my authorities will harmonize presentation of priority expenditures across PRSP, the budget and budget execution reports, to facilitate better tracking of outlays to priority sectors. These procedures will be embedded in the 2003/04 budget guidelines. The provisioning of such a mechanism, with a view to ensuring funding for priority sectors, demonstrates my authorities' commitment to the poverty reduction strategy. My authorities will continue to enhance fiscal management and transparency at the local authority level as well, in order to consolidate fiscal decentralization. In this regard, quarterly reports on fiscal accounts for local governments, on a consolidated and stand-alone basis, will be published beginning end-2002.

Monetary Policy and Financial Sector Reform

My authorities seek to maintain price stability as the main objective of monetary policy, with reserve money as an indicative target. Given the recent rapid increase in demand for money, the monetary program envisages a 21 percent increase in broad money during 2002 compared to an earlier indicative target of 12 percent. Despite the recent increase in monetary expansion, my authorities are of the view that it is unlikely to put pressure on price levels because the increase largely emanates from the improvement of banking services delivery to rural areas and reclassification of financial assets. Moreover, treasury bills and other government securities remain the key instruments of monetary policy, supplemented by repurchase operations with commercial banks and the issue of newly-securitized government debt to address monetary expansion.

In paragraph 28, the staff raises an issue concerning Bank of Tanzania's perceived reluctance to address higher-than-targeted monetary growth on account of potentially undesirable appreciation of the exchange rate and high cost of liquidity paper. The framework within which my authorities are addressing the problem is indicated in the above paragraph. In addition, other measures are being taken, including the process of securitizing about TSH 80 billion during the fourth quarter of 2002. At the same time, Bank of Tanzania has increased the quantum of its own liquidity paper. In the same paragraph, the staff highlights a concern regarding various structural impediments to bank lending, which constrain private sector investment and contribute to the creation of a structural liquidity surplus in the financial sector. My authorities are cognizant of the structural impediments and concur on the need to implement measures that would enhance bank lending. In this connection, my authorities are already pursuing a number of measures including reviewing of the Land Act of 1999 with a view to amending it to facilitate use of land as collateral for bank lending. Other measures to facilitate financial intermediation include Bank of Tanzania's financial support to enhance capacity of the commercial court. Other related measures include computerization of land registry, establishment of a credit information bureau, and judicial reforms to ensure enforceability of legal contracts.

Debt Relief and Delivery

Regarding external debt, more progress is being made in concluding bilateral agreements with commercial creditors. My authorities wish to express their gratitude to the United Kingdom for the grand gesture of debt cancellation and wish that the other creditors who have indicated willingness to cancel will also do so. However, as indicated by the staff, non-Paris Club and commercial creditors are continuing to pose some problems. In this connection, my authorities wish to reiterate their request for assistance of the Fund and the World Bank in finding a more permanent solution to the HIPC-HIPC and the non-Paris Club bilateral and commercial creditors problem.

Debt Sustainability

To ensure debt sustainability, my authorities approved a revised National Debt Strategy (NDS) in August 2002. The strategy underlines the importance of fiscal sustainability through improvement in procedures, selectivity of projects, risk management, and strengthening of the legal and institutional framework with respect to borrowing and managing debt. The authorities have began implementation of the recommendations of the NDS.

Other Structural Reforms

The authorities continue to pursue privatization of public enterprises with a view to promoting private sector development. The privatization process is now focusing on public utilities and large financial enterprises including the Dar-es-Salaam Water & Sewerage Authority (DAWASA), the Tanzania Railways Corporation (TRC), the Tanzania Harbors Authority (THA), Air Tanzania Corporation (ATC) and the Tanzania Electric Supply Company (TANESCO) and the National Micro Finance Bank (NMB). The privatization status of the various entities is as follows: the process of unbundling TANESCO into autonomous commercial entities before privatization is underway, the transfer of DAWASA is expected to be completed by end-2002 after a delay of a draft concession agreement. Privatization of ATC and TRC is well advanced. Privatization of NMB is at an advanced stage and the investment memorandum is being sent to potential investors.

The divestiture of the 35 percent shares of the telecommunication company, TTCL, which the authorities sold to a foreign investor is being held by a dispute between the authorities and the foreign investor over the payment of a second tranche, which depends on the financial audit of the company's accounts for 2000. A dispute on the quality and accuracy of these accounts has thus far prevented an agreement between the authorities and the foreign investor. The authorities and the foreign investor are currently exploring possibilities of a conflict resolution mechanism.

Poverty Reduction Strategy

My authorities will present the second annual PRSP progress report by the end of November 2002. The report will draw on the poverty analysis resulting from the recently published 2000/01 Household Budget Survey. The second annual report will also draw on the Poverty and Human Development Report of June 2002, which provides an overview of the status of the main poverty indicators and includes a detailed analysis of various aspects of poverty, focusing particularly on vulnerability. To complement the PRSP process, my authorities are putting emphasis on maintenance of macroeconomic stability, identifying sources of growth that would be poverty-reducing, and creation of employment.

Technical Assistance

My authorities are grateful for the continued technical assistance support from multilateral and bilateral donors, covering a wide range of areas including balance of payments, revenue mobilization, public expenditure management, and financial sector strengthening. While technical assistance is being effectively utilized, capacity constraints still remain a problem because of the loss of qualified staff from the civil service and limited capacity in specific professions. In this regard, my authorities wish to underline the importance of continued technical assistance support and urge the Fund to give due consideration for technical assistance in the privatization of the People's Bank of Zanzibar.

Conclusion

While significant achievements have been made thus far, the road to prosperity remains a long and arduous one. My authorities have successfully implemented the "first generation" reform process. The challenge now is to move the economy beyond the reform process onto to a higher growth trajectory. Technical assistance, as well as concessional financing, remain critical in complementing the limited and over-stretched human and financial resource capacity. Moreover, the main issue that the authorities are grappling with is the need to identify sources of growth that would lead Tanzania to a higher growth path. Furthermore, having successfully implemented the first generation reforms, my authorities would wish to "graduate" from the PRGF approach, and therefore wish to explore possibilities of other instruments available in the context of Fund support. To conclude, my authorities request the Board to grant waiver for nonobservance of the structural performance criterion on the approval of procedures for foreign borrowing.

Mr. Reddy submitted the following statement:

Tanzanian authorities are to be commended for their impressive macroeconomic performance, evidenced by continuing robust real GDP growth rates, declining inflation and accretion of foreign exchange reserves to a comfortable level. Despite adverse commodity price developments, especially in coffee, exports are buoyant and GDP is projected to grow at an even higher rate. That Tanzania is one of the few countries to have reached HIPC completion point speaks for itself. The challenge now is clearly to sustain high growth and achieve substantial poverty reduction, while gradually lessening the dependence on external aid. In this regard, the authorities' efforts to improve revenue mobilization through a set of coordinated policy measures are welcome and need to be persevered with. So is the decision to review the tax exemptions for export processing zones, in order to make them better-targeted and to avoid revenue leakage.

We commend the Tanzanian authorities for determinedly pursuing their strategy of structural reforms. The initiatives to allow use of land as collateral for bank lending, judicial reforms to ensure enforceability of contracts, and setting up regulatory frameworks in tandem with privatization of public sector entities will, we believe, succeed in stimulating investment and putting Tanzania into a higher growth trajectory. We welcome the significantly increased budgetary allocations for social sectors, particularly health and education, in line with the PRSP.

As the well-written staff report testifies, the authorities are taking expenditure management measures to prevent the recurrence of domestic budgetary arrears and action is on the anvil to meet the structural criterion related to procedures for foreign borrowing. Insofar as overshooting the quantitative benchmarks pertaining to reserve money and broad money is concerned, the report acknowledges that this has not had much discernible impact on inflation and was warranted by the increased demand for money consequent upon a gradual deepening of the financial system. We are persuaded by the rationale, provided by Mr. Usman in his cogent statement, for the more-than-programmed monetary expansion, and of the approach being adopted by the authorities to address this issue. Such instances reaffirm our belief that rigid benchmarks should give way to more flexible criteria providing greater room for maneuver to the authorities in program countries.

We support the proposed review and waivers as well as the short extension to enable the program to be completed and wish the Tanzanian authorities continued success in their policy endeavors.

Mr. Steiner and Mr. Rambarran submitted the following statement:

At the outset, we thank the staff for the reports and Mr. Usman for his informative statement.

Since the mid-1990s, Tanzania has established a good track record of pursuing sound macroeconomic policies and implementing structural reforms that, last November, allowed it to reach the completion point under the enhanced HIPC Initiative. The international community has strongly supported this reform effort, as Tanzania has been one of the largest beneficiaries of official development assistance. Tanzania's recent macroeconomic performance under the PRGF-supported program remains satisfactory, despite a more uncertain global environment. Considerable progress has also been made in implementing the sectoral strategies defined in the PRSP, accompanied by improved expenditure management and more frequent reporting on budget implementation. The recent adoption of a National Debt Strategy, if fully implemented, bodes well for efficiently managing the country's external and domestic debt. We commend the Tanzanian authorities for these achievements, and encourage them to stay the course of reforms supportive of growth, peace, and stability.

Continued fiscal consolidation is central to sustaining macroeconomic stability and growth. Good progress has been made in the areas of expenditure reform and transparency. Tanzania's tax effort, however, remains below the African average of 15 percent of GDP. This has led to an unsustainable dependence on external financing. We, therefore, encourage the authorities to strengthen their efforts to widen the tax base and improve tax administration in the course of 2002/03 and beyond. As plans are being made to mobilize additional fiscal revenue, spending on poverty-reducing and other programs is targeted to rise. The authorities need to place a strong emphasis on better tracking of outlays in priority areas, especially at the local government level where implementation capacity is often weak.

The Bank of Tanzania (BoT) faces the challenge of managing exogenous pressures on monetary expansion arising mainly from large capital inflows and donor assistance to finance rising fiscal deficits. We agree that, in the short to medium term, the BoT will probably have to intensify its sterilization operations to mop up excess liquidity in order to prevent a resurgence of inflation. However, in the continued presence of sizable donor inflows and structural surplus liquidity in the banking system, perhaps the staff could indicate the interest cost to the budget of these sterilization operations. The authorities need to balance concerns about rising interest rates as a result of sterilization with those on export competitiveness stemming from a likely real appreciation of the Tanzanian shilling.

We welcome the various structural measures to enhance bank lending, including the review of the Land Act of 1999 to facilitate the use of land as credit collateral and the judicial reforms to ensure enforceability of legal contracts. A more enabling environment for microfinance would also help in reversing the process of financial disintermediation.

Full and timely participation of all creditors is crucial to the success of the enhanced HIPC Initiative, especially for post-completion point countries such as Tanzania. In this regard, we look forward to the conclusion of bilateral agreements with Paris Club creditors. We urge Tanzania's non-Paris Club creditors who have not already done so to participate in the HIPC Initiative, recognizing that some encounter difficulties in providing their share of debt relief. We commend Tanzania for taking the lead to settle this issue by establishing an escrow account earmarked for honoring debt-service payments to these creditors. We wonder if the staff could elaborate on the progress made by the Fund and the World Bank in formulating mechanisms to resolve this issue of salient concern to HIPC countries. What specific assistance is being provided to the Tanzanian authorities to encourage the participation of non-Paris Club creditors in the HIPC Initiative?

Over the medium term, Tanzania's external debt appears sustainable and its financing requirements are expected to be fully met. We note that the current PRGF-supported program, if extended, would end next June. Looking ahead, a possible successor arrangement would help the country to consolidate the gains under the present program and to prepare for exit from the PRGF framework. Mr. Usman's indication of his authorities' commitment and determination to move Tanzania beyond the PRGF mode is encouraging in this regard. Tanzania's case and that of other post-completion point countries such as Burkina Faso, recently discussed by the Board, raises the more general issue of an exit strategy for low-income countries, and the possible Fund instruments, if any, to support such a "graduation." We, therefore, look forward to next spring's staff report on the role of the IMF in low-income countries.

PRSP

Tanzania has a rich natural resource potential, good geographical access to markets, and enjoys a stable political environment. Yet with a per capita income estimated around US$250, it is one of the poorest countries in the world. We commend the authorities for steadfastly implementing their poverty reduction strategy oriented towards the achievement of the Millennium Development Goals, and look forward to the second annual progress report on PRSP implementation, which benefits from a comprehensive assessment of poverty in Tanzania. We believe that continued firm program implementation should lead to further improvement in social outcomes, especially in the high-priority areas of education, agriculture, and rural development.

Agriculture is central to growth and poverty reduction in Tanzania. It is the leading income generating sector and has the highest linkages and spin-off effects to the rest of the economy. We are, therefore, pleased that the government has confirmed its intention to encourage microfinance, which would increase access to credit facilities by the poor in rural areas, where most Tanzanians live. Better availability of price information, improved road infrastructure, and better coordination among the various government institutions would also go a long way in the transformation of agriculture and rural development.

We note the strong country ownership that has allowed the PRSP process to become the main instrument for coordinating domestic poverty reduction programs between the authorities and the international community. In several respects, however, the strategy remains a work in progress. In particular, there is need to further strengthen both Tanzania's absorptive capacity and the linkages between the PRSP and the budget so as to ensure that the poor benefit fully from the resources freed by HIPC debt relief.

In concluding, we support the proposed decision and wish the authorities well in their endeavors.

