January 22, 2003
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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 02/104

10:00 a.m., October 9, 2002

Contents

Executive Board Attendance

E. Aninat, Acting Chair
S. Sugisaki, Acting Chair

Executive Directors	**Alternate Executive Directors**
S.M. Al-Turki	A.A. Al-Nassar, Temporary
	D. Ondo Mañe
	T.-M. Kudiwu, Temporary
	E. Nyambal, Temporary
	C. Gust, Temporary
	C.J. Faircloth, Temporary
	P.R. Fenton, Temporary
	W.-D. Cho, Temporary
	D. Baasankhuu, Temporary
	H.-H. Jang, Temporary
	W. Szczuka
	T. Skurzewski, Temporary
	S. Antic, Temporary
	B. Siegenthaler, Temporary
	R. von Kleist
	C. Harzer, Temporary
	H. Vittas
	D. Lombardi, Temporary
	B. Bossone, Temporary
D.I. Djojosobroto	T. Segara, Temporary
	H.E. Phang, Temporary
	D.B. Waluyo, Temporary
Y.V. Reddy	V. Bhaskar, Temporary
	R. Gauba, Temporary
	J. Prader
	M. Marques, Temporary
	C. Josz, Temporary
Ó. Ísleifsson	M.L. Nikitin, Temporary
	A. Alber, Temporary
	M. Lundsager
	A. Baukol, Temporary
	N. Epstein, Temporary
P. Duquesne	A. Requin, Temporary
	S. Boucher, Temporary
A. Mirakhor	M. Daïri, Temporary
	J.K. Kwakye, Temporary
	L. Palei, Temporary
	Y. Lissovolik, Temporary
	M. Beauregard, Temporary
	P. Moreno, Temporary
	E. González-Sánchez, Temporary
	M.A. Brooke
	D. Merotto, Temporary
	B. Kelmanson, Temporary
	R. Steiner
	V. de los Santos, Temporary
	A. Maciá, Temporary

C.D.R. Rustomjee
A.S. Shaalan
Wei Benhua

B.T. Mamba, Temporary
N.H. Farhan, Temporary
Liu F., Temporary
H. Litman, Temporary
D. Radev, Temporary
M. Faulend, Temporary
H. Toyama
T. Komatsuzaki, Temporary
C.E. Pereyra, Temporary
D. Vogel, Temporary

S.J. Anjaria, Secretary
A.S. Linde, Acting Secretary
A. Mountford, Acting Secretary
Y. Chia, Assistant
Z.R. Ahmed, Assistant
S. Maxwell, Assistant

Also Present
Legal Department: B. Steinki, D. Siegel, M. Federici; Middle Eastern Department: G.T. Abed, Director; Z. Iqbal, S. Eken, A. Jbili, U. Fasano, V. Can Thai, B. Okogu; Monetary and Exchange Affairs Department: R. Abrams; Policy Development and Review Department: S. Kashiwagi, M. Fetherston, C. Sdralevich, J. Hallaert; Secretary's Department: L. Hubloue, P. Ramlogan, P. Gotur; Statistics Department: L. Fernando; Treasurer's Department: S. Ding; Office of the Managing Director: A. Tweedie; Advisors to Executive Directors: M.A. Ahmed, E. Azoulay, S.A. Bakhache, S.S. Farid, A.R. Ismael, M.F. Melhem, N. Mensah-Zekpa, J. Milton, A. Muganda, K. Sakr, Å. Törnqvist; Assistants to Executive Directors: M. Abbing, T. Belay, X. Bonnet, G.M. Campos, H. Fabig, T. Hadded, J.T. Kanu, G. Nadali-Ataabadi, A. Rambarran, Y. Saito, T. Sekine, J. Sipko, A. Stuart, S. Urinbaev.

1. BOTSWANA—2002 ARTICLE IV CONSULTATION

Documents: Staff Report for the 2002 Article IV Consultation (SM/02/256, 8/14/02; and Cor. 1, 10/4/02); and Selected Issues and Statistical Appendix (SM/02/293, 9/16/02)

Staff: Green, AFR; Kashiwagi, PDR

Length: 1 hour, 25 minutes

The staff representative from African Department (Mr. Green) submitted the following statement:

> The following information has become available since the staff report (SM/02/256) was issued on August 14. It does not change the thrust of the staff appraisal.
>
> The transition from sales tax to value added tax (VAT) has gone well. Most traders registered before the July launch, and despite some teething problems, the system is working without significant disruptions. We will continue to monitor the VAT, in particular the impact on prices, government revenue, and the refund mechanism for exporters.
>
> Headline inflation rose from just under 6 percent in June 2002 to 8.8 percent in July and 9.9 percent in August 2002. Much of the rise is the result of the replacement of the sales tax with the VAT, which is more broad-based. The impact in July—about 3 percentage points—is in line with staff expectations, but a larger than expected rise in food prices in August could push inflation for the year above the current projections of 6.75 percent. In its mid-year review of monetary policy, the Bank of Botswana indicated its intention to be guided by underlying inflation, that is excluding the VAT effect, when assessing inflationary developments, provided that public and private wage settlements are not adjusted to compensate for this tax increase. The staff supports this view.
>
> The regional food situation has not caused problems in Botswana on the scale experienced by some of its neighbors, and the authorities are providing relief to those in need through existing drought relief programs. These include short-term employment projects, which this year have been undertaken as part of the National Master Plan for Agricultural Development.

Mr. Rustomjee submitted the following statement:

> The Botswana authorities wish to express their gratitude for continued Fund support, in particular, for the provision of technical assistance from which the authorities continue to benefit and to utilize effectively. In the same spirit, the authorities wish to convey their appreciation for a candid exchange

of views with the staff during the recent Article IV Consultation discussions. The authorities agree with the staff assessment presented in the 2002 Article IV Consultation staff report, and view the report as fair and balanced, in assessing economic developments and issues, and in providing policy recommendations.

Recent Economic Developments

Botswana continues to pursue sound and market friendly economic policies; this stance has helped the authorities to withstand two external shocks in 2001 and the regional food shortage in 2002. Output growth is expected to recover in 2002/03 reflecting a rebound in the demand for diamonds in the global market and the authorities' efforts towards economic diversification, as evidenced in the strong growth in non-mining sectors. The budget deficit estimated at 2.5 percent of GDP in 2001/02 (April/May), resulted from an unexpected decline in mineral revenue and an increase in recurrent expenditure, reflecting a rise in teachers' salaries and health care costs. Although the inflation rate declined to under 6 percent in June 2002, the Bank of Botswana's provisional estimates suggest that the implementation of value-added-tax (VAT) introduced on July 1, 2002, is expected to result in a one-off rise of Consumer Price Index and cause inflation to rise albeit temporarily, by an estimated 4-6 percent increase. The impact of VAT is reflected in the recent rise in inflation from under 6 percent in June 2002 to 9.9 in August 2002. The external current account is estimated to have been in a surplus in 2001 but considerably lower than in 2000, on account of diamond export earnings. End 2002 reserves were recorded at 32 months of imports.

Economic Prospects

In looking ahead, the authorities are focusing on a number of challenges that could potentially adversely impact on the momentum of economic growth. To ensure prudent macroeconomic policies, sustainable economic growth and poverty reduction, the authorities are focusing their efforts towards diversifying the economy, addressing the HIV/AIDS pandemic, promoting private sector development and boosting non-mineral revenue.

With respect to economic diversification, the authorities are undertaking numerous measures aimed at improving productivity and lowering transaction costs in order to boost competitiveness and to achieve their diversification objective. These measures include infrastructure development, provision of serviced land for private development, streamlining procedures for granting work and residency permits, as well as investing heavily in education to address shortages of skilled labor and in health to tackle the HIV/AIDS pandemic.

These efforts are evidenced by the rise in the share of output in non-mining private sector activities, from 47 percent of GDP in 1990 to 51 percent in 2000. Moreover, staff projections indicate that output in the non-mineral sector would expand by about 5 percent a year in the short-term but slow to 4-4.5 percent in the medium-term on account of the detrimental impact of HIV/AIDS.

The authorities have taken the HIV/AIDS pandemic issue seriously and are addressing the challenge head-on. They have put in place a comprehensive HIV/AIDS program aimed at controlling the spread of the pandemic and alleviating the suffering of the population. Efforts including the coordination necessary for the effective mobilization of support from all stakeholders, the international community, are spearheaded at the highest political level. In this regard, a national AIDS coordinating agency, (NACA) has been established in the office of the President.

The authorities are tackling the HIV/AIDS from different angles. Among other measures, the authorities have increased budget allocations to the health sector substantially and have pursued an aggressive education and public enlightenment campaign for several years now. In addition, an antiretroviral therapy on a pilot basis has begun in major cities. While the budgetary implication of HIV/AIDS may be difficult to quantify at this stage, the impact is likely to be very high. As indicated in the staff report in Box 1, the fiscal implications could reach Pula 1.4 billion or 4.25 percent of GDP by 2006. Other staff estimates (presented in the Selected Issues and Statistical Appendix) project the cost at 10 percent of GDP, by 2010. The authorities are aware of the severity of the situation and intend to continue to address this pandemic aggressively, from all perspectives. As a consequence, a number of measures are being pursued with a view to achieve the following by year 2010: a 50 percent reduction in new infections, a 95 percent rate of access to basic, intermediate and advanced care, and a 50 percent reduction of the overall impact on the population.