Mr. Mirakhor submitted the following statement:

Key Points

Tanzania continued its strong adjustment and reform effort under the PRGF-supported program, achieving impressive results;

Sustained implementation of sound macroeconomic and structural policies has laid a strong foundation for economic stability and growth;

Remarkable progress has been made in expenditure management in the effort to sustain fiscal consolidation. Revenue mobilization will, however, need to be intensified to support the poverty-alleviation program;

Strengthened liquidity management and improved coordination of fiscal and monetary policies are crucial to sustain macroeconomic stability;

We support waiver of the performance criterion, completion of the fifth review under the PRGF, and extension of the current arrangement to June 2003.

Tanzania has continued to achieve impressive results under its PRGF-supported program. Economic growth has been strong and sustained over several years, allowing concurrent increases in per capita incomes; inflation has been reduced to single digits; and the external current account and reserve positions have strengthened. Significant progress has also been made in wide-ranging structural reforms, including in the areas of privatization, expenditure management, agricultural sector reform, trade and foreign exchange liberalization, and governance. The 2002/03 program is appropriately configured to maintain these efforts. The key challenges are to intensify domestic resource mobilization, strengthen domestic liquidity and foreign exchange management, and improve the investment climate. We concur with the thrust of the staff appraisal. We also support waiver of the performance criterion, completion of the fifth review under the PRGF, and extension of the current arrangement to end-June 2003.

The authorities are committed to maintain fiscal discipline, which they consider to be central to sustaining macroeconomic stability, growth, and poverty alleviation. Commendable progress has been made in expenditure management, buttressed by the adoption of the centralized payment and cash-budget systems. Furthermore, expenditure composition has improved, with curtailment of current outlays and concurrent increase in poverty-related spending. We welcome Mr. Usman's indication in his helpful statement that steps are being taken to strengthen public expenditure management and transparency, including harmonizing presentation of priority expenditures to facilitate better tracking of these important outlays. Revenue mobilization, however, remains a key challenge. This will require action on a broad front, including a concerted effort to rationalize tax exemptions and make further improvements in tax administration to accommodate the need for higher spending in the social sectors. In this context, the 2002/03 budget incorporates important revenue-enhancing initiatives, especially with regards to a tightening of the administration of selected exemptions and the elimination of customs and excise duty exemption for government purchases. We welcome the authorities' intention to review the EPZ Act with a view to tightening up the "loose eligibility criteria" and avoid revenue leakages, as well as to rationalize the tax system to improve revenue. The authorities are also planning to take measures to rationalize and simplify taxes and levies at the local government level and intend to publish quarterly reports on fiscal accounts for local governments. The widening of the fiscal deficit in 2002/03 is driven by an expansion in priority expenditure programs and is expected to be financed by concessional external assistance.

Monetary policy has been appropriately geared to containing inflation and building reserves. The high rates of monetary growth have been driven by the large foreign inflows and strong monetary demand in the face of financial deepening. While monetary expansion has not jeopardized the achievement of low inflation, there is a need for vigilance to preserve macroeconomic stability. In this regard, strengthened liquidity management and improved coordination of fiscal and monetary policies are critical. Securitization of non-marketable government debt could provide a useful instrument of liquidity management. The recent fall in interest rates has not had a significant impact on the very large spreads and lending rates have remained rigid on account of structural impediments to bank lending. Accelerating efforts to remove these impediments, including a review of the Land Act to enable collateral, would help promote a more dynamic financial sector and raise the productive capacity of the economy.

Tanzania's exchange rate policy appears to be appropriate. A careful balance is required between intervening in the foreign exchange market for purposes of liquidity management and preserving a competitive exchange rate. The Selected Issues paper underscores that export competitiveness must be seen in a broader context that goes beyond movements in the exchange rate and encompasses structural reforms aimed at improving productive efficiency and removing impediments to private sector development. In this context, we look forward to the follow-up to the policy matrix of short-term actions relating to the investment climate that emerged from the recent Investor's Roundtable conference.

We commend the authorities' strong commitment to structural reforms. The staff noted that the privatization of large strategic enterprises in the transportation and utility areas is proving to be "more difficult" than previously anticipated. However, despite the complexity of the task, the limited capacity and the less-than-propitious investment environment, progress has been made, as indicated in paragraph 34 of the staff report. Given the difficult financial condition of many companies, it will be important to keep up the momentum of privatization and proceed along the lines outlined in Mr. Usman's statement. It is hoped that an agreement will be reached on an equitable policy on retrenchment benefits and a resolution is found to the dispute regarding the divesture of the 35 percent shares of the telecommunications company. We look forward to completion of the civil service reform which should help attract qualified personnel, halt the departure of well-trained staff, and improve the quality of service.

A cautious external debt management policy buttressed by full delivery of relief under the enhanced HIPC Initiative will be crucial for keeping the debt profile sustainable over the medium to long term. The authorities' intention to tighten the approval procedures for foreign borrowing to ensure better coordination is welcome, and we agree with their view that the final approval is better left to the Ministry of Finance. We welcome progress in concluding bilateral agreements with Paris Club creditors and in securing Kuwait's and Libya's participation in HIPC and encourage other non-Paris Club creditors to follow suit.

In sum, Tanzania's performance under the PRGF has been inspiring and the authorities' persistent and courageous adjustments efforts are beginning to bear fruit. Nevertheless, as Mr. Usman notes, the "road to prosperity remains a very long and arduous one" and many challenges remain. The authorities should be encouraged to stay the course and further strengthen the foundations for high and sustainable growth and poverty alleviation.

Mr. Isleifsson and Mr. Farelius submitted the following statement:

Key Points

Tanzania has made substantial progress in macroeconomic stabilization and structural reform during the last years and its performance under the program supported by the PRGF has been positive.

In view of the comparatively low revenue-to-GDP-ratio, as well as with a view to successively decrease its aid dependency, one of Tanzania's main challenges is to raise government revenue and strengthen the fiscal framework.

The large external inflows make it important to generate further instruments for liquidity management. Moreover, the authorities should be commended for requesting an FSAP, which will help Tanzania to strengthen the financial system.

Continued privatization is of vital importance to the further development of the private sector and consequently to economic growth in Tanzania. It is important that the authorities do not lose momentum in their privatization efforts.

Clarification from the staff on the implications on debt sustainability of the non-compliance of some non Paris Club and commercial creditors would be appreciated.

We would like to thank the staff for a comprehensive set of papers, and Mr. Usman for his informative statement. Tanzania has made substantial progress in macroeconomic stabilization and structural reform during the last years. The authorities should be commended for their efforts in raising the rates of growth and reducing the rate of inflation. Furthermore, we welcome the achievements so far in the area of structural reform, which, if continued to be pursued vigorously, should further improve the underlying performance of the economy.

We support the proposed review and waivers, as well as the short extension to enable the program to be completed. While we are in general agreement with the staff on the assessment and recommendations in the reports, we will focus our remarks on the need for further revenue enhancing measures, monetary policy, structural reform, not least the need to speed up the privatization process, and finally, the debt sustainability situation.

Further Revenue Enhancing Measures Needed

It is clear that one of the key challenges facing Tanzania, as well as other countries in the region, is to raise government revenue, not least with a view to decrease its dependence on external assistance. In this regard, increasing domestic revenue mobilization by broadening the tax base and improving expenditure management is the key. Regarding the medium-term outlook on fiscal revenue, in paragraph 18 of the report, the staff suggests a more ambitious increase in fiscal revenue of about 2-3 percentage points of GDP from 2003 to 2006 as appropriate in view of the slow increase of fiscal revenue. In paragraph 21, the staff suggests that this should be done by, “broadening the tax base in an equitable way.” It is unclear how the staff envisages this broadening to be implemented and hence comments from the staff would be useful.

We fully concur with the staff that the recently adopted act on export processing zones (EPZ Act) is not consistent with the current revenue policy; indeed the revenue efforts could be eroded by the existing tax exemptions. Therefore, we welcome the authorities’ decision to delay the coming into effect of the EPZ Act, as well as the decision to review its provisions.

Generally, it could be noted that there is presently significant analytical work on revenue issues in Tanzania being conducted both by the Fund and by other institutions. Some results point to high economic growth, together with a gradual shift towards a larger share of the formal economy as major factors for increased revenue. One explanatory factor of the low tax-to-GDP-ratio in Tanzania is the relatively low monetization of the economy.

Improving the Absorptive Capacity of Monetary Policy

The Tanzanian authorities should be commended for having successfully brought down the rate of inflation during recent years. The main challenge in the monetary policy area now is how to handle the large foreign inflows of primarily donor support. Apart from better coordination between donors and the authorities in order to increase the predictability of aid inflows, it is important to generate further instruments for liquidity management. In this regard, while welcoming the authorities' move to convert the government's large stock of non-marketable debt to the Bank of Tanzania into securities with maturities ranging up to seven years, we agree with the staff that additional sales of liquidity paper will be needed in order to restore positive real interest rates.

As regards the authorities' efforts to strengthen the financial sector, we welcome the plan to prepare measures that will unblock the use of land as collateral for bank loans. We are also encouraged by the authorities' request for an FSAP, which we are sure will be helpful in mapping out the areas in the financial sector in need of further strengthening.

As regards data on inflation developments, the staff suggests that the CPI basket should be updated. This seems important since the consumption pattern probably is changing, most rapidly in the urban areas, but possibly also in the rural ones. The household budget survey 2000/01 contains some indications that the food share of the total consumption may have declined. As the price of non-food items has tended to increase at a higher rate than the food items, this may imply that inflation is higher than indicated by the CPI.

Important Not to Lose Momentum on Privatization Efforts

Continued privatization is of vital importance for the further development of the private sector and consequently to economic growth in Tanzania in general. While welcoming the achievements so far in this area, further efforts, especially as regards the sale of large strategic enterprises in the utility and transportation areas will be important. Moreover, we concur with the staff that, although improvements have been made in past years, the investment environment remains difficult, and further measures in the areas of institution-building and administrative and legal reform will be necessary to achieve higher growth. In this regard, we welcome the Investors' Roundtable inaugurated in July 2002 and stress the importance of measures to address the areas the Roundtable identified as impediments to the investment climate.

While the development agenda of the authorities is to be commended, there could be a risk of "process overload" in regard to the many simultaneous processes taking place, which all demand intense attention by key officials in the Tanzanian public institutions. The delays in the observance of some of the structural benchmarks could be seen in this context. High ambitions, both by the government and its development partners, could add up to unrealistically short implementation periods. Coordination between the authorities and the international community seems therefore to be important for a continued successful implementation of structural reform.

The fight against corruption and measures to improve governance will be crucial for sustained growth. We are encouraged by the fact that Tanzania improved its standing in the Transparency International report of this year. However, the consultant report on the state of corruption in 2001, referred to in paragraph 37 of the staff report, reveals that there is still a lot to be done by the government to demonstrate a clear political commitment in the fight against corruption. We, therefore, urge the authorities to increase their ambitions in this area.

Debt Sustainability

According to the staff report, Tanzania's public and publicly-guaranteed external debt is sustainable, provided that the debt relief under the enhanced HIPC Initiative is fully delivered. As indicated in Mr. Usman's statement, some non-Paris Club and commercial creditors have failed to provide debt relief on terms comparable to those obtained in the Paris Club. It would be useful if the staff could assess the implications of the non-compliance with the HIPC Initiative of non-Paris Club and commercial creditors on the debt sustainability indicators. We also support the authorities' request for assistance from the Fund in encouraging the participation of non-Paris Club creditors in the HIPC Initiative.

Other Issues

The form of future Fund support for Tanzania will, of course be influenced by the forthcoming review of Fund assistance to low income countries. As indicated by Mr. Usman, the Tanzanian authorities would wish to "graduate" from the PRGF approach. We support this goal and find it important that the next program includes an exit strategy from the PRGF framework.

Finally, we encourage the authorities to consent to the publication of the staff papers.

Mr. Ondo Mañe submitted the following statement:

Tanzania's economic performance under the PRGF-supported program has been satisfactory in 2001/2002, with real growth rising by almost 6 percent and overall inflation falling. Large financed inflows and higher exports of gold have contributed to lower external current account and gross official reserves remain well above the three months' threshold. All performance criteria but one, and most of the benchmarks, have been met. I commend the authorities for this performance and for the strong implementation of policy measures. Overall, I am pleased to note the commitment of the Tanzanian authorities to the adjustment process, and the significant progress being achieved. I am also encouraged by the authorities' determination to continue the reform efforts.

In the fiscal sector, the continuation of fiscal consolidation will be central to the improved economic performance over the medium term. I welcome the measures taken, such as the adoption of a centralized payment system, to improve expenditure management. I note the fiscal deficit in 2002/03 is likely to widen, due to higher poverty reduction-related spending entirely financed by external concessional loans. In that connection, I think that the revision of the National Debt Strategy in August 2002 is an important step to support the fiscal policy with regard to debt management and I welcome the early implementation of its recommendations. Quarterly reports from local governments, in the context of fiscal decentralization, are also important step to improve use and tracking public resources, especially those stemming from HIPC debt relief.

Although fiscal performance has been quite good in 2001/02, revenue mobilization to date did not provide significant results since tax administration as well as tax policy reforms have been weak. I welcome the measures, mentioned in Mr. Usman's informative statement, to improve revenue collection, in order to achieve the revenue target for 2002/2003. In particular, I appreciate the authorities' cautious attitude to postpone enforcement of EPZ Act, in order to ensure a global tax legislation consistency aiming at avoiding revenues leakages, while granting specific exports-related benefits to EPZ participants. I support also the authorities' request for Fund technical assistance for the enhancement of tax administration.