Fiscal Policy

Botswana will continue to pursue prudent fiscal management anchored on the National Development Plan (NDP) and the overarching principle of sustainability. The 2002/03 budget projects a deficit of 4.75 percent of GDP largely on account of continued weakness in the diamond market and health expenditure reflecting HIV/AIDS and related illnesses. Notwithstanding the projected deficit, the authorities are determined to maintaining the tradition fiscal sustainability. While staff observes the likelihood of a higher-than-budgeted deficit for the foreseeable future due to rising healthcare costs, the authorities are of the view that this could be avoided through a reduction in capital expenditure, not least because of capacity limitations. Moreover, on the revenue side, the authorities are intensifying efforts to improve tax administration in order to strengthen medium-term budget sustainability and to boost non-mineral revenue, and to compensate for the decline in SACU revenues. To this end, the authorities introduced a value-added-tax (VAT) replacing the domestic sales tax on July 1, 2002. In the same vein, the authorities have indicated an interest in establishing a revenue authority as a further means of augmenting domestic tax collections and underpinning domestic revenue mobilization efforts.

Monetary and Fiscal Policy Coordination

With regard to better coordination of monetary and fiscal policies, the authorities concur with staff that a better understanding of the link between government expenditure and the crowding out of the private sector could improve the policy mix. In this context, the authorities support staff recommendations in the report, in particular those relating to the Ministry of Finance and Development Planning to develop a domestic balance measure of the fiscal policy jointly with the Bank of Botswana.

Monetary and Exchange Rate Policy and Inflation

Monetary policy is anchored by Botswana's exchange rate peg to a basket comprising the South African rand and the SDR. The Bank of Botswana also seeks to maintain a low inflation rate by maintaining inflation in the current range of 4-6 percent. To this end, the Bank of Botswana will remain vigilant in monitoring inflation trends following the introduction of VAT to ensure that the monetary policy stance of maintaining sustainable low and stable inflation is adhered to both in the short and medium term.

Other Issues

Data issues—the authorities still face a number of deficiencies in their economic and statistical data, in particular, in the national accounts, balance of payments and some fiscal data. The authorities are aware of the deficiencies and are therefore taking appropriate measures to address them. To strengthen the economic and statistical data and to address comprehensively the deficiencies, the authorities are actively participating in the Fund's General Data Dissemination System (GDDS) and concur with staff on the need to accelerate efforts to complete the process.

Mr. Guinigundo and Mr. Baasankhuu submitted the following statement:

Key points:

Botswana has demonstrated that sound macroeconomic and structural policies and adequate financial resources are critical to a country's ability to weather external shocks and to provide sufficient room for addressing new challenges. The authorities are encouraged to further pursue these sound policies;

The foremost challenge for Botswana is the high incidence of HIV/AIDS. The government should continue to mount concerted efforts to address this challenge, in addition to sustaining efforts to reduce poverty and promote growth despite lower diamond production. It would be useful to conduct a further study of the impact of HIV/AIDS on the economy, budget and human development in terms of cost and policy options;

The staff's report would have been more beneficial if it demonstrated how their own suggestion of using alternative fiscal balance measures would work and the benefits the country could derive from them;

We urge the authorities to address the adverse impact of tight monetary policy on the business environment. A more accommodative monetary policy may need to be considered with due regard to its potential impact on domestic demand and inflation;

The authorities are encouraged to more regularly collect poverty data and to conduct social and poverty impact analysis on recent and contemplated policies.

The authorities should be commended for their sound macroeconomic and structural policies which, with adequate foreign reserves, allowed Botswana to weather two external shocks in 2001 and the regional food shortage this year. We note the acceleration of output growth in the non-mining sector, while inflation was reduced to a two-year low at the end of 2001. Botswana has also been able to sustain a healthy surplus in its external payments position. The international perception of Botswana's financial strength and commitment to sound policies was reinforced with the recent investment-grade sovereign debt ratings.

We would like to see this positive trend in key economic indicators continue and for a retention of market confidence. We would therefore encourage the authorities to pay close attention in the near future to some key challenges and the risks to a favorable outlook.

Fiscal policies

We agree that the government's commitment to further restrain non-health expenditures and to balance the budget is appropriate given the great uncertainty related to HIV/AIDS spending and the declining revenues from the mining sector. However, the country's high incidence of HIV/AIDS is a challenge that cannot be ignored. The selected issues paper has estimated the high cost of treating HIV/AIDS patients: about 10 percent of GDP by 2010, which is only a baseline estimate and does not include indirect costs such as increased sick leave among the working population.

The authorities' efforts in developing a medium-term expenditure framework and improving fiscal management are impressive, as noted in both the staff report and the selected issues paper. In this regard, we urge the authorities to sustain this medium-term perspective so that any potential obstacle to the healthy fiscal position could be anticipated and addressed expeditiously.

We note with concern that the current mix of fiscal and monetary policies is impeding private sector investment. We support the staff's recommendation that greater coordination between fiscal and monetary policies is necessary. In particular, we are somewhat disappointed in the absence of discussions between the staff and the authorities on future tax policy to reduce the relatively high ratio of revenues to GDP and to help stimulate private sector activity and economic growth. The staff's comments would be welcome.

The approach by the authorities to achieve fiscal sustainability by restricting the use of mineral revenue to development spending, and using non-mineral revenues for current spending, has led to an accumulation of considerable revenue. This has helped the authorities to cope with the new diamond plateau environment and to partially meet the costs of the HIV/AIDS prevention and treatment programs. In this respect, we welcome the staff's suggestion to consider alternative fiscal balance measures to judge the appropriateness of public spending and tax levels, in particular, their impact on domestic resources and inflation. We are encouraged by the authorities' assurance that they would consider the proposals. We believe the staff report could have been more useful and interesting if it was able to demonstrate how those possible options would work and if it provided detail on the benefits that could be derived from them.

Parenthetically, with respect to the staff's medium-term projections, we are concerned that some of the estimates, in particular the growth rate of fiscal indicators, seem to be overly optimistic. For instance, the growth rate of expenditures would remain at 4 percent on average against much higher revenue growth. What about the prospect of allocating higher resources to the HIV/AIDS program, poverty reduction and social safety nets?

HIV/AIDS

HIV/AIDS is becoming a more daunting challenge. As the selected issues paper indicates, the country has the highest HIV/AIDS incidence in the world with 38.8 percent of adults (15-49 years old) being infected. The authorities are to be commended for their efforts to more comprehensively address this issue by substantially increasing health expenditure, and public awareness programs. We also welcome the establishment of the National AIDS Coordinating Agency to help spearhead the anti-HIV/AIDS program at the highest political level, as Mr. Rustomjee reported in his statement. It is encouraging that the government's efforts towards combating the spread of HIV/AIDS have been doubled in recent years. However, as the incidence of HIV/AIDS remains high, further efforts are necessary to accelerate the allocation of more resources to the anti-HIV/AIDS program. The future of all Botswanians is at stake.

The staff analysis to some extent shows the impact of the increasing incidence of HIV/AIDS on the economy, particularly the budget. As indicated by staff, what hampers further progress on this work is the lack of a true measure of the spread of HIV/AIDS, effectiveness of the treatment, and the cost of medical treatment so as to predict the long and medium term implications of the problem. We urge the authorities to further review and study the problem and estimate its impact and implications on economic, social and human development as fully and widely as possible. We also urge the authorities to review its experiences in implementing the anti-HIV/AIDS program.

Monetary issues

While sustaining a good balance of monetary and fiscal policies, we urge the authorities to give more focus to the pressing issue of the adverse impact of tight monetary policy on the business environment. Interest rates are high, crowding-out private spending including business investment. We believe that a more accommodative monetary policy would be helpful as long as domestic demand remains generally subdued. Already there have been indirect signs that domestic demand pressures have started to ease. However, at the time of the consultation, the staff advised the central bank to further monitor economic trends before relaxing monetary policy. We wonder if the trends have changed and signs of further easing in demand pressures have emerged so that staff may now advise the authorities to shift gear in favor of a more accommodative monetary policy.

While the current exchange rate arrangement and price stability goal seem to be consistent, it would be useful for the authorities to continue monitoring closely the country's external competitiveness. An unwavering pursuit of structural policies will support a more competitive economy.

Other issues

We are pleased that the staff report provided some information about the differences between the staff's and the authorities' projections and assumptions. We encourage both parties to be more conservative in their assumptions, particularly on growth.

Moreover, it is somewhat disturbing that poverty data has not been collected since 1994. This lack of documentation is making it almost impossible to determine the impact of recent economic policies on poverty. We encourage the authorities to pay more attention to this issue and to resume more regular collection of poverty data. This will allow a meaningful analysis of the problem, its extent and incidence, and to monitor progress on public efforts to address it.

We are encouraged by the authorities' efforts to address the deficiencies in the national accounts, BOP and fiscal data, and participation in the GDDS.

Mr. Reddy submitted the following statement:

We thank the staff for an objective report and Mr. Rustomjee for his concise and insightful statement. We note with satisfaction the broad convergence of views between staff and authorities and have the following brief comments.

Botswana is to be commended for steadfast implementation of sound macroeconomic policies, which has enabled it to weather multiple external shocks and a regional food crisis. Output growth in nonmining sector demonstrates the success of Botswana's ongoing diversification efforts. We welcome their efforts aimed at building infrastructure, boosting competitiveness, improving financial services and lowering transaction costs. Diamond production has plateaued and maintaining the high levels of growth recorded over the last fifteen years is admittedly difficult. The authorities are, however, more optimistic than staff, the difference in their projections arising from varying assessments of macroeconomic consequences of HIV/AIDS. Over time, it should be possible to aim for greater convergence.