In the monetary sector, I am encouraged that the monetary authorities maintain price stability as the main monetary policy objective. Moreover, given the explanations of monetary expansion, I agree with Mr. Usman that risks to inflation revival are quite low. However, I urge the authorities to keep an eye on the evolution of inflation. In this vein, the BoT resolution to mop up excess liquidity through sterilization operations and securitization of government debt is appropriate.

I welcome the authorities' intention to continue the strengthening of the financial sector, especially with regard to the use of land as collateral for bank loans and the development of microfinance in the agricultural sector. I would like to highlight the necessity to set up a well-disclosed legal and regulatory framework regarding land reform. This issue of land is more important in the context of parastatals reform, where many workers will be laid off and in those circumstances, land acquisition for business purposes could be a solution for their reintegration into the economy. It could be linked to the strategy implemented to foster agricultural activity. Similarly, I welcome the inauguration of Investors' Roundtable in July 2002 aimed at addressing impediments to investment.

Turning to the external sector, it is regrettable that traditional exports are not benefiting from the real depreciation of the shilling. However, I am pleased to note that diversification of the export base is increasing, as non-traditional exports offset in 2001/2002 the reduction of traditional coffee and cotton exports, and are projected to more than compensate their further decline. This should encourage the authorities to pursue the export base diversification process, in particular through the EPZs.

As regards the privatization process, I support the suggestion to wait for the conclusions of PSIA to update divestiture policy and program and to seek opportunities for retrenched workers. In particular, I think the problem of accompanying the social plan is of primary importance and should be addressed seriously, given the risks of further disputes.

Turning to poverty reduction, I welcome the holding of stakeholders' meetings at the local level, which, together with the household budget survey and poverty and human development report, should help to update and improve the strategy. Good progress has been made in implementing the poverty reduction strategy, especially with respect to the participatory process, and I welcome the creation of a fund at the BoT to secure resources from debt relief aimed at financing the strategy. I look forward to the second annual PRSP progress report by end-November 2002.

With those remarks, I support the request for waiver of the performance criterion, the completion of the fifth review under PRGF and the extension for three months of the present arrangement, and wish the authorities every success in their endeavors.

The staff representative from the African Department (Mr. Reitmaier) noted that a supplement for the staff report with a revised decision on Tanzania's request for waivers under the PRGF, had been issued earlier in the day. The need for a revised decision stemmed from a claim by Russia that Tanzania was in arrears on US$735,000 of debt payments. Tanzania had disputed the amount owed, based on the applicability of the November 2001 bilateral agreement between Russia and Tanzania under the Paris Club agreement. However, Tanzania had identified one small amount—US$3,600—as being post-cutoff date debt, even though it had been identified by Russia as pre-cutoff date debt. As the staff had advised, the Tanzanian authorities had paid this amount. Nevertheless, as the payment was late, that constituted a nonobservance of the performance criterion on the non-accumulation of external arrears, which gave rise to the need for a request for a waiver. It should be emphasized that the staff's advice to pay that amount did not constitute a staff judgment on the entirety of the claim by Russia. It was only a recognition that this amount was not in dispute, and the staff rendered no judgment as to whether it represented pre- or post-cutoff date debt. The remaining dispute on the bulk of the initial claim needed to be further discussed between Tanzania and Russia.

The authorities had consented to the publication of the staff report, and would be consulted about publication of the supplement as well, the staff representative added.

Mr. Usman confirmed that his authorities had consented to the publication of the Fund report. The issue of payment arrears was a subject of ongoing discussion between the Tanzanian and Russian authorities, but the undisputed amount was already paid.

Mr. Mirakhor welcomed Mr. Esdar as a new Acting Secretary.

Mr. Isleifsson commended the authorities' decision to publish the staff report, noting that this step was of great importance to a country like Tanzania, where increased transparency and substantive reports would enhance the quality of economic discussion within the country.

Mr. Wei made the following statement:

> At the outset, let me join other speakers in thanking the staff for the well-written papers, and Mr. Usman for his comprehensive and insightful statement. The Tanzanian authorities should be commended for the excellent macroeconomic performance. Economic growth has remained strong, inflation has been kept under control, and international reserves are at a comfortable level. Prudent fiscal and monetary policies have been the anchor of macroeconomic stability, and structural reforms are contributing to enhanced efficiency, competitiveness, and sustained growth. Implementation of the PRSP is on target, as reflected in budgetary allocations and other policy interventions. The authorities' resolve to achieve their end-2000 and medium-term macroeconomic targets is a demonstration of their commitment to sustain a solid track record. As we broadly agree with the thrust of the staff appraisal, we will confine ourselves to a few points for emphasis.
>
> The authorities correctly regard fiscal consolidation as central to sustaining macroeconomic stability and growth, and they remain committed to maintaining fiscal discipline and transparency, enhancing government revenue mobilization, and improving expenditure management, in line with the poverty reduction strategy. We welcome the authorities' efforts to improve

revenue mobilization, through well-coordinated policy measures, including abolition of customs and excise duty exemptions, nationalization of tax rates, improvement in tax administration, review of tax laws, and amendment of some of the increasing tax incentives. We also welcome the decision to review the legislation on the export processing zones, in order to increase exports, as well as avoid the possibility of revenue leakages in the future.

On monetary policy, we are encouraged that price stability remains the main objective of monetary policy, with reserve money serving as the operating target. We share the view that the recent monetary expansion is unlikely to put pressure on price levels, because the increase largely emanates from the improvement in the delivery of banking service to rural areas, and the reclassification of financial assets.

On financial sector reforms, in order to promote financial intermediation and further development of the financial sector, it is important to take measures to remove impediments to bank lending. In this regard, we welcome the authorities' commitment to engage in a consultative process with the banking community, with a view to determining the scope of any needed amendments of the Land Act, so as to facilitate use of land as collateral for bank lending. Other measures to facilitate financial intermediation, including the Bank of Tanzania's financial support, enhanced capacity of the commercial court, computerization of land registry, establishment of a credit information bureau, and judicial reforms to ensure enforceability of legal contracts, are also commendable. While welcoming the establishment of an export credit guarantee scheme, with a view to promoting agricultural exports, we are not quite clear about the mechanism, and the legal and the institutional framework, of this scheme. The staff's elaboration on this topic would be welcome.

Finally, while we take note that technical assistance is being effectively utilized, capacity constraints still remain a problem. Therefore, we join Mr. Usman in urging the Fund to consider the possibility of technical assistance in the privatization of the People's Bank of Tanzania.

In conclusion, we support the completion of the review, the authorities' waiver request, and the proposed decisions, and we wish the authorities continued success in their policy endeavors.

Mr. Brooke made the following statement:

We welcome the Tanzanian authorities' continued commitment to pursuing sound macroeconomic policies and structural reforms and note the progress they have made on their Poverty Reduction Strategy, including, importantly, in the area of governance. Reflecting these positive developments, we support the proposed waiver and completion of the 5th review.

We broadly share the staff's assessment, and I will, therefore, focus my comments on four key areas of the program and one issue relating to documentation.

First, approval procedures for foreign borrowing. Here we strongly support the staff's call for tighter controls on new foreign borrowing and for appropriate prioritization of new expenditure projects. The need for this was highlighted in previous staff papers relating to the ATC project. Consequently, we share the staff's concern about the delay in approving new procedures. That being said, we are prepared to accept the staff's judgment that the authorities' amendments to the Loans, Guarantees, and Grants Act will deliver a more coherent debt management strategy that would avoid a recurrence of the ATC episode. We would, however, welcome some clarification from the staff about the extent to which the new procedures will improve transparency.

My second point relates to the management of aid flows. This is becoming an increasingly important issue in both Uganda and Tanzania and is a topic that deserves further analysis—both in dialogue with donors in Tanzania, and in other countries. As the International Community mobilizes additional aid, in line with the targets set out in Monterrey, it will be important for the Fund to help countries to absorb the inflows they need to achieve the MDGs without precipitating other problems for macroeconomic management.

In Tanzania, this issue is closely related to financial deepening and resource mobilization. The staff highlights that strong monetary expansion has been at least partly caused by large and unsterilized foreign aid inflows. This, in turn, risks rekindling inflation. Moreover, looking to medium-term prospects, staff warn of possible Dutch Disease-type effects on external competitiveness from large aid inflows and private investment.

Against these risks, I found it puzzling that inflation is projected to continue falling in the near term. Is this because of the impact of the staff's forecasts for further declines in commodity prices? I would welcome some clarification from the staff on this point.

Clearly, the authorities are very concerned about the risks of a real appreciation of the Tanzanian shilling owing to aid inflows. Indeed, their relatively modest sterilization actions suggest that they may well be overly concerned about this prospect. That being said, we do not know a great deal about how financial deepening, increased monetization and increased absorption in Tanzania will influence the degree to which increased aid affects short-term macro stability and the medium-term path of the real effective exchange rate. Until the staff and the authorities have undertaken a fuller analysis of these issues, it would seem sensible to adopt a flexible approach to monetary policy management. We feel, therefore, that the authorities need to remain alert to any signs of emerging inflationary pressures and to tighten monetary conditions through more aggressive sterilization and foreign exchange sales, if and when inflation pressures re-emerge. I guess this places our position on this issue somewhere between the views of the staff and the authorities.

This brings me to my third point, financial sector deepening. The staff helpfully exposes that structural impediments to bank lending are constraining investment and contributing to excess liquidity in the financial sector. Given this situation, an in-depth analysis of necessary measures to deepen the financial sector and improve banking competition is needed. Hence, I agree with Mr. Wei and other Directors on the need for reforms to facilitate the use of land for collateral. We hope that the FSAP will address these issues and that together with any recommendations from the Investors' Roundtable, will lead to the development of a comprehensive program of policies, actions and technical assistance. We would like the staff to give further attention to these important issues in subsequent program reviews.

Fourth, I join the staff and other Directors in calling for renewed efforts to reduce tax exemptions and to improve revenue administration. The large size of the informal and subsistence sectors—which are a cause of the thin financial sector—are also making it difficult for the government to increase revenue mobilization in the short-term. As the economy gradually becomes more formal, the financial sector will deepen, the tax base will widen, and aid dependency should start to fall.

Finally, I welcome the introduction by the staff of the table on actions to strengthen expenditure tracking. The update of the joint Bank/Fund tracking diagnostic is particularly helpful. I would encourage the staff to maintain this format in all PRGF reviews. This approach is consistent with the underlying philosophy of NEPAD and should provide us with a clearer understanding of where progress in this critical area is being made, and where additional analysis and technical assistance are required. Additional information to assess progress over time in these areas would also be helpful.

We wish the authorities further success with their reform agenda.

Mr. Fabig made the following statement:

We welcome the progress that has been made in Tanzania during the last years. Mr. Usman is right when he states that the first generation reform process was successfully implemented. It is particularly reassuring that growth in Tanzania does not stem from a single source, but from sectors so diverse as tourism, mining and agriculture. Just like the giraffe—the symbol of Tanzania—cannot stand on one foot alone, Tanzania seems to have decided not to let its economy stand on only one foot. This diversification makes Tanzania much less vulnerable to external shocks than many other developing countries.

However, there is still room for improvement, and thus I would like to make four points.

First, I fully concur with the staff's view expressed in paragraph 18 that revenue collection in Tanzania must be improved. This point is all the more critical as Table 4 states that the overall deficit, before grants, is scheduled to rise from 5.6 percenet of GDP in 2001/2002 to 9.8 percent in 2002/2003. Very clearly, improved revenue collection would reduce Tanzania's aid dependency and would thus be an important step towards the graduation that Mr. Usman outlines. The Fund should certainly try to support this progress by providing Technical Assistance where appropriate.

Second, concerning the risk of rekindling inflation, I would like to ask the staff if they are persuaded by Mr. Usman's rationale for the recent monetary expansion, or if these arguments were already taken into consideration when judging, in paragraph 29 of the staff report, that the risk of rekindling inflation is real.

Third, I agree with the staff's recommendation to the authorities to announce indicative quarterly targets of foreign exchange sales. However, this procedure must not be abused to steer the exchange rate in a way that is inconsistent with market developments.

Fourth, weaknesses in the Tanzanian banking system remain a source of concern. Financial intermediation needs to be improved. A strengthening of the judiciary would—among other things—improve the framework for bank activity. Moreover, measures to unblock the use of land as collateral for bank loans should be taken as soon as possible. These and other improvements in Tanzania's financial sector would remove serious obstacles to bank lending, investment and growth. They could thus be among the sources of growth that would lead Tanzania to a higher growth path.

Concerning the bilateral debt issue that is raised in Supplement 1 of today, I would like to express, at this stage, my hope that this issue will be settled in a mutually satisfactory way.

In closing, let me say that I support the proposed revised decision and that I hope that, given truly committed authorities, Tanzania's future will be as bright as a sunrise on the Serengeti plains.

Mr. Guinigundo made the following statement:

Tanzania has indeed gone a long way since the union of Tanganika and the islands of Zanzibar in 1964. The support of the international community has been critical in this respect. Tanzania's impressive performance in the real sector and in the implementation of structural reforms has been the key to unlock this very important source of material support.