While exact quantification of its impact may vary, there is little doubt that HIV/AIDS remains the major challenge for Botswana and could undo years of economic growth. We find it reassuring that the authorities are responding in full measure to tackle this problem. The substantial increase in public health spending has contributed to reemergence of fiscal deficit. The staff has observed that this is due to temporary factors. While we agree that the drop in mineral revenue could be so, the long-term cost implications of HIV/AIDS are yet unclear. With nearly forty percent of the adult population believed to be affected and the number of AIDS cases projected to more than double by 2006, the enormity of the challenge is daunting. This in fact is an issue that concerns the whole region. Adequate international support needs to be mobilized to ensure that the fiscal and human resource implications of fight against HIV/AIDS do not jeopardize the growth and poverty reduction efforts. Is this materializing in Botswana? Staff comments are welcome.

We welcome the authorities' efforts to improve tax administration, introduction of VAT and the proposed establishment of a revenue authority. These should be complemented by considering the staff's suggestion to limit public sector wage increases to compensating for inflation. The authorities are in agreement on the need to improve fiscal and monetary policy coordination to facilitate private sector development and we look forward to concrete measures in this direction.

Finally, we wish the Botswana authorities success in their policy endeavors.

Mr. Daïri submitted the following statement:

Key points:

Botswana has weathered well the recent exogenous shocks;

The exchange rate peg and prudent monetary policy have contributed to stability;

Mounting AIDS-related spending and lower diamond revenue projections necessitate a modification of fiscal policy framework over the medium term;

To facilitate private-sector development, fiscal and monetary policies need to be better coordinated;

Growth promotion and poverty reduction require structural reforms geared toward economic diversification.

We thank the staff for the well-written and high-quality papers, and Mr. Rustomjee for his illuminating statement. Sustained pursuit of prudent macroeconomic policies, combined with abundant diamond resources, has transformed Botswana to a middle-income country. In 2001/02, notwithstanding adverse external shocks, the real economy continued to expand, albeit at a much slower pace, reflecting weak diamond demand, while nonmining output grew faster, following the authorities' intensified efforts toward economic diversification. Inflation fell to a 20-year low, and, despite lower diamond export earnings, the external current account recorded another surplus, and gross official reserves remained abundant. There was also some progress in structural reforms and in the evaluation of a draft poverty reduction strategy. The overall fiscal balance, however, moved into deficit as a result of lower mineral revenue, combined with higher expenditure. The authorities deserve credit for their commitment to sound economic policies, as well as their progress in implementing a comprehensive approach to HIV/AIDS, which has bolstered investor confidence and market perception, evidenced by Botswana's investment-grade sovereign debt ratings. We concur with the thrust of the staff appraisal and its main policy recommendations. We also believe that achieving the growth target of the ninth National Development Plan (NDP-9) in the face of daunting challenges posed by HIV/AIDS human tragedy and the plateau in diamond production hinges on enhanced policy coordination as well as perseverance with structural reforms.

Botswana benefits from a sound fiscal policy anchored in the NDP and the overarching principle of sustainability. However, rising HIV/AIDS demands, slowing growth in diamond revenue, and the expected fall in Customs Union receipts argue for a strengthened policy framework over the medium term. We agree with the staff that adopting a new fiscal rule to accommodate emerging fiscal pressures, improving the coordination of monetary and fiscal policies, disseminating more comprehensive information on the budget, and moving toward an outcome-oriented budget process would contribute to greater effectiveness. On the revenue side, we welcome the introduction of the new VAT in July 2002, as well as efforts in ensuring future efficiency gains through careful implementation. Plans to establish a revenue authority are also appropriate, promising to further bolster domestic tax collection. On the expenditure side, given an already high government spending to GDP ratio by regional standards, and the potentially large fiscal cost of HIV/AIDS program, we welcome efforts to restrain spending increases through public sector reform. This should help reduce high interest rates and crowding out of private spending, particularly business investment. A more conservative capital expenditure program, in line with available supervisory capacity, would eliminate inefficiency in the implementation of public projects. We also welcome the government policy to limit the use of supplementary budgets to emergency situations.

Monetary policy, anchored by an exchange rate peg, has contributed to low inflation and a stable financial environment. Botswana's insufficiently-developed capital market has allowed the central bank to pursue an independent interest rate policy to achieve the inflation objective, while maintaining the peg. Despite high borrowing costs curtailing investment, the authorities are right in maintaining a tight monetary stance until there are firm signs that demand pressures are abating. On the exchange rate policy, we note partial loss of external competitiveness due to sharp depreciation of the South African rand against SDR, and the authorities' decision to give up an effective targeting of the rand and to strictly implement the basket peg arrangement. However, given the lackluster performance of Botswana's manufacturing sector over the past years, we share the staff's view on the need for cost containment through productivity gains and wage moderation.

Promoting private sector-led growth and reducing unemployment and poverty will require structural reforms aimed at diversifying the economy and reducing its heavy reliance on the diamond sector. Botswana has appropriately adopted a market-based approach to diversification conducive to private sector development. With shortages of skilled labor restraining growth, we welcome increased investment in education as well as easing the permit process for skilled foreign workers. Recent measures to strengthen government efficiency, including the formation of a privatization agency, and plans to make more serviced land available for private sector use should enhance competitiveness of the non-diamond sector. The staff's suggestion to turn over some of the development projects anticipated under NDP-9 to the private sector also merits the authorities' careful consideration. Given the rapid growth in the nonbank financial sector, and privatization of government employee pensions, we welcome the planned review of financial sector supervision as well as the authorities' careful monitoring of recent asset price increases.

Finally, given that long data reporting lags, and different reporting periods for the major sectors hamper the assessment of macroeconomic conditions, the authorities are encouraged to complete the process of participation in the Fund's GDDS at an early date.

Mr. Kudiwu made the following statement:

We would like to join Directors who have issued statements in commending the authorities of Botswana for their steadfast implementation of prudent policies, and a disciplined use of the diamond revenue. This prudent approach has enabled the country to sustain a high level of economic growth and financial surpluses, which have enabled Botswana to withstand well the several exogenous shocks that it has experienced recently. We would also like to commend the authorities for their comprehensive approach to address the HIV/AIDS epidemic, and, in particular, the measures taken to prevent further infection.

Overall, we are in general agreement with the staff's analysis and policy recommendations, and we welcome the broad agreement of the authorities with the staff's assessment, as noted in Mr. Rustomjee's informative statement.

Despite the good progress made by Botswana, the country faces a number of serious challenges. We are encouraged by Mr.Rustomjee's statement that the authorities are focusing on these challenges and are implementing policies to address them.

As regards the HIV/AIDS epidemic, there is not much that we can add. The authorities are fully conscious of the problem, and they are taking a comprehensive approach to HIV/AIDS. With the number of cases projected to double by 2006, this is a human tragedy of enormous proportion, and the macroeconomic consequences will last over the longer term. We, therefore, join Mr. Reddy in calling for adequate international support for Botswana, to meet this daunting challenge.

Turning briefly to other issues, we welcome the authorities' focus on diversifying the economy. They are appropriately using the resources from diamond to diversify the productive base, thus preventing the creation of large debts. It is encouraging to note that the share of output of non-mining private sector activity has increased to over 50 percent, with projection of over 4 percent over the medium term. This is an encouraging projection. However, we would urge the authorities to ensure that these new areas of activity remain competitive. Besides, prudent macroeconomic and incomes policies, efforts will need to be pursued to improve infrastructure, strengthen and simplify the business environment, and especially invest in the right type of education to address the shortages of skilled labor.

As regards macroeconomic policy, the authorities have pursued a prudent approach. The anchoring of their fiscal policy to the National Development Plan has served the country well, and has been a source of stability. In this respect, we note that over the past 20 years, Botswana has registered only two deficits, and both were due mainly to unexpected drop in mineral revenue. The prudent approach of the authorities is seen by the fact that mineral revenue is allocated to development spending, including health and education, while government recurring spending is met through nonmineral revenue. We commend the authorities for this excellent approach. However, it may be useful to get a better coordination between fiscal and monetary policy, as monetary policy seems to be carrying most of the burden of the fight against inflation. The higher level of interest rates also seems to be inhibiting private investment.

The introduction of the VAT is welcomed, as well as the efforts to establish a revenue authority. Given the resource needs for the fight against the HIV/AIDS epidemic, a more restrained approach to outlays in other areas may be necessary over the medium term.

On structural reforms, we commend the authorities for the progress made towards creating an environment conducive to private sector development. However, the issue of competitiveness, as mentioned above, including improving labor skills need to be given greater attention.

In conclusion, let me say that this chair commends the Botswana authorities for their prudent management of their economy, and for their approach to the HIV/AIDS epidemic. We wish them continued success in their ongoing efforts.

Mr. Lombardi made the following statement:

At the outset, we would like to express our appreciation to the staff for writing an excellent set of papers and to Mr. Rustomjee for his informative statement.

Botswana's authorities need to be commended for pursuing sound and stability-oriented macroeconomic policies. Indeed, these policies helped the authorities to weather two external shocks in 2001 and to withstand the regional food shortage this year.

Since the staff report covers well the relevant issues, we shall confine our remarks to the following points.

As we learn from the report, monetary authorities have pegged the pula to a basket comprising the South African rand and the SDR. However, the currency weights are undisclosed and analysts have typically to recur to their judgment about what the weights in the basket are likely to be. Our concern is that such a lack of transparency in the monetary framework may hamper the efforts by agents to correctly assess their expectations on given economic variables. Eventually, with the gradual development of capital markets, this may become more relevant.