Tanzania sustained such a performance, as shown by the staff report for the 2002 Article IV consultation and Fifth Review under the PRGF. Growth has averaged 5 percent in the last 2 years of the PRGF-supported program while inflation has dropped below 5 percent. With the exception of a few slippages in meeting some of the performance targets, we can agree with the rest of the Directors in granting the waivers to the Tanzanian authorities. After all, as Mr. Usman indicated, his authorities have already taken measures to address the unfinished business.

Going forward, we believe the key issue for Tanzania is to sustain economic growth to be able to reduce its heavy dependence on donor support while addressing the overriding issue of poverty.

What is central for Tanzania's ability to sustain the momentum of economic growth is to improve its overall competitiveness in exports, tourism, construction and mining.

In terms of enhancing external competitiveness of Tanzania, the immediate task of the authorities is to keep the momentum of structural reforms. We join Mr. Reddy, Mr. Steiner and Mr. Rambarran and the other chairs in commending the authorities in this important area of structural reforms. This is their most effective countervailing force to real exchange rate appreciation. As the fundamentals analysis by the staff shows, while the Tanzanian shilling suffered from a large overvaluation in 1997–98, the implementation of important economic reforms has made a sea of difference because the overvaluation was reduced to 10 percent by 2001. Moreover, the trend is converging towards some equilibrium level.

There are also remaining challenges to Tanzania's other aspects of competitiveness. The provision of key infrastructures is indispensable. As the staff pointed out in the Selected Issues paper, Tanzania needs to do more work in reducing the costs of transportation, electricity, and telecommunications. Moreover, the banking system, while considered relatively open, is far from adequately serving the credit requirements of business. Labor hiring practices also need to be made more flexible to support the relatively less-disruptive work environment. Strengthening the educational system will also be important to ensure a durable strategy of growth and development.

Beyond these, there are two pillars that have to be built to afford Tanzania even greater latitude in pursuing growth and addressing poverty among its people.

The first pillar is the effective mobilization of revenues. This is easier said than done, as shown by the experience of many countries. But we are confident Tanzania, with its demonstrated record of reform, will be able to expand the tax base in an equitable fashion, as its revenue to GDP ratio remains low, due to the large size of the informal economy and the widespread poverty. The four-point 2002–2003 budgetary plans to increase revenues and the six-point plans for the medium term are quite impressive.

In this connection, we draw the staff's attention to the Letter of Intent of the authorities. It talks of reducing revenue leakage. How do they specifically intend to do this? What is the extent of revenue leakage in Tanzania? How serious is it? What specific suggestions can the staff offer in terms of governance?

The second pillar is the strengthening of public expenditure management. We are encouraged by the level of awareness among the Tanzanian authorities of the need to harmonize the presentation of priority expenditures based on uniform budgetary codes across PRSP, budget and budget execution reports as a first step to achieve effective PEM. This is also true for the plans to sustain the enforcement of fiscal discipline and transparency especially on the local government levels. With their hands full, we encourage the Tanzanian authorities to keep pushing for these important measures to take roots. They will serve the country in an important way in ensuring the integrity and medium- and long-term prospects of Tanzanian public finances and contribution to real growth. There is no time to lose or integrity to compromise if Tanzania were to sustain its path to more dynamic economic growth.

As a final point, I join Mr. Isleifsson and Mr. Farelius in indicating the possible precariousness of the debt situation in Tanzania on account of the non-delivery of debt relief from non-Paris Club members and commercial creditors. A more definitive assessment by the staff will be most useful.

Tanzania has chalked up very impressive accomplishments and we wish the authorities will be able to sustain these in the years ahead.

Mr. Alazzaz made the following statement:

Tanzania's policy perseverance is paying off in the rising, albeit still modest, pace of per capita income growth. The outlook also remains favorable in a welcome environment of falling inflation, fiscal improvements, and rising external reserves. I also commend the authorities for ensuring the rise in fiscal spending on priority areas. It is set to exceed this year's program target. As Mr. Usman underscored in his comprehensive statement, the country's progress also reflects the catalytic role of external assistance. Clearly, notwithstanding the relatively minor policy slippages, the international community's continued support is necessary and well-deserved.

Against that background, I support the proposed decision to complete this review and grant the requested waivers. I also broadly agree with the staff appraisal. I will therefore only add a few brief remarks for emphasis.

First, the authorities are rightly focused on policies to sustain a higher growth. In that context, I am encouraged by the evident progress toward further economic diversification. The economy's enhanced resilience is evident in the ability to withstand the adverse effects of the falling pries of traditional commodity exports. While gold exports have been a major element in this trend, help has also come from other sources including tourism. Here, I will appreciate the staff's views on further prospects for growth in nontraditional exports.

Second, regarding the importance of additional fiscal consolidation, the emphasis is rightly on improved administration and rationalization of revenues, and stronger controls and prioritization of spending. This is clearly to be preferred to an increased reliance on fresh tax measures. In that connection, I welcome the authorities' active collaboration with the Fund and the World Bank. Implementation of the envisaged reforms, including the sustained focus on restructuring in favor of the priority sectors, bode well for further growth and poverty reduction.

Third, I welcome the authorities' continued priority for containing inflation. Indeed, price pressures, while slowing, are still sizable and should be closely watched to avoid any reversal of the downtrend. Regarding the policy details, I can appreciate the authorities' case for some flexibility on monetary targeting in an economy still at a somewhat early stage of monetization and exposure to banking. In that connection, I welcome the authorities' emphasis on facilitating greater banking intermediation through far-reaching reforms. I note in particular the moves toward use of land as security for bank loans and strengthening the judicial framework for enforcement of contracts.

Before I conclude, I thank the staff for a well-written and insightful report. With these remarks, I wish the authorities further success.

The staff representative from the African Department (Mr. Reitmaier), responding to questions from Executive Directors, noted that while the interest cost of potential monetary sterilization operations was a concern for the authorities, it should not be an insurmountable problem. Although the staff had not separated out the estimated interest expense, the current budget under the PRGF program did incorporate the cost of interest payments resulting from securitization of previously non-marketable debt. Moreover, the other cost of liquidity paper issuance would be incurred by the Bank of Tanzania (BoT), and should be offset by the interest earned on international reserves, which had increased as a result of large donor capital inflows. Therefore, the staff believed that priority should continue to be given to the monetary stabilization objective, over concerns about the cost of sterilization.

On the export credit guarantee scheme, the BoT would be providing a limited amount of seed money to this scheme, and a larger amount would be supported by the budget, the staff representative stated. Once the scheme was off the ground, however, it would be turned over to the private sector and it was expected to become self-sustaining. The staff had emphasized to the authorities the need to limit strictly any exposure of the central bank.

The inflation projection in the staff paper was based on the BoT's own target, which the staff considered to be consistent with the intention to tighten monetary conditions, the staff representative continued. The staff's monetary policy recommendation tried to balance the objectives of accommodating the expanded demand for money and financial deepening against the risk of rekindling inflation. The staff had taken into account the explanation given by Mr. Usman and his authorities, that the growth of broad money figures had been largely due to a shift of government deposits from the Bank of Tanzania to accounts of local governments and commercial banks, but the staff believed that this had contributed only one percentage point of growth in the money supply in June 2002. Therefore, the staff continued to urge caution, as significant lags could be involved between the expansion of money and the inflationary impact. The final staff recommendation was positioned in the middle between the initial staff view and the Tanzanian position. Accordingly, the envisaged monetary program accommodated a significant increase in the targeted money supply, but also required some tightening action, through the securitization of government debt, and the issuance of additional liquidity paper—to be paid for by expected income from the investment of international reserves.

On a topic related to the budget, one Executive Director had asked about strategies to broaden the tax base in an equitable manner, the staff representative noted. Tanzania relied on wage taxes, VAT, and import taxes, all of which tended to be easy to collect. To broaden the tax base, authorities would need to reduce tax exemptions, tax the informal sector of the economy, and rationalize local government taxation. An estimate of total tax leakage was not available.

Transparency of debt management had improved, the staff representative remarked. The national debt strategy had been published and would be the subject of quarterly reports by the government, and decisions about the debt were subject to the public expenditure review, as were public investment projects in that context. Moreover, as noted in the staff report, the new database of donor-funded projects had also led to a significant reassessment of the totality of donor flows for project finance, which had improved the identification and direction of resources for individual projects in the budget.

On specific measures that the Fund could take to encourage non-Paris Club creditors to participate in the HIPC Initiative, the staff had suggested to the authorities that the BoT set up an escrow account to service foreign debt, which might provide an incentive for creditors to reach an agreement on debt relief at HIPC terms, the staff representative noted. Tanzania had agreed to set up such an account, even though, given the country's high level of international reserves, Tanzania's payment ability was not really in doubt. Amounts accumulated in the escrow account could eventually also be used to buy back other eligible debt at HIPC-related terms. Noncompliance by non-Paris Club creditors would, of course, have adverse consequences for Tanzania's debt sustainability indicators.

On the prospects for growth of non-traditional exports, the staff was optimistic, the staff representative said. Tourism, manufacturing, and gold and other mining were expected to grow faster than traditional export sectors, and the mining sector was already benefiting from improvements in the investment climate triggered by the Investor Round Table.

The staff representative from the Policy Development and Review Department (Mr. Hadjimichael) made the following statement in response to questions and comments from Executive Directors:

> I would like to add some more information on the efforts by the staff and management to encourage non-Paris Club creditors to participate fully in the HIPC Initiative. The efforts have included presentation of the scale of the problem and explanation of practical steps to encourage participation in the two most recent HIPC progress reports. The Board has endorsed guidelines for the staff to encourage participation based mainly on informal moral suasion, since the Fund's decisions on the HIPC Initiative do not create any legal obligations for member countries—and especially non-Paris Club bilateral and commercial creditors—to adhere to its terms. One practical step that the staff is taking is to give more prominence in staff reports to the names of non-Paris Club creditors and the amounts of the obligations to those creditors by individual HIPCs. In addition, in briefing papers for the debtor countries, we are inviting the staff to solicit more information on which other creditors are not yet complying. In briefing papers and reports to the Board for the creditor countries, we try to ask the same question, and also informally encourage them to participate. Thanks to these informal efforts, we have recently received letters from the authorities of Korea and India, in which they have indicated to management that they would participate fully in the HIPC Initiative. In the case of another creditor country, Libya, which is particularly important for Tanzania and Uganda, the staff has recently visited the country at the invitation of the authorities, and even had meetings with the head of state. Following that, there was a formal communication from the authorities of Libya to Fund management that the country is willing to participate fully in the HIPC Initiative. Management conveyed this news to the most affected countries at the 2002 Annual Meetings. We will continue these efforts, but obviously we cannot go beyond the framework that has been outlined in the HIPC status report. So far we have seen some progress, and we hope to generate more progress in the future.

Mr. Brooke expressed his support for the efforts of the Fund to persuade non-Paris Club creditors to participate in the HIPC Initiative, and noted that, as indicated by the staff representative, the efforts had already been rewarded by increased participation.

The Acting Chair (Mr. Sugisaki) noted that the Fund would continue such efforts.

Mr. Mirakhor thanked the Acting Chair for his efforts at the Annual Meetings to speak to non-Paris Club creditors on participation in the HIPC initiative. The debtor countries receiving HIPC support should also directly engage non-Paris Club creditors on this topic, by making presentations of their cases to the creditor governments.

The Acting Chair (Mr. Sugisaki) agreed and also thanked Mr. Mirakhor for his advice on soliciting the participation of non-Paris Club creditors in the HIPC program.

Mr. Steudler made the following statement:

> First of all, I would like to commend the Tanzanian authorities for their continued efforts and commitment to implement their ambitious reform agenda. Steady progress in macroeconomic stabilization and structural reform has lead to robust economic growth and declining inflation.
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> Despite recent delays on the structural side and the failure to meet the performance criterion on the procedures for new foreign borrowing, we agree to complete this review and grant the requested waiver.
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> I would like to stress just a few points, beginning with the fiscal side. We welcome the strengthening of public expenditure management, but further progress in fiscal consolidation is needed, as the primary balance is deteriorating. While the entire adjustment of total expenditure is solely based on a reduction of foreign financed development expenditures, most expenditure categories are rising. This said, we support the shift in expenditure toward social spending. Unfortunately, this limits at the same time the room for significant cuts. One notable exception is military expenditure, which is still growing worryingly fast.
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> However, there is scope for more ambitious measures on the revenue side. Above all, we urge the Tanzanian authorities to revoke, or at least limit, the recently introduced tax exemptions in the EPZ Act. As the staff and Mr. Brooke point out, they not only reduce tax revenues, but also jeopardize the tax system as a whole, by weakening the payment discipline of taxpayers who do not profit from tax exemptions.
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> Moreover, we are disquieted by the accumulation of domestic payments arrears and urge the authorities to undertake everything necessary to avoid their recurrence.
>
> Furthermore, we fully share the concerns expressed by the staff about the delay in tightening the approval procedures for foreign borrowing. To avoid imprudent and uncoordinated foreign borrowing and to improve

transparency, we urge the Tanzanian authorities to tighten the approval procedures and to implement their National Debt Strategy as soon as possible.

Finally, in the context of the purchase of the new air traffic control system, we called during last spring's discussion for the prioritization of public investment projects, proper budget procedures and transparent procurements. I would like to ask the staff for clarification not only on the total costs for the new system, but also on the extra budgetary status of the purchase.