Furthermore, the Bank of Botswana also pursues a policy of low inflation by aiming to hold inflation within a range between 4 percent and 6 percent. Obviously, controlling two variables with one instrument may prove challenging. Also in this case, the development of capital markets will call for a change in the monetary framework. We would like to know whether any change in the current framework is envisaged by authorities in the near future.

On the exchange rate, the prudent policies implemented by the authorities have resulted in an appreciation of the pula that has highlighted some problems as far as the competitiveness is concerned. As the staff report notes, the authorities are reluctant to allow for a depreciation of the currency since this could undermine the public perception of policy stability, as well as compromise the gains made in breaking expectations of nominal depreciations to offset domestic inflation above that in trading partners. As a result, the alternative available to authorities to avoid loss in competitiveness is increasing productivity. To this end, monetary authorities may consider loosening their monetary stance later on, when demand pressure will ease somehow, since real interest rates are currently quite high. Actually, the report points to some evidence that business investment has been remarkably affected by the current restrictive monetary stance.

In fact, a better policy mix that would not crowd out business investment might also be of help in increasing the diversification of

Botswana's production base, since the production of diamonds has reached a plateau. In this regard, we also note that government revenues are too heavily dependent on the mineral sector. This is worrisome since the social spending needs to rise due to, among other things, the HIV/AIDS pandemic.

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

Mr. Baukol made the following statement:

The economy of Botswana can be summed up in two words: diamonds and HIV/AIDS. Botswana is blessed with an abundance of diamonds and, more importantly, it has managed these resources well. Over time, the authorities have built reserves, refrained from excessive debt, generally avoided ill-conceived schemes to spend money, and followed through with structural reform measures that have encouraged the development of the non-mineral economy. As a result, Botswana built a relatively stable and well-off economy, and has made progress in reducing poverty. In the past decade, however, this positive picture has been severely complicated by the HIV/AIDS tragedy. And, in the past year, the economy has suffered some shocks, including the regional drought and the instability in neighboring Zimbabwe.

HIV/AIDS

Botswana faces the highest HIV rate in the world. The authorities have been addressing HIV/AIDS in the past few years in a comprehensive manner, including both prevention and treatment programs, as described in Mr. Rustomjee's forthright statement. We welcome this approach and the efforts of the international community to assist the authorities.

The staff has provided useful analysis on the fiscal implications of HIV/AIDS. While the Fund has a limited role in designing HIV/AIDS strategies, staff assistance in analyzing growth and fiscal implications can be critical for ensuring that any strategy is consistent with medium- and long-term sustainability. Unfortunately, Botswana, with the rest of the world, will be dealing with HIV/AIDS for many years to come.

Fiscal

Turning to fiscal policy, the authorities should continue to keep medium-term goals in mind, as the cost of HIV/AIDS will rise significantly, revenues decline, and diamond wealth unlikely to keep pace. To this end, the sizable jump in expenditures planned for next year seems ill-advised. A 40 percent increase in capital spending is particularly questionable, as we doubt that the authorities will be able to spend such a large increase in funds in a productive manner. And we share concerns of the staff that relatively high public spending overall contributes to crowding out of the private sector. The selected issues paper indicates that spending often deviates significantly from the levels in the 6-year National Development Plans. Clearly, more progress could be made here in making the annual reviews more transparent and linking the plans more closely to the budget.

The authorities have boosted civil service salaries by 20 percent late last year, after several years of no changes. We urge the authorities to follow through on their plans going forward to shift to smaller, annual adjustments in public sector salaries, rather than engage in larger adjustments every few years. The authorities should also take additional steps to improve the efficiency of the public sector, including through privatization and through channeling some planned development projects from public management to the private sector.

Monetary/Banking

On monetary issues, the staff supplement indicates that inflation has risen to almost 10 percent, significantly above the target band, and not only because of the introduction of the VAT. This suggests that the authorities' decision not to cut interest rates earlier this year was probably correct. It also argues against an easing of interest rates going forward. Staff comments are welcome.

On the exchange rate, we concur with the concerns of Mr. Lombardi regarding transparency of the current exchange rate regime. While avoiding a strict peg to the rand, the authorities should continue to guard against the impact of Dutch Disease on non-mineral exports. The data suggest that non-mineral exports have declined for several years, which is a worrisome trend. I concur with the comments of several Directors regarding the need for cost containment and productivity gains to safeguard competitiveness. I note that Botswana has been added to the list of countries eligible for AGOA benefits, and we encourage Botswana to take advantage of these preferences. Going forward, Fund staff and the authorities should monitor the monetary regime closely, as well as the authorities' ability to target both the exchange rate and interest rate with one instrument.

The authorities appear to have managed the financial sector well, and they should continue to monitor banks' exposure in light of the strong growth in asset prices related to the development of the private pension system. We note the steps described to combat money laundering and commend Botswana for its efforts to search for and block the assets of terrorists. We urge the authorities to follow up on the recommendations of the recent MAE mission to strengthen their AML/CFT regime. We would also appreciate any further information from the staff regarding earlier plans to develop an off-shore financial center, and possible risks involved.

Finally, we encourage the authorities to take further steps to improve their data collection and dissemination. As an investment grade country, it is surprising that Botswana is still not fully on board the GDDS. We would encourage Botswana to move forward with their aim to join SDDS. We also welcome publication of the staff report.

Mr. Marques made the following statement:

Botswana has earned universal recognition for its consistently high growth rates, prudent macroeconomic management, and political and economic stability. Because the discovery of diamonds was accompanied by judicious economic and political management, Botswana has become one of the fastest growing countries in the world.

Botswana's accomplishments stand out with special clarity because it is surrounded by neighbors who have suffered both economic and political mismanagement.

Despite its remarkable economic performance, Botswana remains afflicted by widespread poverty due mostly to the economic weakness of its rural areas, a lack of adequate human assets, high population growth, unequal access to resources, and socio-cultural problems (including gender relations), and high unemployment.

The economy is still vulnerable. Its geographic situation exposes it to drought. For the rural majority, eking out a livelihood is arduous, with little relief from such aids as irrigation. Its large size and thinly dispersed population increases the costs of transportation, provision of services, and construction.

Botswana's serious economic vulnerability results from its great dependence on mining, particularly of diamonds, which account for about one-third of GDP and three-quarters of export earnings, and provide nearly half of government revenues. This overreliance on a single export threatens Botswana with a form of the Dutch disease. Luckily for Botswana the cycles in the diamond market have generally trended upwards. But this may not continue.

Botswana's high growth rates have not been met with matching increases in foreign direct investment (FDI) or increased diversification. Its economy remains mired in extractive industries. Mining continues to dominate the economy due to the absence of efforts to transform and restructure it. The slowing growth rate of agriculture is also troubling, since the majority of the labor force depends on it for employment.

There have been modest gains in diversification in recent years, in response to active promotion by the authorities, with strong growth in some non-mining sectors. Much more needs to be done. In his helpful statement, Mr. Rustomjee points out several promising measures aimed at improving productivity and lowering transaction costs.

If the National Development Plan is to succeed, the authorities must overcome two great structural constraints. First, wage growth in the mining sector has distorted wages in the rest of the economy. Non-mining wages tend to increase faster than changes in productivity can justify, which discourages investment in these sectors. Wage restraint is badly needed in both the public and private sectors. And if excessive wage growth were not enough, the increased income it generates have stimulated demand for imports from South Africa, defeating efforts to establish efficient import-substitution within the country.

The second constraint stems from Botswana's failure to transform its high saving rates into higher investment. During the 1990s, the savings rate was around 40 percent of GDP, and total investment was between 25 percent and 30 percent of GDP, suggesting that the economy's absorption capacity was too low to keep up with the savings rate. Even so it must be noted that both savings and investment rates in Botswana are quite high by any standard.

The current mix of fiscal and monetary policies is another source of concern, since it is interfering with private sector investment. Closer coordination between fiscal and monetary policies is needed. The tight monetary policy, required by demand and inflationary pressures, is having harmful effects on business, and should be eased as soon as conditions permit. To make better decisions about the appropriate policies, I support the staff's recommendation for developing a domestic balance measure of the fiscal stance.

The current exchange rate arrangement and price stability goal appear consistent with one another, but Botswana's external competitiveness should be closely monitored. Under real exchange rate targeting, there is a tradeoff between inflation objectives and export competitiveness objectives. When targeting a particular real exchange rate in order to influence export competitiveness, the authorities must remember that the inflation rates of both South Africa and the United States have short-term inflationary effects in Botswana. If macroeconomic policies could be used to keep Botswana's inflation below that of its trading partners, it would become possible to improve export competitiveness without resorting to devaluation.

The authorities are to be commended for their vigorous and disciplined fight against the HIV/AIDS tragedy. The recently established national AIDS coordinating agency in the office of the President clearly indicates an official commitment at the highest level. Given the uncertain budgetary implications of HIV/AIDS, the authorities are urged to continue the prudent fiscal management based on the principle of sustainability. This will mean making needed improvements to tax administration and boosting non-mineral revenues, while at the same time curbing the growth of government spending.

With these remarks, I wish the authorities every success.

Mr. Moreno made the following statement:

We thank the staff for the well balanced and comprehensive set of papers they have prepared for this discussion, and Mr. Rustomjee for his candid statement.

The Botswana authorities deserve recognition for their sound macroeconomic policies and their efforts on structural reforms, which have helped alleviate the effects of the external shocks that have affected the economy in 2001 (weak demand for diamonds and volatility of the South African Rand). The main challenge for the authorities will continue to be HIV/AIDS. Other challenges will be maintaining economic growth and poverty alleviation. We broadly share the staff's assessment; therefore, we will concentrate our comments on the following main aspects: fiscal and monetary policy, and HIV/AIDS.

Fiscal and Monetary Policy

We believe that the projected 2002/2003 fiscal deficit of 4.8 percent by the authorities is fully justified by the increase in health expenditures and the completion of investment projects of the eighth National Development Plan (NDP). Furthermore, we do not share staff concerns regarding a slightly higher-than-budgeted deficit of 5 percent (instead of 4.8 percent). Therefore, we do not think that counteracting measures in terms of reducing capital expending are justified. Nevertheless, we note the authorities' position, stressed in Mr. Rustomjee's statement, that capacity limitations could reduce capital expenditures and indirectly reduce deficit pressures.

Regarding the medium-term fiscal policy framework, we believe that the NDP and the principle of sustainability provide the appropriate guiding tools. We welcome the authorities' efforts to strengthen the tax administration and boost non-mineral revenues, which will reduce the mineral dependence of revenues while ensuring the future sustainability of the budget. We encourage the authorities to establish the announced revenue authority. Concerning the rise in expenditures with an expected increase in the ratio of public expenditures to GDP up to 50 percent, we believe that it should not be a source of concern as long as expenditures continue to be targeted to social services, especially education and health, and to the NDP process. We welcome the authorities' intention to adjust salary increases yearly for inflation.

We concur with staff that the authorities should consider relaxing monetary policy and thereby helping to enhance private investment, should there be an easing of inflation pressures from the demand side an the introduction of the VAT. On the coordination of fiscal and monetary policy, we support the staff recommendations. In this respect, we note from Mr. Rustomjee's statement, the authorities' agreement with the staff's proposals.

HIV/AIDS

In our view, the HIV/AIDS pandemic in Botswana, which, with an almost 39 percent holds the highest illness incidence-rate in the world, remains the paramount challenge for the authorities. In this respect, we welcome both the recent establishment of the National AIDS Coordination Agency at the highest political level, and the authorities' efforts to undertake a comprehensive and aggressive approach tackling both the prevention and treatment fronts. We also welcome the 50 percent increase in health budget for 2002/03.

The staff stresses the uncertainty of the medium-term fiscal implications of HIV/AIDS expenditure growth, which depend on the effectiveness of the prevention efforts and the number of patients seeking treatment in the future. We encourage the authorities to increase their efforts in estimating and closely monitoring the fiscal implications of their HIV/AIDS strategy, to adequately project future health expenditure needs and potential budgetary measures to ensure them. The authorities should avoid budgetary considerations imposing restrictions to the HIV/AIDS strategy.

Other Issues

We note Botswana's efforts and progress on trade liberalization within the context of the SACU. We particularly value as a very positive step the free trade area with the European Union.

We encourage the authorities to update and strengthen the analysis of the poverty and social impacts of the major policy reforms in order to better assess their effectiveness and to draw lessons for future reforms. We also encourage the authorities to address the acknowledged deficiencies of their statistical data and encourage the authorities to participate on the SDDS.

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

Mr. von Kleist made the following statement:

I thank the staff for a good set of papers and Mr. Rustomjee for his concise and informative statement. Botswana continues to be a very fine example of sound economic management. The authorities deserve strong praise for their prudent macroeconomic policies, their strategic efforts to diversify the economy, and their sound management of diamond revenues. More recently, the determined approach to fight HIV/AIDS has provided another example of the government's ability to confront challenges in a proactive way. Botswana clearly demonstrates that prudent and stability oriented policies are possible for a country with difficult climatic conditions and which largely depends on one export commodity. Too many other countries with broadly similar circumstances point to those circumstances as the underlying reasons for their bad performance. I am especially happy that Botswana demonstrates that good policies are not dependent on given natural circumstances. In this context, one major external shock that is not mentioned in Mr. Rustomjee's otherwise excellent statement, is the development in Zimbabwe.

The HIV/AIDS challenge, but also the structural challenges posed by the expected decline in mineral output growth, is daunting. All previous speakers have made this point. These will result in severe budgetary strains, both on the revenue and the expenditure side. It will therefore be doubly important that the authorities adhere firmly to their prudent policies, going forward. In this context, we welcome the government's assurance that this year's considerable budget deficit will remain an exception.

Since I broadly share the thrust of the Staff appraisal, I shall confine the remainder of my remarks to monetary and exchange rate policy:

I support the authorities' cautious monetary stance aimed at keeping inflationary pressures firmly in check. Clearly, greater fiscal discipline could create leeway for a more neutral monetary stance thereby supporting weak business investment. In any event, further refinements of the analytical toolkit would certainly be helpful to improve the conduct of monetary policy. I therefore welcome Mr. Rustomjee's announcement that the authorities intend to develop a measure of the domestic fiscal balance, which will also lead to further fiscal transparency.

On exchange rate policy, it appears indeed that - in the case of Botswana's small open economy - the pegged-basket framework worked relatively well in the 1990's. However, as Staff note in the Selected Issues-Paper, it is only since late 2000 that the framework really has been allowed to operate freely. Prior to that, the de facto regime was one of targeting the rand exchange rate through discretionary adjustments of the peg. Since 2000, Botswana's external competitiveness has been eroded by the marked depreciation of the rand, as reflected in the slowdown of nonmineral manufacturing activity. Staff rightly notes that the real effective appreciation of the pula complicates Botswana's efforts to broaden the export base and to diversify the economy in general. This underscores the need for continued structural reforms as well as prudent macroeconomic policies and wage settlements. However, it also suggests there may be room for further refining the exchange rate regime. I agree that the de facto targeting of the rand, as practiced previously, is not the best way to go, since it reduces the transparency of the regime, thereby undermining the government's credibility. But as previous speakers have noted, the transparency of the current system is also not ideal, since the relative weights are not known. Perhaps the currency basket could be modified by changing the weights or the underlying calculation methods so as to bring the basket more closely in line with the weighted average of the currencies of Botswana's major trading partners. Furthermore, in the longer run, a more flexible exchange rate regime could be considered, once more effective monetary policy instruments and analytical tools have been put in place.

Lastly, I note Botswana's very high level of reserves, 32 import months, which could constitute a world record.

Mr. Liu made the following statement:

At the outset, let me join other speakers in thanking the staff for the well-prepared papers and Mr. Rustomjee for his informative and helpful statement. It is very commendable that, over the past 30 years, real per capita GDP growth averaged more than 7 percent a year, allowing Botswana to progress from one of the poorest countries in the world to a position as a middle-income country today. Clearly, this remarkable achievement is the result of the strong macroeconomic and structural reforms being implemented by the authorities. We are also pleased that the economy has weathered two external shocks in 2001 and the regional food shortage in 2002. Going forward, priority should be given to HIV/AIDS economic diversification, strengthened coordination of fiscal and monetary management, and acceleration of structural reforms. Since we concur with the thrust of the staff appraisal, we limit our remarks to a few areas for emphasis.

On the fiscal side, the authorities are to be commended for their commitment to fiscal consolidation, while maintaining social spending as a priority. On the revenue side, we commend the authorities for their efforts to improve tax administration so as to strengthen medium-term budget sustainability, and welcome the introduction of the new value-added tax that replaced domestic sales tax on July 1, 2002. We encourage the authorities to monitor the VAT implementation carefully and address problems as soon as they develop. On the expenditure side, the efforts to contain spending, in particular through public sector reform and the NDP process, are commendable. The intention to adjust government salaries yearly for inflation and therefore reduce the likelihood of less frequent, but large, adjustments is welcome. It is also advisable that supplementary budgets only be used for emergency situations.

Monetary policy, anchored by Botswana's exchange rate peg to a basket comprising the South African rand and the SDR, aimed to maintain a low inflation rate, is appropriate. We are encouraged that the Bank of Botswana will remain vigilant in monitoring inflation trends following the introduction of VAT to ensure that the monetary policy stance of maintaining a sustainable low and stable inflation rate is adhered to both in the short and medium term.

On HIV/AIDS, we are pleased to note that the authorities are fully aware of the severity of the situation and are tackling HIV/AIDS from different angles. We encourage the authorities to continue their efforts from all perspectives to address this pandemic aggressively, together with the international community's support.

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

Mr. Al-Nassar made the following statement:

Sound economic policies along with diamond revenue have helped Botswana move from one of the poorest countries to a middle income one. The outcome last year, however, was less favorable as growth slowed, the external current account surplus narrowed, and the fiscal position moved into deficit. These unfavorable developments were largely due to external shocks and regional food shortages. The outlook is also daunting with the country facing the highest HIV/AIDS incidence in the world. The authorities past achievements and the strong commitment to take the necessary measures are assuring. Since I broadly agree with staff appraisal, I will add a few remarks for emphasis.

First, the biggest challenge that the authorities are facing is the high rate of HIV/AIDS. In addition to the tragic impact on the population, the epidemic is a real threat to the impressive economic gains. Indeed, it will have a serious negative impact on growth and fiscal position. In this regard, I fully endorse the highest priority accorded to resolving this crisis. The government's comprehensive HIV/AIDS program is appropriate and should help alleviate human suffering and reduce the spread of the disease. I also welcome the international community support for the Botswana anti-Aids campaign.