Turning to the monetary side, the Bank of Tanzania seems to be confronted with a dilemma. On the one hand, the staff argues that the stronger-than-expected monetary expansion calls for a mop-up of excess liquidity. On the other hand, the Tanzanian authorities attribute the expansion to extraordinary circumstances. Should the strong increase of monetary aggregates indeed be mainly due to structural reasons, a restrictive monetary policy might not be advisable. We should keep in mind that there has been a period with an overshooting of reserve and broad money targets in the past (August 1999 to June 2000), which was not followed by inflation. In this regard, we would appreciate some additional information from the staff, supporting their view that corrective action by the monetary authorities is called for.

The problem of partial ineffectiveness of monetary policy may be due to still-significant impediments to bank lending. In this context, and in line with other speakers, we strongly encourage the Tanzanian authorities to speed up the process to enable the use of land as collateral in bank loans, to improve the land registry, and to enhance the commercial court's capacities. A strong legal framework, which supports borrowers and creditors equally well, is a precondition to develop an efficient credit system. Together with a well-running financial infrastructure, it should stimulate investments in Tanzania and lay ground for further growth.

Addressing the delayed report on the implementation of ministerial anti-corruption plans, we urge Tanzanian authorities to publish the report as soon as possible and to strengthen their efforts to fight corruption by the full implementation of the ministerial plans. We encourage the government to widen the scope of the program to all sectors and all levels. Areas of main concern are public procurement and contracting, tax and customs administration as well as business licensing.

We see much merit in the authorities' ambition, as Mr. Usman mentioned, to graduate from the PRGF framework, and we are looking forward to the forthcoming discussion on the options of Fund support for countries like Tanzania.

As a last point, we would like to ask the staff about their view on the issue of the power producer IPTL. As we understand it, the government is paying US$3 million a month in capacity payments, without any electricity actually being produced.

Ms. Lanza made the following statement:

At the outset, let us thank the staff for its comprehensive set of papers, and Mr. Usman for his insightful statement.

Tanzanian authorities should be commended for the tremendous effort carried out in the past few years in pursuing sound macroeconomic policies and in jump starting a deep process of structural reforms. However many challenges still lie ahead.

A Positive Juncture to Carry Out Structural Reforms

Given the very favorable juncture at which the ruling Chama Cha Mapinduzi coalition operates, thanks to political stability and parliamentary and presidential elections not due until late 2005, we would expect the authorities to push ahead with structural and institutional reforms.

In this context we are pleased to note the impressive progress made in the areas of expenditure reforms and transparency, in strengthening the financial sector and in pursuing a coherent privatization strategy. Nevertheless, as carefully noted by the staff, a number of issues remain to be addressed. In particular, it will be of paramount importance to broaden the tax base and improve the tax administration as to limit the dominant role of donors for fiscal sustainability. This process is, to some degree, hindered by the past large number of tax exemptions offered to attract large investors, which is even reinforced by the recent adoption of the EPZ act, which grants generous tax incentives to foreign direct investors. We concur with the staff that this Act may jeopardize the revenue-enhancing strategy agreed by the authorities and welcome the decision to postpone its implementation by better focusing its scope. We, nevertheless, note that attracting foreign direct investments will be crucial to diversify the country's export basis and to promote job creation. In the same direction, to promote investment, there is the much-needed reform of the financial sector, especially with regard to bank lending and the possibility of using land as a collateral to bank loans. Needless to say that judicial reforms, such as strengthening of the commercial court, will provide an improved ground to attract investments. Establishing a sound track record in the privatization process will greatly enhance the authorities' forthcoming privatization agenda. In this respect, resolving the current dispute over the payment of the second tranche of the telecommunication company, TTCL, is crucial to maintain a positive investment climate. The authorities may wish to consider carrying out a new financial audit with an internationally respected audit company chosen in agreement with the foreign investors involved.

Paving the Way to an Exit Strategy from the PRGF: the Role of Donors

All the above actions will be of vital importance in approaching Tanzania's graduation from the PRGF, for which we support the staff's recommendation of a three-month extension to June 2003. At that time, in fact, Tanzania will have to rely more on its own capacity to promote a sustainable development. From this angle we have some concern looking at the staff's thorough debt sustainability analysis. Its results indeed show very clearly that, while the country's external position is not overly affected by a sudden—although limited—appreciation of the exchange rate, it is extremely sensitive to a potential withdrawal of financing by the donor community. Given the pressures to spend resources on social priorities such as health and education, the staff correctly underscores that a retrenchment in fiscal expenditures will not be a viable way to reduce financial needs. Strengthening the tax administration and enlarging the tax basis will be needed to be able to face potential exhaustion of donors' aid. With this perspective, we would greatly appreciate it if the staff could comment more broadly on an overall strategy to provide a safety net for the country, should donors' aid shrink significantly.

As for the current creditors' situation, we are once again faced, on a policy level, by the difficulty of reaching an agreement with non-Paris Club bilateral and commercial creditors, which is certainly an issue which deserves merit of its own and we are thus looking forward to hearing on it in the forthcoming HIPC review Board meeting, while supporting the Tanzanian authorities' call for creditors to provide debt relief on HIPC terms.

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

Mr. Komatsuzaki made the following statement:

At the outset, I would like to thank the staff for its comprehensive and excellent analysis, and Mr. Usman for the useful information he provided in his statement.

Tanzania maintains good overall economic performance. Solid economic growth in a low inflation environment continues. The PRGF program is broadly on track as well, although there were some performance criteria and benchmarks that were not satisfied.

The authorities are encouraged to continue their good performance in macroeconomic policies. In the fiscal area, the main issues are revenue mobilization, strengthening of expenditures, and debt management. In the monetary area, the conduct of monetary policy needs to be reviewed, in light of the need for prudent monetary management, to maintain the hard-won low inflation environment and provision of sufficient liquidity to continue rapid economic development. The relationship between monetary aggregates and inflation might change in the future as the financial sector develops and money demand increases.

With a sustained period of political and macroeconomic stability, Tanzania has the potential to diversify into non-traditional sectors and realize rapid economic growth for a sustainable period by further promoting private sector activities. There are a number of key structural reform measures that must be taken to enable this, including financial sector development, improvement in governance issues, and infrastructure.

I broadly agree with the staff appraisal and support the proposed decision, and will make some specific comments.

Regarding revenue mobilization, the staff recommends that the authorities envisage a more ambitious increase in fiscal revenue in their medium-term macroeconomic framework. I concur with the staff, and virtually all the previous speakers, in the emphasis on revenue mobilization. Considering the stagnation of the revenue to GDP ratio in recent years, despite the authorities' efforts, enhancement of revenue is no easy task, however. I understand from the staff paper that customs and VAT exemptions are causing losses in tax revenue on a large scale, and that their reductions would be beneficial to a revenue increase. From the same standpoint of revenue mobilization, I urge the authorities caution regarding the EPZs, and welcome that they have decided to review its provisions. Some of the measures in paragraph 26 and 27 of the letter of intent are revenue-enhancing too.

On expenditure management, the authorities appear to recognize challenges and are making progress. I would encourage solid implementation of their plan. Box I.5 of the selected issues paper regarding tracking of foreign financed development expenditure is a good illustration of how far the authorities have come, but how much farther they still have to go.

Regarding the monetary area, it is indeed hard to balance inflation and growth considerations in view of stronger money demand, possibly the structural change. Proposed modifications to program targets, namely an increase in monetary aggregate targets and the reduction in the program floor of international reserves, in order to prepare for a potential increase in inflation, appear appropriate. We note the recent pickup in financial sector activities, which could affect the relationship between monetary aggregates and inflation, thereby making it easier for the Tanzanian economy to accommodate higher money growth.

If higher money demand can be accommodated, it could be seen as an indicator of a "higher growth trajectory," drawing from Mr. Usman's statement. However, structural impediments that must be addressed remain. Regarding the supply side of credit, in the banking sector, while it is heartening that the soundness of the banking system is improving, there is still a large spread between lending and deposit interest rates, reflecting a weak legal structure, the ban on the use of land as collateral for bank loans, and insufficient credit information. We hope to see progress made in each of these areas. Another important area to be tackled is governance of microfinance institutions. As it is hard for rural residents to have access to commercial banks, sound development of microfinance institutions is complementary to commercial banks in supplying credit. Regarding the demand side, in the corporate sector, a weak infrastructure and a difficult investment environment are the obstacles. Reform of utility companies is important for improvement in infrastructure, as high-energy prices are a deterring factor for foreign direct investment, as well as a burden to the local population. On governance, we endorse the authorities' efforts to promote good governance, as well as their dialogue with the business community.

Finally, we welcome the progress in non-Paris Club creditors' participation in the HIPC Initiative, explained by Mr. Hadjimichael, and concur with Mr. Mirakhor in encouraging the authorities efforts on their part.

With these remarks, I wish the authorities every success.

Mr. Marques made the following statement:

The last few years have seen Tanzania make good progress toward creating a stable macroeconomic environment. The authorities have made commendable efforts to increase growth and reduce inflation. The main task remaining is to implement the structural and institutional reforms needed to reach the ambitious growth target of around 6 percent per year in the medium term and achieve a sustained reduction of poverty.

While the authorities are to be commended for keeping fiscal deficit relatively modest so far, we must not forget that this would not have been possible without strong donor support.

Instead of relying still more heavily on external assistance to finance potentially larger budget deficits, the authorities should increase their mobilization of domestic revenues by broadening the tax base and improving tax administration. Mr. Usman's explanations in his helpful statement are very encouraging in this regard. The management of expenditures also needs improvement. The large number of tax exemptions should be reduced and the EPZ Act should be revised to eliminate revenue leakages.

Improving the revenues collected would both reduce Tanzania's dependence on foreign aid and reduce the need for the central bank's sterilization operations, which exert upward pressure on the exchange rate and damage Tanzania's competitiveness.

Additional measures to increase the generation of revenues will also be necessary to reduce Tanzania's fiscal dependence on debt financing, including external concessional financing, and achieve a healthy, sustainable debt path. Little progress has been made so far toward reaching agreements with its non-Paris Club bilateral and commercial creditors, and I urge everyone involved to increase their efforts.

Since continuous mobilization of highly concessional financing is still required for priority outlays, there is a need to increase the transparency and accountability of government operations, including those of local governments. Data recording and reporting must be improved. Though the authorities proclaim their commitment to reducing corruption, little progress has been made so far. The current efforts should be greatly strengthened.

Tanzania has generally good relations with its donors, but these have been strained in recent years by various questionable steps, including the purchase of an expensive air traffic control system and a private jet plane for the president's use, at a time when the country's main policy thrust was supposed to be poverty reduction. Tanzania must actively seek to repair and maintain its good relations with the donor community.

Given the somewhat disappointing behavior of real *per capita* GDP, many Tanzanians do not believe that they have benefited from the country's macroeconomic stability and high growth rates. Unemployment and poverty remain high. Discontent is compounded by the fact that, despite the commitment of civil servants to reform, progress is slowed by a lack of capacity. Even when the efforts are successful, the results are unlikely to be highly visible. The president's recent decision to establish a Department of Communications to educate the public concerning the benefits of the present policies is a useful step.

As to the monetary and financial sectors, monetary policy's successful reduction of inflation has not sufficiently boosted aggregate demand, due to circumstances that impede bank lending. Removal of these obstacles would increase the number of viable borrowers and the loan-to-deposit ratio. A financial deepening, and a halt to the deterioration of commercial bank loan portfolios, both require a tighter monetary policy that would restore positive real interest rates. In this connection, I support the authorities' request for an FSAP. Their approach to the development of microfinance is also to be commended.

With these remarks, I support the proposed decisions, including the request for the extension of the arrangement and the waiver of the performance criterion.

Mr. O'Murchú made the following statement:

Like others, this Chair would compliment the Tanzanian authorities on the significant progress they have made over the past several years in maintaining growth, curbing inflation, pursuing structural reform and implementing the PRSP agenda. We can thus endorse the completion of the fifth PRGF review, the requested waiver and the extension of the current arrangement.

We agree generally with the views of staff and other Directors as to policy requirements going forward and, for emphasis, would add some remarks on the following issues:

The main message of the staff report is that increased revenue mobilization in Tanzania is critical to fiscal and monetary stability, to economic and social development and to reducing aid-dependence. It is encouraging that the authorities realize this and are acting accordingly, but the question is whether they are doing enough. For instance, paragraph 24 of the report speaks of the 2002/03 budget targeting an increase in revenue to GDP of only 0.2 percentage points to 12.3 percent, and table 4 projects a further modest rise in the following year. Given the need for immediate fiscal tightening and the increasing demands of priority expenditure, there should be more urgency in the authorities' approach to raising revenue from domestic sources.

In this context, I note from the LOI that, though the government is taking steps to eliminate customs and excise exemptions, an unspecified number of tax exemptions will remain. I would appreciate it if the staff could say how significant these remaining exemptions will be in terms of revenue foregone, and if discretionary exemptions will be among them? If the latter will still exist, they should be abolished because of their implications for governance. On the more general issue of governance, it is regrettable to note from paragraph 37 that the activities of the Prevention of Corruption Bureau are being curtailed by capacity constraints – hopefully, this is not the result of deliberate neglect.