Second, in the fiscal area, the authorities are to be commended for the impressive performance over the past years. The expected decline in the mineral revenue and the rise in healthcare cost as the spending on HIV/AIDS continues to increase underscore the importance of being vigilant. Indeed, following substantial surplus for a number of years, the fiscal position moved into deficit last fiscal year and is expected to remain in deficit this year. Here, I welcome the authorities' reassurance that this is not a deviation form the sustainable fiscal path and that the future budgets will be balanced. To maintain fiscal sustainability over the medium term, however, current spending needs to be contained and the effort to enhance the non-mineral revenue needs to be accelerated. Therefore, broadening the tax base and improving tax administration are essential. In this regard, the introduction of the value-added tax (VAT) and the intention to establish a revenue authority to enforce tax collections are steps in the right direction.

Third, I endorse the authorities' objective to promote private sector led growth and economic diversification. However, the high interest rates have hampered business investment and thereby private sector development. In this regard, improving the policy mix will allow for a reduction in the interest rates without undermining the achievement of the inflation target. The other obstacle to private sector development is the shortage of skilled workers. While relying on foreign workers can be a short-term solution, improving the citizens' skills through education and workplace training should be the ultimate goal. Therefore, I am reassured by the authorities' efforts in this area. The authorities are also encouraged to pay more attention to developments in the exchange rate and take the appropriate measures to boost the eroded export competitiveness.

Finally, I thank the staff for a very well written and insightful report and wish the authorities success.

Mr. Vogel made the following statement:

I would like to thank staff for a well written report, and Mr. Rustomjee for his helpful statement. The commendable macroeconomic performance shown by Botswana in its post-independence period is not the result of a miracle. This performance has been achieved through careful implementation of sound economic policies and solid institutions, reflected in the favorable governance indicators. There are however some difficulties that could threat this admirable position if they are not properly addressed. Despite the impressive GDP growth rate over the last decade, the unemployment rate remains high. In addition, the production of diamonds, which has been the main engine of economic growth, is already showing signs of decay, and finally the massive incidence of HIV/AIDS and its health related cost will most likely have very serious fiscal implications as well as a negative effect on the potential growth rate of the economy.

As the Selected Issues Report notes in many respects, Botswana's National Development Plan is a textbook example of a well designed medium-term expenditure framework. This experience demonstrates the benefits of achieving fiscal surpluses during the expansionary phase of the economic cycle to build up resources to be used by fiscal policy in the contractionary phase, thus smoothing out the deepness of economic fluctuations. Accumulating a safety cushion is even more important in the case of countries that relay on non-renewable resources with uncertain future production. Given the uncertainties, we share the staff's views that the authorities should persevere in their cautious approach at financing budget deficits with the accumulated reserves. In order to diminish uncertainties, it would be adequate to establish some rules, as the staff suggest, that would institutionalize the prudent management of fiscal policies.

Given the great uncertainty related to HIV/AIDS, special caution is necessary in controlling non-health expenditures as the future health costs are quite uncertain. As underscored in the Selected Issues Paper, it is advisable to further analyze the future budgetary implication of the incidence of HIV/AIDS. On the revenue side, we welcome the recent introduction of the VAT and, more generally, the authorities' intention to improve tax administration, which would help to strengthen medium-term budget sustainability.

The fiscal and monetary policy mix needs to be defined considering the need for stimulating private sector development and the diversification of production and exports away from diamonds. The right mix will favor a more depreciated currency and favor competitiveness. Changes in the policy mix including a tighter fiscal policy may give room for lowering domestic interest rate, whose high levels discourage business investment and keep a relatively appreciated value of the domestic currency. Furthermore, the recent nominal appreciation of the local currency vis-à-vis the South African Rand is a not favorable movement. However, as the staff rightly points out, sudden changes in the real exchange rate entail the risk of undermining the public perceptions of policy stability and the investment-grade sovereign risk rating.

Finally, even though poverty alleviation has been a central priority and some programs have been implemented towards that end, we regret the lack of information about poverty conditions and the evolution of poverty indicators. Without them it is not possible to adequately evaluate the existing programs, and use the experience to improve their effectiveness. With these remarks we once again commend the authorities for the performance of the Botswana economy and wish them every success in their future endeavors.

Mr. Faircloth made the following statement:

I also would like to thank the staff for their concise staff report and informative selected issues paper. Botswana's economy has recently been hard-hit by soft global demand for diamonds and exchange rate fluctuations that have undermined economic activity in non-traditional sectors, such as manufacturing. And, while these adverse developments have begun to unwind, Botswana must nevertheless confront major challenges going forward. Efforts to diversify the economy will need to bear fruit to accommodate the plateau in diamond production. An equally daunting task will be to minimize the economic and human impact of the HIV/AIDS pandemic.

Fortunately, Botswana's long track record of prudent public finance management and the accumulation of reserves provide the authorities with scope to finance deficits and meet these challenges head-on. That said, prudent financial management will need to be a policy mainstay going forward, as will striking a balanced and sustainable macroeconomic policy mix, and successfully implementing diversification and health strategies.

As I broadly concur with the staff's recommendations, I will only comment on a few select points. First, on monetary and exchange rate policy, the recent real appreciation of the pula against the rand is singled out as a major concern in the staff report and selected issues paper, as the erosion in Botswana's competitiveness in the rand area may undermine the authorities' ability to expand the export base and diversify the economy. At the same time, staff advises against a nominal depreciation, as it would unwind hard-won in gains in terms confidence in a freely functioning exchange rate basket system. On balance, staff considers Botswana's pegged exchange rate arrangement and inflation objective framework to be appropriate, but encourages the authorities to monitor competitiveness closely while pursuing structural reforms.

This thrust of this policy advice is appropriate within the context of Botswana's policy framework, but we would have welcomed a more detailed of discussion of the underlying policy debate. The fundamental question here is how best to address and overcome competitiveness concerns. And, the answer is by pursuing structural reforms that provide real economic gains, not by targeting the real exchange rate, which is fundamentally an endogenous variable. Given its relatively undeveloped financial sector, Botswana has been able to target two variables—the exchange rate and future inflation rate—with some success in terms of stabilizing the real exchange rate. The point is that this is strategy is not sustainable—especially given that a further deepening of the financial sector figures prominently on the structural reform agenda.

With this in mind, we would believe that future Article IV policy discussions should increasingly emphasize the need to shift to a more robust monetary policy and exchange rate framework—one where monetary policy clearly targets a single nominal anchor, namely inflation, and a freely floating exchange rate helps to reinforce economic stability by acting as a shock absorber to negative external developments. To that end, it would be useful to develop a timetable that sees Botswana exit the pegged-basket / inflation target framework from a position of strength.

Second, in terms of structural reforms that will strengthen competitiveness and underpin economic diversification, the aggressive education campaign in recent years constitutes an important step—certainly the sharp increase in adult literacy bodes well for potential productivity gains. However, to fully address shortages of skilled labor that have been impeding growth, the authorities will need to ease restrictions on foreign workers.

Third, in terms of the macroeconomic policy mix, the most pressing priority will be to strengthen policy coordination, mainly on the fiscal side, to avoid a crowding-out of private investment. With this in mind, I am encouraged that the authorities intend to pursue staff's suggestion of developing a domestic balance measure for fiscal policy.

More generally, while I agree that Botswana's National Development Plan is in many respects a textbook example of a medium-term expenditure framework, the authorities should take steps to further strengthen this framework where there is scope to do so. For example, the deviation from budgeted expenditures has in recent years outpaced the deviation from budgeted revenues by a substantial margin (20 percent in 2001/02 and more than 30 percent in 2002/03). Given that health-related expenditures will increase substantially in coming years and the risk that diamond revenues may generally fail to keep pace, this aspect of the budget process will need to be strengthened. With this in mind, I encourage the authorities to increase budget transparency by publishing annual revisions, as well as to begin moving to a more output-oriented budget process. Like Mr. Daïri, I also believe that a new fiscal rule might be needed to accommodate the fiscal pressures that will emerge in coming years, and encourage the authorities to carefully consider the options presented in the selected issues paper.

Finally, on poverty reduction, Botswana's fast growing economy and relatively high per capita income (US$3600) likely masks severe disparities in the income and living standards between urban and rural dwellers. Unfortunately it is difficult to assess the degree of income inequality that actually exists or the impact of recent poverty alleviation initiatives given a lack of data. With this in mind, I join with Mr. Guinigundo in encouraging the authorities to regularly collect poverty data and to conduct a social and poverty impact analysis on recent and contemplated policies.

> In closing, I would like to commend the authorities for their impressive efforts to strengthen and diversify their economy over the past number of years, while at the same time adhering to the principle of fiscal sustainability. As Mr. Von Kleist has already noted, Botswana stands out from many countries in the region with similar resources endowments, and in our view clearly demonstrates the potential dividends that come with good governance. As I noted at the outset, Botswana faces many difficult challenges, but is in a relatively good position to meet these head on. To that end, I wish the authorities success in their policy endeavors.