In relation to monetary policy, the authorities seem so far to have been successful in balancing a number of objectives. However, the staff is correct in warning about the danger of renewed inflation the longer the liquidity overhang persists. Should the economy relapse into the high inflation it experienced in the mid-1990s, it could end up with the consequences which policy is currently trying to avoid but with the added problem of having to fight the anti-inflation war all over again. In this context, fiscal policy should be acting in support of monetary policy, another reason for greater effort in tax-mobilization. Removing obstacles to financial intermediation would also be a help, and we would certainly encourage the authorities to expedite measures to this end, especially regarding the important issue of land as collateral.

Beyond this specific land issue, references to general property rights in the Selected Issues paper are very instructive, including that in paragraph 63 to labor laws, which "are not sufficiently flexible to dismiss non-performing employees". What these references suggest is that, insofar as property rights in real estate and employment are concerned, the climate for private investment in Tanzania is not as favorable as it could be. However, I note that these and other issues are being discussed in the government's continuing dialogue with the business community. It might be helpful to this dialogue if a future Selected Issues paper were to address the subject of impediments to private investment in Tanzania.

In regard to future debt management, we would support the intention of the authorities in paragraph 34 of the LOI to vest, in the Minister for Finance, all powers to raise or guarantee loans, and to require parastatals to get the Minister's approval of their borrowing. However, to ensure that outcomes measures up to intentions, it is essential that all the necessary arrangements and procedures be put in place both within the Finance Ministry, and between it and the borrowing agencies and their parent departments. These procedures should also be transparent so as to eliminate any possibility of corruption from the system.

On privatization, we welcome the progress being made but would agree with the staff that the process would be helped if there was broad equity of treatment of displaced workers across parastatals. Perceived inequities will only increase resistance to privatization, whereas the availability of compensation over and above statutory minima would help to facilitate it.

We would encourage the staff and the authorities in their efforts to secure HIPC relief on Paris Club terms from non-Paris Club bilateral creditors.

Finally, we look forward to the PRSP progress report and commend the authorities for agreeing to the publication of the papers for today's meeting.

Mr. Lushin made the following statement:

The performance of the Tanzanian economy under the PRGF program remains broadly satisfactory, as evidenced by the steady GDP growth rates and low inflation. In 2001, GDP per capita increased by about 3 percent and it is projected to grow at about 4 percent annually in 2002 and 2003. We commend the authorities for the achieved macroeconomic stability and welcome the improvements in the living standards.

We agree with the staff that to deal with large capital inflows, the authorities have to tighten both monetary and fiscal policy. The fast growth of liquidity is worrisome, and the authorities should not rely on the assumptions of continuing fast growth in money demand and the lack of enthusiasm in the banking sector for lending activity. The central bank needs to upgrade expeditiously its ability to mop up liquidity. While we welcome the authorities' intention to securitize some of the existing obligations, they need to become more proactive in creating additional instruments for liquidity management. Since the introduction of these instruments will take time, we can also go along with the staff proposal to embark on the sales of foreign exchange. To minimize market disruptions, it would be advisable to pre-announce the schedule of these operations.

In the fiscal area, efforts to strengthen revenue mobilization remain insufficient, while expenditures jumped in 2002, leading to an increase in the fiscal deficit by 3 percentage points of GDP. We are concerned not only with the short term fiscal plans, which may create difficulties for control of inflation, but also with the structural weaknesses in the fiscal area. Despite extensive technical assistance and the authorities' declared commitment to fiscal consolidation, between 1999 and 2002 budget revenue has increased by only 1 percent of GDP. We consider this progress to be insufficient. Moreover, weak revenue performance, coupled with growing expenditure, leads to increased aid dependency, an outcome that can hardly be welcome for the country that has just graduated from the HIPC Initiative.

In this respect, we are surprised with the adoption of the Export Processing Zone act. This measure is not consistent with the goals of fiscal consolidation as it leads to the erosion of the tax base and leakage of revenues. The staff has to make sure that the delay in the EPZ Act is used to tighten the zone entrance criteria, so that the potential damage to fiscal accounts is minimized. In this respect, we would prefer to see corresponding conditionality included into the structural part of the program.

We took note of the recent establishment of an export credit guarantee scheme under the management of the Bank of Tanzania. In our view, such a scheme could potentially increase conditional fiscal liabilities of the authorities. Therefore, the authorities should keep the performance in the framework of this scheme under close supervision.

Finally, we are very much concerned with long delays in concluding bilateral agreements between Russia and Tanzania following Paris Club restructurings. As a result of these delays, Russia has not received any debt service payments from Tanzania following the decision point in April 2000 and the consequent Paris Club agreement (except for the tiny amount mentioned in Supplement 1 distributed today). We are looking forward to the speediest resolution of the outstanding debt issues between Russia and Tanzania and the start of debt service.

Let me also make one comment on the issues touched upon in Supplement 1. The Russian authorities consider non-payments mentioned in this Supplement to be arrears. Under these circumstances, we are not prepared to grant a waiver for the nonobservance of the performance criterion on non-accumulation of external payments arrears by Tanzania.

Concerning the proposed decision we would like to be on record as having abstained.

Mr. Ralyea made the following statement:

The authorities' policy performance was less robust under this review period than the last review period. In the new environment of streamlined conditionality, this could be a source of concern. However, based on the corrective actions the authorities have taken, or plan to take, and their track record and ownership of the program, we support completion of this review and the extension of the arrangement. We also welcome publication of the staff documents.

We share the staff's belief that Tanzania needs to improve its domestic revenue base, which most, if not all, previous speakers noted. During the last Article IV consultation, the Board also encouraged the authorities to make a more determined revenue effort. The authorities appear to share this view, and have taken some steps to improve revenue performance. But a projected increase in domestic revenue of 0.5 percent of GDP over two years is insufficient to reduce Tanzania's heavy dependence on volatile donor funding. Again, we urge the authorities to widen the tax base, reduce exemptions, and improve tax administration.

On a related note, we welcome the authorities' decision to amend the EPZ Act to focus its provisions more narrowly. We also find interesting the authorities' decision to publish in the print media, on a quarterly basis, the names of individuals, companies, and institutions that are exempt from paying taxes. This will certainly increase the transparency of the tax regime. We look forward to reading about the implementation of this decision at the next review, as well as the outcome of any technical assistance missions completed during the next review period.

Turning to monetary policy, we view the staff's arguments for mopping up excess liquidity in the banking system as persuasive. Fortunately, the authorities now appear to share the staff's view. The key will be the aggressive application of the newly-created instruments to tighten monetary policy. With respect to the new export credit guarantee program, we would have preferred that the authorities had not created such a scheme, but we appreciate their willingness to modify it to ensure that it does not lead to excessive exposure by the government. The Bank of Tanzania would also do well to restore price stability as the focus of monetary policy.

Nonetheless, the effectiveness of monetary policy as well as economic growth will likely remain constrained until impediments to bank lending are removed. Chief among those impediments is the inability to use land as collateral for bank lending as highlighted by the United Kingdom, German, Italian, Japanese, Canadian, and other chairs. Indeed, one could make an argument that the private ownership of land, and its use as collateral for bank loans, would be critical to the achievement of the program's principal objective of economic growth.

We were disappointed to learn that the two structural benchmarks covering financial transparency and good governance remain unfulfilled. We share the Swiss, Belgian, and Canadian chairs' desire to see a more determined effort in tackling corruption. We expect these measures, in addition to the other unobserved structural benchmark, to be completed before the next review, as contemplated by the authorities. Going forward, we also encourage the staff to point out how the authorities implemented recommendations contained in the fiscal ROSC or the proposed FSAP.

Ms. Phang made the following statement:

I join other Directors in commending the Tanzanian authorities for their success in the management of the economy. Not only was growth sustained, but it was raised, despite the difficult global environment. In addition, inflation was lowered, significant progress was achieved in terms of structural reforms and performance targets were broadly met, while measures have already been taken to address nonobservance of selected quantitative benchmarks. Hence, I support the proposed review and waivers as well as the short extension to enable the program to be completed.

I am in broad agreement with the general thrust of the staff appraisal and recommendations, but would like to highlight four areas of concern.

Firstly, on the fiscal front, I appreciate the sensitivity shown by the staff in its appreciation of the importance of mobilizing revenue rather than cutting back on expenditure, which is largely in line with the aims of the PRGF initiative. I concur with the views expressed by Mr. Mirakhor, that revenue mobilization will require action on a broad front. I support the authorities' use of fiscal incentives to guide investment in line with their plan for structural transformation, as developing countries in general need to provide incentives to encourage investors to participate in their developmental efforts despite problems due to market imperfections. However, based on the experience of other developing countries, I would encourage the Tanzanian authorities to review their total fiscal incentives package, not just the EPZ Act. If the aim of the EPZ Act is to expand exports through encouraging investment in export-oriented industries, it would be more efficient to do so through offering incentives such as 100 percent foreign equity for production that exceeds a certain threshold of export-orientation, and perhaps a lower level of taxation, rather than through the use of EPZs, which tend to encourage the growth of enclave economies—with low interlinkages to other sectors in the domestic economy. High interlinkages would have high spillover effects, with important implications for sustainable growth and poverty reduction and this is an important issue for Tanzania, as not only has the number of those below the poverty line increased, from 9.5 million in 1991/92 to 11.4 million, but the proportion below the poverty line has changed little and per capita income of Tanzania is significantly lower than in Sub-Saharan Africa and low income countries (US$270 compared to US$470 and US$410 respectively). This is particularly sad in view of Tanzania's success as one of the few countries that has persevered with the program and has successfully reached the completion point. The staff's comments would be appreciated, as would its views on the appropriate exit strategy, so that Tanzania's dependence on foreign aid would be significantly reduced.

In the same vein, I would suggest that the fiscal incentives provided by the 1998 Mining Act are overly generous. Based on the experience of other developing countries, the 100 percent capital expensing, with a loss carry-forward of five years, is already generous, as there is little point in supporting an investment that continues to make losses beyond five years. This is particularly so in the case of mining, which is an extractive industry and has a limited lifespan. I would appreciate it if the staff could provide an assessment of the comparison of the impact on revenue mobilization of a simplified fiscal incentives regime with a uniform 100 percent capital expensing, and 100 percent loss carry-forward of 5 years, compared with the present regime, as well as one with the above incentives for the mining sector and 50 percent expensing for other industries, with a depreciation schedule as proposed in the 2002/03 budget.

On debt relief, I join other Directors in emphasizing the importance of full and timely participation of all creditors for the success of the HIPC Initiative. I empathize with Mr. Usman's plea for assistance from the Fund and the World Bank to find a solution to the non-Paris Club bilateral and commercial creditor problems, and I welcome the assistance outlined earlier by Mr. Hadjimichael to encourage timely participation of non-Paris Club creditors in the HIPC Initiative.

On privatization, I note that the staff has provided information on the pace of privatization. However, privatization is not an end in itself. The ultimate aim is improved efficiency, with the provision of goods and services to a wider segment of the population at a lower cost. Hence, monitoring the implementation and evaluating the benefits of privatization are important. I note from footnote 13 of the staff report that they are mindful of this, but that the World Bank does not expect to complete the study until 2004. In view of the importance of privatization in all programs supported by the Fund and the World Bank, I would hope that the project is speeded up and completed in time for its results to be included in the upcoming review of the PRGF/HIPC, scheduled for 2003.

Finally, on the financial sector, I note that, despite high liquidity, and the fact that the banking sector has already developed from just one state-owned bank in 1992 to 12 commercial banks (and there is a high foreign presence in the banking sector), the intermediation function of the banking sector is still far from satisfactory, and growth in lending is still a problem, particularly for small and medium scale enterprises (SMEs). While the problem of using land as collateral may be an important factor in general, the real problem for the majority of SMEs in Tanzania, in terms of gaining access to reasonably priced financing, is the conservatism of banks towards lending to SMEs. Experience of other countries has shown that microfinance institutions, rather than banks, have been the major sources of financing for SMEs. Hence efforts to establish an enabling environment for the development of microfinance should be strongly supported, not only in terms of prioritization of support, but also in terms of the provision of technical assistance. I would appreciate information from the staff on how much of this effort is supported by the Fund and Bank, or is the support provided only by DANIDA?

With these comments, I wish the authorities continued success in their efforts to graduate from the PRGF approach.

Mr. Costa made the following statement:

We commend the staff for the well-focused set of papers, and Mr. Usman for his comprehensive and reassuring statement. The Tanzanian economy continues its remarkable performance, in terms of macroeconomic stability and high rates of growth, which bodes well for achieving the goal of reducing poverty on a sustainable basis. In assessing Tanzania’s prospects, it is important to keep in mind that to a considerable extent the good performance of the Tanzanian economy is linked to substantial donor support, doubtless related to the authorities proven commitment to sound macroeconomic and structural policies. The high aid-dependency ratio, amounting to more than 40 percent of budgetary revenues, represents, nonetheless, a sort of structural weakness for the economy, as donors' help is also determined by political considerations, predicated, at times, on volatile domestic or external developments. Thus, large donor support may lead to a distorted image of the actual strength of the Tanzanian economy. It is reassuring in this regard that the present government is firmly committed to advance the structural and institutional reforms needed to consolidate past gains and to sustain growth in the future.