The staff representative from the African Department (Mr. Green) made the following statement:

> Let me address the questions by area. First, HIV/AIDS. Is Botswana receiving international support? The answer is definitely yes. The best proof of this is that, during the last consultation, we estimated the cost of providing advanced antiretroviral medication to patients at $1,000 per month per patient. That figure is now below $100 per patient per month, largely due to international support and falling prices for advanced medication. This puts Botswana in range of treating all HIV/AIDS patients, even though the costs will be very high.
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> A related question is the medium-term fiscal projections. The fiscal projections that we show are based on current policies. It does not include the very large estimated potential costs for treating HIV/AIDS. Those estimates will be included in the new National Development Plan, NDP-9, which will be published at the end of this calendar year. Given the huge cost in this area and the very large changes they imply for the budget, we thought that it was appropriate that the authorities make the decision on how to deal with the problem—whether through expenditure cuts, or by using their substantial reserves, or a mix of those two options. Our role was to point out the macroeconomic impact of HIV/AIDS on growth and the potential costs. We have been working on this over the past two consultations.
>
> On fiscal policy, there was a question about the very high level of tax revenues. Tax collections in Botswana are very high, but I should point out that 85 percent of revenues last year came from diamonds and SACU revenues. Therefore, the imposition on the business sector is very minimal. Hence, the discussions on tax policy over the years, as Directors picked up on, have been on ways to raise tax collections in the future, as SACU revenues stabilize or fall because of lower tariffs, and as diamond revenues plateau.
>
> On monetary issues, there were questions on whether interest rates should remain the same, go up, or come down. The recent evidence is that domestic inflation over the past few months has been moving up. The two leading indicators used by the Bank of Botswana—underlying credit growth

and government spending—have been both rising. The Bank of Botswana has announced that it is going to target, at least in the near future, underlying inflation in the range of 6-7 percent. This is without the VAT effect, which has not been determined because food prices took an unexpected rise. We would support this plan of the Bank of Botswana because it implies that interest rates would not be raised. Underlying inflation would be either within or close to target. We also support the Bank of Botswana's statement that this policy would be dependent on the VAT level change not being incorporated into wages. This would be very important around next February or March when government wages are announced.

There are plans to review possible changes to the monetary framework. In the previous consultations, we discussed this issue at length with the authorities, and suggested that they needed to establish an exit strategy, as well as strengthen real sector data and study the links between the real economy and monetary policy. The study is ongoing. It will be a good idea to assess the results during the next consultation. But currently, there are no plans to abandon the current framework. The authorities feel that it will be quite some time before financial markets become deep enough to allow the peg to be challenged.

Botswana opened a financial service center targeted at back office operations. It has been in operation for about 18 months and has attracted 10 companies. More are coming in. The potential problem lies in the fact that a bank license was granted to the African Banking Corporation, an international bank, and there is a question whether the Bank of Botswana is in a position to supervise international banks. The recent Fund mission from the Monetary and Exchange Affairs Department recommended more technical assistance in this area, which in fact the authorities had been asking for. We would note that the ABC Bank is very small right now, and therefore does not pose an immediate risk. The Bank of Botswana has also required the ABC branch or subsidiary operating in Botswana to raise its capital when its capital fell below 16 percent.

The multiple currency decision has to be renewed every year, even though the policy under which it came about expired ten years ago.

Ms. Phang inquired whether the staff planned to study further the nature of the interlinkages in the economy, as well as the value added of the various industries. This information was important, as the high per capita income in Botswana could be merely due to a small sector that was driving the growth. Such a situation might give rise to problems later on.

The staff representative from the African Department (Mr. Green) replied that the household survey, which would underpin a poverty estimate, was currently being conducted. The staff would examine the results of the survey in detail as they became available.

Mr. Rustomjee made the following concluding statement:

> First, my thanks to colleagues for their many valuable comments, both written and verbal, and also to the staff for their strong commitment to help the authorities. This is another model of a very strong cooperative relationship between our institution, the staff, and the member country. I would say, from my dealings with the authorities in Botswana, that the authorities have great respect for the staff's advice. And this shows through in the manner in which advice from successive consultations have been carried out and followed through. Because of this, technical assistance is well utilized in Botswana.
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> I have tried to note all the very valuable comments that have been made by colleagues in this discussion. Having participated in the consultation discussions for the last three or four times, I sense that there is now a shift toward treating Botswana as—I hesitate to use the term "emerging market"—but as a country with a financial sector that is now starting to become worthy of note in a developing country context. And the kinds of challenges that are emerging as the authorities batten down the structural reforms that they have been undertaking—focusing much more now on the fiscal-monetary policy mix, the nature of the exchange rate regime, and the financial sector—and the kinds of comments that we have heard this morning attest to the strengthening nature of the economy and the prospects it can offer for higher growth and poverty alleviation in a successful environment.
>
> Therefore, this has been a very valuable discussion for us. I would request colleagues who made oral interventions if they would be willing to send copies of their remarks to my office because I found them very valuable. I would like to try to summarize the comments that have been made and send them on to the authorities.
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> On the issue of fiscal policy and the staff proposal for a domestic balance measure, I did want to reiterate my authorities' full agreement with the staff's proposal. The authorities will be working on that in the period to come. It is a very valuable suggestion and reflects the comparative experience we have in the institution on countries in a similar situation with large natural resource-based revenues.
>
> On the monetary-fiscal policy mix, there are clearly major challenges to the authorities. It has been identified clearly, and the authorities fully recognize the danger of crowding out private sector investment, given very high interest rates. There is also the need, as reflected in some of the written

statements, to change the policy mix, given the twin challenges to diversify away from diamond revenue, which has plateaued.

There is also the challenge of HIV/AIDS. I am grateful to the staff for being candid in acknowledging that it is difficult to quantify the fiscal impact of the pandemic. I hope that the work that has been done within the institution to try to evolve measures and analytical frameworks to assess the impact of HIV/AIDS, not just in Botswana, but elsewhere—and some of the papers that have been done by the staff are very valuable—will be built upon in the future and start leading to some of the answers that we are all searching for.

There were comments on the need to contain costs, particularly in the context of wage moderation and productivity gains. The authorities share this concern of colleagues.

On exchange rate policy, I greatly benefited from the comments of Mr. Lombardi and other colleagues. The issue of the two-variable, one-instrument challenge has been raised in previous discussions, and the authorities are attentive to this challenge. As mentioned by the staff, although Botswana’s financial sector is relatively strong, there is a long way to go before it becomes deep enough. The authorities are not averse, in principle, to moving away from the currency peg. It is a question of how to phase their strategy.

I did note the comments on the need for increased transparency in the weights of the pula basket, and the need to reexamine the weights themselves to bring them more in line with the relative shares of major trading partners.

There were also several comments on the erosion of external competitiveness. As I said earlier, the authorities take the point clearly that productivity gains will need to be recorded, and structural reforms will need to be pursued to address competitiveness in the longer term.

On fiscal policy, I have noted down the need to boost nonmineral revenues. I am gratified by my colleagues’ welcoming the implementation of the VAT and their appreciation of the merit of the planned increases in expenditures. These increases are taking place in the context of a well-structured framework, and it is comforting to see that this is appreciated by colleagues.

On HIV/AIDS, I particularly welcome the appreciation that the authorities are dealing with this problem in a comprehensive way. Botswana’s approach could be a model for other member countries. But this approach is expensive because the authorities have taken the plunge and are trying to address the problem comprehensively. The costs, as we have recognized, are not easy to calculate. It would be important to learn the lessons from Botswana's experience, and also recognize the limitations of the model.

I did note the point that the authorities need to place greater attention to statistical quality. I noted particularly the comment that, as an investment-grade country, Botswana would need to accelerate the improvement of its statistical data. I did want to say that the authorities were host at the end of last year to 14 member countries in my constituency, all working jointly on improving their GDDS statistical capacity base. There is a strong momentum to build statistical capacity in the context of the GDDS. I did also take the point made by some colleagues that Botswana should be aiming in the medium term for SDDS standard.

A few colleagues commented on the regional issue of Zimbabwe. The authorities are well aware of, and attentive to, this issue.

On anti-money laundering and combating the financing of terrorism, I noted colleagues' exhortation for the authorities to follow up on the recommendations of the Fund mission from the Monetary and Exchange Affairs Department.

Finally, a few comments on poverty reduction. I noted down the issue of the lack of poverty data, which was raised by Mr. Guinigundo in his statement, and the need to collect poverty data more regularly for conducting PSI.

I do want to reiterate my thanks to the staff. It has been an excellent relationship over the years.

The Acting Chair (Mr. Sugisaki) made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They noted that since the last Article IV consultation, Botswana's economy has been hit by several negative shocks, including a temporary decline in global diamond demand, the near 40 percent depreciation in the South African rand in 2001, and the regional food crisis. Directors commended the authorities for pursuing prudent macroeconomic policies, which, together with Botswana's substantial financial reserves, have helped the country weather these adverse external shocks.

Looking ahead, Botswana's medium-term growth prospects will depend on the continued sustained development of the nonmining economy, as diamond production and revenue reach a plateau, and on decisive action to contain the enormous social and economic costs of the HIV/AIDS pandemic. Directors were encouraged by the authorities' demonstrated commitment to meet these challenges successfully through the continued implementation of sound and market-friendly economic policies.

Directors commended in particular the government's head-on approach to the challenges of HIV/AIDS, by adopting a coordinated response that aims at preventing further spread of the infection, alleviating suffering, and treating all patients with advanced medication. They also welcomed the establishment of a national AIDS coordinating agency to help spearhead the program at the highest political level and help to mobilize international support. While the cost implications of the authorities' response are still highly uncertain, Directors noted that its budgetary impact is likely to be very high over time. They welcomed the authorities' commitment to expenditure restraint and public revenue enhancement, including the recent introduction of the VAT. Looking ahead, Directors urged the authorities to use the forthcoming National Development Plan 9 as the appropriate planning tool for addressing the budgetary impact of HIV/AIDS in a comprehensive manner, and for making the difficult choices concerning government resources and spending in a medium-term policy framework.