Perhaps the most critical institutional aspect the government will have to face is the issue of governance, because of its far-reaching implications. In the first place, it impinges on the government's authority to implement structural reforms, given their costs to several interest groups that would be unable or unwilling to act in more competitive markets. On the other hand, a strengthening of the rule of law and a more transparent and sound regulatory regime would improve the investment climate, attracting more foreign direct investment, a critical factor to increase efficiency and productivity in the economy over the medium and long term. Another important consequence of the governance issue is the present deficiencies in revenue mobilization, which not only call for the elimination of excessive exemptions and the broadening of the tax base, but they also require improvements in tax-administration, closely linked, in turn, to good governance. Finally, transparency in public expenditures, particularly in areas such as health and education, are of great importance to the effectiveness of poverty reduction programs.

Regarding the goals of sustainable growth and of reducing poverty the agricultural sector, which represents about half of GDP and more than 80 percent of total employment, is critical. This sector is facing significant structural constraints such as poor infrastructure, lack of credit and inputs, and weak marketing channels. The vagaries of climate and the volatility of prices in international markets add to its difficulties. The authorities are implementing an ambitious development strategy in the agricultural sector, with increased spending in roads and infrastructure. There are also plans to encourage micro-financing through an appropriate legal, regulatory and supervisory framework for MFIs. It is important that those plans be implemented as scheduled, including the privatization of the National Microfinance Bank.

Other areas that are increasingly important as driving forces of growth in Tanzania are mining and tourism, which are receiving substantial foreign direct investment. Providing incentives for foreign direct investment into other sectors would help spread the benefits of higher productivity throughout the economy. In this regard, the tax-exemptions granted under the "Export Processing Zone" Act could, in principle, play a positive role, but it is necessary, as suggested by the staff, that the authorities review the existing law to avoid loopholes, so that future FDI may be better-targeted to investment projects aimed at opening up new export markets. In any event, more important than fiscal incentives to promote growth is the strengthening of the investment climate, both through improving infrastructure in transportation and communications and, more importantly, through advancing the privatization process. The strengthening of the intermediation role in the financial system and of the rule of law are also key component of a successful pro-investment strategy.

Regarding privatization, it is necessary to extend it to the large strategic enterprises particularly in the utility and transportation areas. It does not seem likely that the main hurdle to privatize these enterprises has to do with the retrenchment benefits, as the report seems to imply. We wonder how firm is the political will on this point. The staff's comments would be welcome.

As to the weak intermediation role shown so far by the financial system, which has caused a large structural liquidity surplus, and an excess demand for treasury bills and real negative interest rates on deposits, the authorities are committed to address it through measures aimed at making possible the use of land as collateral, as well as the strengthening of the commercial court. It may also help if bank management teams adopted more competitive attitudes and become more willing to assume risks and increase lending opportunities.

On monetary policy issues, the report highlights the sharp increase in broad money in the wake of large donor support. Earlier monetary targets were thus expanded, but a tightening will be needed to meet targets, given the size of the monetary expansion. This will require sterilization operations, through the sales of government bonds or foreign exchange. In this regard, we find reasonable the Bank of Tanzania's reluctance to make an excessive use of these instruments. The fact that the expansion of monetary aggregates has not yet impacted inflation points to a parallel increase of money demand, which makes the growth of monetary aggregates less of a problem. We share the view that a greater mobilization of domestic revenue to deal with the expansion of liquidity is more desirable than sterilization efforts on the part of the monetary authorities.

With these comments we wish the authorities continue success in reaching their challenging objectives.

Mrs. Boucher made the following statement:

Let me join other Directors in thanking the staff for the very interesting and comprehensive set of papers before us today and confirm, at the outset, our agreement with the thrust of the staff's appraisal.

At this stage of the discussion, I can be brief.

We commend the Tanzanian authorities for their continuous progress and good performance under the program. We share the comments made by previous speakers, on the need for the authorities to focus their attention on the issue of revenue mobilization—projected to increase only modestly and at a rate below the average for sub-Saharan Africa (as noted by Mr. Steiner and Mr. Rambarran)—and the need to improve the business environment, as well as to strengthen implementation capacity, so as to reach the objectives set, in terms of increase in priority outlays. On the business environment, we welcome the steps enacted by the authorities to improve their dialogue with the business community. I also associate myself with the comments made by Mr. O'Murchú and Mr. Costa on the issue of governance, the persistence of discretionary tax exemptions and the need to identify and address the impediments to private sector development.

Regarding debt management, we join the staff in urging the authorities to press ahead with the full implementation of the recently adopted National Debt Strategy and to exert tight controls on new borrowing.

In this regard, we welcome the indications in Box 1 of the report, on the fact that the conditionality under the upcoming World Bank's PRSC expected in May 2003 will be also linked to measures in the area of institution-building as well as debt and financial management.

This is of paramount importance for a country like Tanzania, which is among the very first countries to have reached the completion point under the enhanced HIPC initiative. We would also like to join other Directors in urging non-Paris Club creditors to participate fully. We thank Mr. Hadjimichael for the information provided earlier on this matter and like other Directors, encourage the staff and management together with the Tanzanian authorities to pursue their efforts in this area.

We also noted the interesting section in the Selected Issues paper, on the assessment of public debt sustainability, which rightly points to the issue of public domestic debt, including government guarantees, which can become an important source of additional stress on the government's fiscal position. We find the conclusions of this section very useful, as they confirm the need for the Tanzanian government to bring about a positive change in revenue generating capacity from domestic sources so as to reduce its dependency on external financing. We wonder whether the staff envisages to undertake this type of analysis for all HIPC cases. We would certainly welcome that and would favor the establishment of a common methodology on how to assess the post-HIPC era together with appropriate sensitivity analyses.

Finally, on the prospects of graduation or "exit strategy," I have nothing specific to add at this point. We mentioned this during the discussion on Burkina Faso last week, and we believe that Tanzania also provides an interesting case for our reflections on this very important issue, and we look forward to further discussions with the staff and management in the context of the upcoming paper on the Fund's assistance to low-income countries.

Mr. Bakhache made the following statement:

Like previous speakers, we would like to commend the Tanzanian authorities for the impressive progress they have made in stabilizing and reforming the economy. This progress has been clearly reflected in the recent developments in the real, fiscal and external sectors, with growth reaching healthy levels in a low inflation environment and public finances improving in recent years, notwithstanding the need to do more in this area. As Mr. Guinigundo said, foreign assistance, as a complement to the ongoing reforms, has been a major factor in producing the favorable developments that Tanzania is experiencing. We are hopeful that with further improvements in the investment climate in the country, the strong confidence of official investors would spill over to private investors.

Most of the issues we wanted to raise have already been addressed. I will therefore focus my remarks on the issue of dependence on foreign aid, which was discussed by others, but I will add a point to it, and say a word on monetary policy.

On the issue of dependence on foreign financing, it is clear that the increase in the level of budgetary support from donors has provided the authorities with an important degree of freedom in implementing their poverty reduction strategy. At the same time, with budgetary (as opposed to project financing) rising, donor resources are increasingly built into the recurrent spending plans of the government, making the fiscal position more vulnerable to delays or cuts in aid disbursement. With regard to temporary changes in disbursement, the authorities can resort to domestic sources of financing to offset the effect of lower foreign financing on their expenditure plans. However, shortfalls in budgetary support of a more prolonged nature would likely cause serious problems, as the authorities do not have the relatively easy option of postponing the implementation of projects, as the case would be in situations where foreign funds are financing development projects. Outlays on salaries and wages and purchases of goods and services, particularly in the social sectors, need to be maintained to keep the poverty reduction efforts on track. This certainly places a burden on donors to maintain the disbursement of assistance and to have clear medium-term assistance plans. More critical in this regard is the role of the authorities to sustain their reform efforts and to design plans to reduce their dependence on foreign sources of financing.

Improving revenue performance, which at present is at around 12 percent of GDP, takes on added importance. While we welcome the ongoing plans to raise revenues by 0.2 percent of GDP, we feel that a more focused effort in this area is needed over the medium term to narrow the gap between revenue and expenditure, especially the recurrent type. We hope this issue would be given adequate attention in the period after the current arrangement is concluded.

With regard to monetary policy, we find the staff's approach to the ongoing monetary expansion, as described by Mr. Reitmaier, to be pragmatic. The overshooting in monetary targets is a complication with which many countries in Africa and elsewhere would be happy to deal. Still, the challenge is to strike an appropriate balance between the need to mop-up liquidity, to prevent an acceleration in inflation on the one hand, and maintain a competitive exchange rate on the other. Tanzania cannot afford loss of competitiveness at a time when the economy's growth momentum is still picking up.

Finally, I would like to confirm what Mr. Hadjimichael mentioned with regard to Libya's decision to participate fully in the HIPC Initiative, and would like to add that Kuwait has also indicated its willingness to provide relief on HIPC terms.

With these remarks, we support the proposed decision and wish the authorities further success.

The staff representative from the African Department (Mr. Reitmaier) agreed with Ms. Phang that a comprehensive review of fiscal incentives would be desirable. In that context, he welcomed her proposal to assess and compare the impact on revenue mobilization of different fiscal regimes. The staff would consider the issue further. Such an examination was in fact timely, as Tanzania had recently received technical assistance, including from the Legal Department, for a comprehensive revision of the income tax code, which was outdated and a source of frustration and confusion to taxpayers and tax authorities alike. The authorities had been interested in the staff's advice on comprehensive reform.

The staff's view on retrenchment benefit payments differed from the view of the authorities, the staff representative indicated. While the authorities intended to make a statutory payment and then allow some room for parties to negotiate higher payments, the staff favored a more rapid settlement, with the government deciding on the terms of a reasonable package, and then applying it uniformly. The authorities had agreed to consider the staff's suggestion.

To underscore the importance of implementing a legal and supervisory framework for microfinance operations, the staff had suggested that the submission to Parliament of a draft law establishing such a framework should be a structural benchmark, the staff representative noted. The World Bank and DANIDA were also providing assistance for the formulation of such a framework. Thus, there had been no lack of donor support, and the Tanzanian authorities had been receptive to attempts to improve the provision of microfinance.

On the topic of capital investment projects, the staff had emphasized the need to prioritize public expenditure, make the execution of the budget more transparent, and tighten the approval procedures for borrowing, the staff representative remarked. Those issues had been discussed particularly with regard to the purchase of the air traffic control system. According to the authorities, the extra-budgetary status of the air traffic control system purchase would be regularized through a supplementary budget in the course of FY 2002/03. There had been various reviews of this controversial purchase, including the most recent one by the International Civil Aviation Organization, and the final judgment would depend on the government's regularization of this expense as envisaged in the letter of intent.

Another controversial capital investment project mentioned by Directors was the IPTL power plant, the staff representative continued. The terms of a settlement by the ICSID of an investment dispute over the construction of this power plant required the electricity company to pay US$2.8 million each month, with half of this monthly payment coming directly out of the government budget. Once the plant reached the operational stage, that expenditure would seem to be more reasonable—assuming enough demand for electricity. However, if there were to be no demand, the payments would remain onerous.

Finally, he thanked Ms. Boucher for welcoming the staff's incorporation of domestic debt into an analysis of debt sustainability in the background paper, the staff representative said. That had been a worthwhile exercise, which might prove useful for other countries as well.

Mr. Usman made the following concluding statement:

> Thank you for the opportunity to make a few remarks in appreciation of the Board's support and commendation of my authorities' macroeconomic performance and reform efforts. I will communicate to them the constructive and valuable views, comments, and advice candidly expressed in the discussion today. Meanwhile, however, I wish to reaffirm my authorities' commitment to the reform efforts and their determination to move to a higher and sustainable growth path, in order to reduce poverty and to lessen dependency on external assistance. I thank the staff, especially Mr. Reitmaier, for the comprehensive and balanced reports, and recommendations, and for the thorough responses to the issues raised during the discussion. The staff has considerably eased my work, and I will only add a few passing remarks.

On the key challenges for my Tanzanian authorities to sustain macroeconomic stability and to enhance poverty reduction efforts in the short to medium term, I agree with Mr. Mirakhor, Mr. Ondo Mañe, Mr. Reddy, Messrs. Isleifsson and Farelius, Mr. Steiner and Mr. Rambarran, and several other Directors, that the priorities continue to be: (1) to intensify domestic resource mobilization, strengthen domestic liquidity and foreign exchange management, and improve the investment climate; (2) to continue with fiscal consolidation, and keep an eye on the evolution of inflation; (3) to sustain high growth and achieve substantial poverty reduction, while gradually lessening the dependence on external aid; and, (4) to implement the national debt strategy, and improve public expenditure management.

On monetary and exchange rate policy, the Bank of Tanzania will continue to regard as critical the intensification and strengthening of liquidity management, and improvement in the coordination of monetary policy with fiscal policy. In this regard, the need for striking an appropriate balance between containing inflationary pressures to restore positive real interest rates, and preserving a competitive exchange rate for export competitiveness, will remain the Bank's top priority.

On privatization, my authorities are aware of the importance of not losing momentum, and will heed seriously the advice to continue reforms, to improve the investment climate, accelerate economic growth, and further develop the private sector.

On debt sustainability and the HIPC initiative, I welcome the call on the staff, by Mr. Isleifsson, Mr. Varela, Mr. Steiner, Mr. Rambarran, and Mr. Guinigundo, to elaborate on the progress in formulating mechanisms to resolve the non-Paris Club and commercial creditors' noncompliance with the HIPC Initiative, and to assess the implications of this on debt sustainability indicators. Clearly this is proving to be a thorn in the flesh, seriously affecting the implementation of the initiative. I also welcome my authorities' request for assistance from the Fund on how to encourage participation of the non-Paris Club and commercial creditors in the HIPC Initiative.

On debt relief, I would like to assure Mr. Lushin that the authorities are aware of their obligations and responsibilities, and bilateral discussions between the Bank of Tanzania and the Russian authorities are taking place. In fact, my authorities are concerned about the slow pace of the bilateral discussions and the conclusion of bilateral agreements, but they are making every effort to accelerate the process.

Of particular interest to my Tanzanian authorities, and several other low-income program countries, is the general issue of possible successor arrangements, to help the countries consolidate the gains under previous programs, and to facilitate drawing up an exit strategy, leading to graduation from the PRGF. Having gone through the first generation of reforms, for a period spanning nearly one and a half decades, Tanzania, like other countries in similar circumstances, is looking forward to the opportunity to explore possible innovative options and strategies. I am confident that the staff report on the role of the Fund in low-income countries—which is planned for next spring—and the subsequent scheduled discussions by the Executive Board, will provide some positive guidance and point the way forward.

One of Mr. Kohler's visions of the IMF's role is for it to be committed to openness, dialogue, and learning from experience. In this regard, Mr. Reddy's observation could not be more apt, echoing our belief that rigid benchmarks should give way to more flexible criteria, providing greater room for maneuver to the authorities in the program countries. Based on the experience in Tanzania and other countries, this is especially true if we are to encourage policy and program ownership by countries. Dialogue, and learning from experience should be our guides in dealing with member countries.

In conclusion, I wish to reiterate my authorities' gratitude to the Board and the staff of the Fund, as well as to donors, for the recent launch of the East AFRITAC Center in Dar es Salaam, Tanzania, to serve the six eastern African countries of Eritrea, Ethiopia, Kenya, Tanzania, Uganda, and Rwanda—which is the only country among these that is not in my constituency. I have expressed their gratitude before, when Mr. Aninat delivered his report to the Board upon his return from Tanzania, but I feel that this is another opportune moment to read verbatim, for the record, the concluding remarks of Tanzanian president, Mr. Benjamin William Mkapa, at the official luncheon ceremony. "In conclusion, let me underline that the setting-up of East AFRITAC has come at a time when our needs for capacity building are critical. Our countries are struggling to cope with the ever increasing pace of globalization, which calls for opening up of our economies, including our capital accounts, to the outside world. At the same time, a number of new challenges in capacity building have emerged, particularly those related to the building up of revenue bases, expenditure control systems, domestic debt management systems, money laundering, terrorism, and the need to set up financial intelligence units. All these require expertise and resources to address them. We hope the Center will be able to meet the challenges of human resources development in these areas and become a source of advice, especially on strategies for steering our economies in the right direction. Africans must be in charge of their destiny. We must ourselves determine the task and chart the path ahead, but we can only do so well if we have the knowledge, the skills, and the capacity. To insist you are in charge, when you do not have capacity to make meaningful and informed choices, is meaningless nationalism. We, in Tanzania, feel greatly honored to host this Center. We now face the challenge to prove we were worthy of this trust and honor. We will strive to live up to our obligations, but above all to fully utilize the Center to improve our technical capacity for policy reform, for macroeconomic stability, for broad-based growth, and for the war on poverty."

The Acting Chair made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They commended the Tanzanian authorities for their steady pursuit of sound macroeconomic and structural policies, which, despite serious capacity constraints and an often adverse external environment, have resulted in high real GDP growth, low inflation, and a comfortable level of international reserves, and which have been supported by a steady flow of highly concessional assistance and debt relief from the international donor community. Directors considered that the main challenge for Tanzania is now to sustain high growth and reduce poverty while gradually lessening the dependence on external aid. In this regard, they noted that good progress has been made in the implementation of the poverty reduction strategy, and believed that with the continuation of sound policies Tanzania will be well on the way to achieving the targets set out in its Poverty Reduction Strategy Paper (PRSP).

Directors attached high priority to medium-term fiscal consolidation, but noted that Tanzania's low revenue yield and concomitant heavy dependence on external assistance hinder the attainment of this objective. They therefore welcomed the recent measures to increase revenue collection, but stressed that further and more concerted efforts to widen the tax base and improve tax and customs administration will be needed. Directors endorsed the decision not to introduce the Export Processing Zone Act until it has been reviewed, given the potential for revenue losses.

Directors commended the impressive progress made in the areas of expenditure reform and transparency. However, they noted that domestic arrears have continued to accumulate, and urged the authorities to move quickly to strengthen expenditure control and to set up the institutional and legal framework needed to give effect to the recently adopted national debt strategy. Directors welcomed the budget's increasing focus on education and health. They believed that the effectiveness of expenditure in these sectors, especially at the local government level, would be enhanced by the planned measures to improve the tracking of poverty-related spending. Directors looked forward to the completion of the civil service reform, which should help attract qualified personnel, halt the departure of well-trained staff, and improve the quality of public service.

Directors emphasized the need to keep monetary developments under control in order to contain inflation and to restore positive real interest rates. They therefore supported the decision to convert the government's non-marketable debt to the central bank into securities. Directors considered that the flexible exchange rate regime has served Tanzania well, by facilitating timely adjustments to changes in Tanzania's external environment. Nevertheless, they believed that Tanzania's competitiveness needed to be strengthened by structural reforms to improve the investment climate and strengthen the productive sectors.

Directors considered privatization to be vitally important to the development of the private sector and to the achievement of the authorities' economic growth objectives. They applauded the government's accomplishments to date in this area, and encouraged the authorities to push ahead with the privatization of the large enterprises, especially those in the utility and transportation sectors. Directors also stressed the importance of improving the business environment and removing impediments to private investment, particularly through institution-building, and labor market, administrative, and judicial reform. They looked forward to follow-up action on the policy matrix of short-term actions that had emerged from the recent Investors' Roundtable Conference.

Directors regarded financial deepening as another crucial input into the expansion of the private sector in Tanzania, with microfinance development considered to be especially important. They noted the existence of structural impediments to bank lending and persistent large interest rate spreads, and called for an accelerated effort to remove these impediments, including an amendment of the Land Act to unblock the use of land as collateral for bank loans. Directors welcomed the authorities' request for an FSAP review.

Directors noted the strong country ownership that has allowed the PRSP to become the main instrument for coordinating domestic poverty reduction programs between the authorities and the international community. Directors also recommended that the linkage between the PRSP and the budget be strengthened to ensure that the poor benefit more fully from the resources freed from the HIPC Initiative. They looked forward to receiving the second annual progress report on PRSP implementation, and the joint staff's assessment of it.

Directors noted with satisfaction that Tanzania's public and publicly-guaranteed external debt burden remains sustainable after the HIPC Initiative completion point. They urged a cautious external debt management strategy, with tightened approval procedures for foreign borrowing. However, Directors expressed concern that some non-Paris Club and commercial creditors have failed to provide debt relief on terms comparable to those provided by the Paris Club. They commended the authorities for establishing a special account earmarked for honoring debt-service payments to these creditors, and supported the authorities' request for Fund assistance in encouraging the participation of these creditors in the HIPC Initiative.

Directors looked forward to the publication of the second progress report on implementation of a national anticorruption strategy. They urged the authorities to vigorously enforce laws and regulations aimed at promoting good governance.

Directors observed that, notwithstanding considerable technical advice in the statistical area and generally good implementation of such advice, Tanzania's database remains weak because of capacity constraints. They recommended that priority be given to removing key data weaknesses in the areas of the national accounts, the balance of payments, and the consumer price index.

It is expected that the next Article IV consultation with Tanzania will be held on the 24-month cycle, subject to the provisions of the decision on consultation cycles approved on July 15, 2002.

Additional Points Relating to the Fifth Review Under the Poverty Reduction and Growth Facility

Directors welcomed the continued good performance under the program, noting that most quantitative and structural performance criteria for end-June 2002 had been observed.

Directors expressed concern over the higher-than-programmed growth of reserve money, and considered that a stronger effort is needed to mop up excess liquidity and restore positive real interest rates. They welcomed that the overall fiscal performance has remained in line with the program. However, they stressed the need to contain the fiscal deficit and reduce Tanzania's dependence on external financing by boosting tax revenue, and welcomed the revenue-enhancing initiatives of the 2002/03 budget.

Directors stressed the importance of good debtor/creditor relations and urged the authorities to settle the issues related to the outstanding debt service obligations to one creditor expeditiously.

Directors welcomed the takeover of the electricity supply company's management by a new team from the private sector, and the subsequent progress made in addressing the financial problems of the company, and hoped that an agreement will be reached soon on a retrenchment benefits package. They also urged the authorities to search for a creative solution to the dispute regarding the divestiture of the 35 percent shares of the telecommunications company.

Directors noted the authorities' wish to "graduate" from PRGF borrowing. They indicated that the authorities and the staff would need to think about an appropriate exit strategy for Tanzania, possibly in the context of the broader discussion of the Fund's role in low-income countries scheduled for early 2003.

The Executive Board took the following decision, with one abstention from Mr. Lushin (RU):

1. Tanzania has consulted with the Fund in accordance with paragraph 2(ee) of the three-year arrangement for Tanzania under the Poverty Reduction and Growth Facility (PRGF) (EBS/00/44, Sup. 1; 4/6/00) in order to review program implementation and reach understandings regarding phasing and conditions for disbursements during the remainder of the arrangement. Tanzania has also requested an extension of the period of the arrangement to allow disbursement of the seventh loan.

2. The letter dated November 2, 2002 from the Minister of Finance of Tanzania (the "Letter"), is attached to the three-year PRGF arrangement for Tanzania, and the letters dated March 9, 2000, July 18, 2000, February 24, 2001, August 31, 2001 and March 29, 2002, from the Minister of Finance of Tanzania, together with their respective Technical Memoranda of Understanding, shall be read as supplemented and modified by the Letter.

3. Accordingly, the commitment period is extended until June 30, 2003 and the three-year PRGF arrangement for Tanzania shall be amended as follows:

a. The period of the arrangement is extended through June 30, 2003 and paragraph 1(a) of the arrangement shall be amended by deleting the phrase "For a period of three years from March 31, 2000" and replacing it with the phrase "For the period through June 30, 2003".

b. Paragraph 1(cc) shall be amended to add:

"(iv) the seventh disbursement under the arrangement, in an amount equivalent to SDR 15 million, will be available on May 15, 2003 at the request of Tanzania and subject to paragraph 2 below".

c. The performance criteria for December 31, 2002, set forth in paragraph 2(a) of the arrangement with respect to the seventh disbursement shall be as set forth in Table 3 of the Letter.

d. A new paragraph 2(ccccc) shall be added as follows:

"2(ccccc) If, with respect to the seventh disbursement referred to in paragraph 1(cc)(iv) above, the Managing Director of the

Trustee finds that Tanzania has not carried out its intentions with regard to:

(i) by end-February 2003, the submission to parliament of the amendments to the Loans, Guarantees and Grants Act, as set out in paragraphs 3 and 34 of the Letter and its Table 4; and

(ii) by end-February 2003, the identification of budgetary codes for priority expenditures and the incorporation of these codes into the budget guidelines for 2003/4, as described in paragraph 28 of the Letter and its Table 4."

e. A new paragraph 2(eee) shall be added as follows:

"2(eee) until the Trustee has determined that the sixth review referred to in paragraph 1 of the Letter has been completed".

4. The Fund decides that the fifth review contemplated in paragraph 2(ee) of the three-year arrangement under the PRGF for Tanzania is completed and that Tanzania may request the sixth disbursement under the arrangement, notwithstanding the nonobservance of (a) the continuous performance criterion on nonaccumulation of external arrears, and (b) the structural performance criterion on the submission to parliament by October 31, 2002 of legislative amendments which require cabinet approval of the contracting or guaranteeing by Tanzania of any new foreign debt, as specified in paragraphs 2(b) and 2(cccc)(iii) of the arrangement, respectively, on the condition that the information provided by Tanzania on the performance under these criteria is accurate. (EBS/02/187, Sup. 1, 11/18/02)

Decision No. 12883-(02/114), adopted
November 18, 2002

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/02/113 (11/13/02) and EBM/02/114 (11/18/02).

3. REPORT ON OUTCOME OF FATF PLENARY MEETING AND PROPOSAL FOR ENDORSEMENT OF METHODOLOGY FOR ASSESSING COMPLIANCE WITH ANTI-MONEY LAUNDERING AND COMBATING FINANCING OF TERRORISM STANDARD

Executive Directors take note that the conditions set forth in BUFF/02/122 are met and add the FATF 40+8 Recommendations to the list of areas and associated standards and codes useful to the operational work of the Fund for which assessments will be undertaken and reports on the Observance of Standards and Codes (ROSCs) will be prepared.

Executive Directors endorse the comprehensive and integrated methodology that was endorsed at the FATF October 2002 Plenary. (SM/02/349, 11/8/02)

Decision No. 12884-(02/114), adopted
November 15, 2002

4. APPROVAL OF MINUTES

The minute of Executive Board Meeting 02/47 is approved.

5. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors, by Advisors to Executive Directors, and by an Assistant to Executive Director as set forth in EBAM/02/138 (11/13/02) is approved.

6. TRAVEL BY MANAGING DIRECTOR

Travel by the Managing Director as set forth in EBAP/02/133 (11/13/02) is approved.

APPROVAL: February 10, 2003

SHAILENDRA J. ANJARIA
Secretary