While Botswana's tight monetary stance is appropriate in view of demand and inflationary pressures, Directors agreed that an easing of monetary policy would be desirable to promote business investment and support the medium-term diversification objective. They stressed, however, that moves in this direction should be part of a broader effort to achieve a better balance between fiscal and monetary policies, and should be made only as demand conditions permit. To facilitate a better coordination of monetary and fiscal policies, Directors saw merit in the proposal of adopting the domestic budgetary balance as the main measure of the fiscal stance.

Directors considered that Botswana's exchange rate arrangement and inflation objective continue to constitute an appropriate framework for ensuring financial stability. A number of Directors saw scope, however, to further improve the transparency of the framework. Directors noted, that adherence to the framework was tested during 2001 and early 2002 by significant swings in regional currencies, which had resulted in an erosion of competitiveness. They underlined the need for close monitoring in the period ahead. Directors also underscored that continued structural reforms to lower domestic costs, as well as wage moderation, will be key to strengthening competitiveness.

Directors commended the authorities' commitment to structural reforms aimed at promoting private sector activity, and welcomed in particular their efforts to address shortages of skilled labor, make more serviced land available to the private sector, and update their privatization policy. They also encouraged the authorities to consider turning over to the private sector some of the projects anticipated under the National

Development Plan. Directors noted that the quality of banking supervision is adequate, and welcomed the authorities' plan to review supervision of the nonbank financial sector in view of the recent rapid growth in this area. They also recommended that the authorities enhance their supervisory capacity over banks in the international financial services center. Directors commended the efforts to combat money laundering and the financing of terrorism, and encouraged them to follow up on recent Fund technical assistance in this area.

While welcoming Botswana's commitment to good quality statistics, Directors urged stronger efforts to reduce reporting lags and better harmonize data in the various macroeconomic accounts. Some Directors also encouraged the authorities to give a higher priority to the collection of timely data on poverty indicators.

It is expected that the next Article IV consultation with Botswana will take place on the standard 12-month cycle.

The Executive Board took the following decision:

1. The Fund takes this decision relating to Botswana's exchange measure subject to Article VIII, Sections 2(a) and 3, in light of the 2002 Article IV consultation with Botswana conducted under Decision No. 5392-(77/63), adopted April 29, 1977, as amended (Surveillance over Exchange Rate Policies).

2. Botswana maintains a multiple currency practice subject to Fund's approval under Article VIII, Sections 2(a) and 3 arising from the Foreign Exchange Risk-Sharing (FERS) scheme applicable to outstanding external loans obtained by certain public enterprises before October 1, 1990. In view of Botswana's discontinuance of the FERS scheme in 1990 and its intention to eliminate the multiple currency practice by 2006, when the last loan under the scheme will mature, the Fund grants approval for the retention by Botswana of the multiple currency practice until October 30, 2003 or the conclusion of the next Article IV consultation with Botswana, whichever is earlier. (SM/02/256, 8/14/02)

Decision No. 12867-(02/104), adopted
October 9, 2002

2. SAUDI ARABIA—2002 ARTICLE IV CONSULTATION

Documents: Staff Report for the 2002 Article IV Consultation (SM/02/252, 8/8/02); and Selected Issues and Statistical Appendix (SM/02/255, 8/13/02)

Staff: Iqbal, MED; Kashiwagi, PDR

Length: 3 hours, 5 minutes

The staff representative from the Middle Eastern Department (Mr. Iqbal) submitted the following statement:

> The following information has become available since the Article IV consultation mission in May 2002, and supplements the staff report (SM/02/252). It does not change the thrust of the staff appraisal.
>
> The international oil market has continued to be stronger than envisaged, with prices rising by 15 percent in the third quarter, partly reflecting political and security concerns in the Middle Eastern region. On the assumption that prices remain at presently WEO projected levels for the rest of 2002, the staff calculations indicate that the average price of the WEO crude oils would be US $25.51 per barrel for 2002.[1] The staff estimates indicate that such a price development would result in the fiscal deficit declining to 1.2 percent of GDP, while the current account surplus would rise to about 5 percent of GDP. The medium-term projections are expected to remain broadly unchanged.
>
> The cabinet has approved the privatization strategy and 30 percent of the Saudi Telecommunications Company (STC) shares will be sold during the current year. This would generate about SRls 15 billion (about US $4 billion) in privatization proceeds as against the budgeted SRls 12 billion, part of which would be used to reduce the public debt.
>
> Available data up to end-August 2002 indicate that broad money increased by 8.7 percent, on an annual basis, from 4.6 percent in the 12 months ending at end-August 2001. This owed, in part, to an acceleration of credit to the private sector of 8.2 percent of beginning money stock from 6.2 percent in the 12-month period ending at end-August 2001. Net foreign assets of the Saudi Arabian Monetary Agency (SAMA) declined by about US $9 billion in the first eight months of 2002.

Mr. Al-Turki submitted the following statement:

> The Saudi Arabian economy has performed well over the past 12 months. Non-oil GDP growth picked up without any inflationary pressures and the external account remained in surplus. This good performance was largely owing to sustained implementation of sound macroeconomic policies and structural reform. These encouraging developments notwithstanding, my authorities are aware of the need to enhance growth prospects, improve the structure of the budget, and increase employment opportunities for the growing Saudi Arabian labor force.

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[1] The WEO price is the average of the West Texas Intermediate, U.K. Brent, and Dubai.

Following a slowdown in non-oil GDP growth in the final quarter of 2001, an economic recovery started early this year. Preliminary data for the first half of the year indicate that non-oil GDP growth in 2002 will exceed 4 percent with no inflation. The improved performance, despite the very difficult security situation in the region and the slowdown in the oil sector, underscores the increased resilience of the economy. The expansion was especially strong in the industrial sector as well as in tourism and other services owing to increased private sector investment and liquidity. The efforts by the Higher Tourism Authority that was established in 2000 should further enhance the prospects for the tourism sector over the medium-term.

My authorities expect these favorable trends to be further bolstered by sustained implementation of structural reforms aimed at enhancing the environment for a self-reliant private sector. Here, the approval of a comprehensive privatization strategy, that establishes the legal and institutional frameworks needed for successful implementation, is an important milestone. In this connection, the recently announced plans to divest 30 percent of the Saudi Telecom Company (STC) through a stock offering have been well received by the market. This major undertaking, set for completion before the end of the year, is expected to generate more than SR 15 billion ($4 billion), which is to be partly used to reduce the public debt.

My authorities are also continuing to increase private sector involvement in utilities and infrastructural development. Private sector involvement in the water sector will proceed following the consolidation of water-related activities under the new Ministry of Water. In addition, the private sector can now invest in desalination projects. The restructuring process of the electricity sector is already being implemented. Indeed, the regulatory body for electricity, established earlier this year, is now operational. Finally, a Petroleum Service Company has been set up as a joint stock holding company with private sector participation to serve the major sectors such as oil, gas, petrochemicals, and utilities. This company will supplement the already extensive activities in oil, petrochemicals, and desalination

Improved growth and investment by the private sector should help increase job opportunities for the growing Saudi labor force. Indeed, this is a priority area for my authorities. To this end, a multi-pronged approach is being followed.

First and foremost, the focus is on ensuring the availability of a well-educated and well-trained national labor force that meets the needs of the private sector. The Human Resource Development Fund has been established to help achieve this objective. The focus will be on improving vocational and technical training. In this regard, the private sector can now establish colleges that specialize in science and technology. Moreover, a database to help match

Saudis seeking employment in the private sector with job openings has been developed.

Second, a more determined implementation of the Saudiization policy is being pursued. The focus is on increasing the proportion of Saudis in new jobs created by the expanding economy, while taking precautions not to weaken the competitiveness of the private sector.

Third, a new labor law that includes improving the flexibility of labor regulations related to Saudi nationals is under consideration.

Saudi Arabia's oil policy will continue to aim at fostering stability and predictability in the oil market. Indeed, to ensure a smooth functioning of the market, my authorities maintain a large excess oil production capacity despite the considerable costs of this undertaking. My authorities will also continue to work with consumers and oil producers within and outside OPEC to achieve this objective. This cooperation should be facilitated by the agreement in Osaka between leading oil producing and consuming countries to set up a permanent secretariat for the International Energy Forum in Riyadh, Saudi Arabia. However, even with these efforts, oil price spikes cannot be ruled out especially in the present conditions of market uncertainty.

In line with my authorities' objective of diversifying the economic base and increasing private sector involvement, efforts are underway to intensify development of gas resources in Saudi Arabia. While the modalities on how best to move forward are still being discussed, investments in this area are expected to start in the coming year. These investments are estimated to total about $25 billion over 10 years. The resulting benefits will multiply with increased integration of the upstream operations with downstream activities.

My authorities are committed to a balanced budget and the reduction in the debt ratio over the medium-term. While the fiscal position turned into a deficit in 2001, this reflected in large part lower oil revenues, reduction in customs receipts following the 60 percent cut in external tariffs, and higher spending since the September 11 events. The settlement of late payments that predate 1995 also played a role.

In light of these developments, fiscal efforts were strengthened in the context of the 2002 budget. In this regard, spending on supplies and services, subsidies, and capital was budgeted to decline, and expenditure controls were strengthened. Non-oil revenue was budgeted to increase despite the full year effect of the reduction in external tariffs. This reflected in part higher revenues especially in the telecommunications area.

Preliminary data for the first half of the year indicate that both spending and non-oil revenues are broadly on track. Accordingly, the fiscal position for 2002 is projected to improve compared to last year. Here, it is worth noting that while measures implemented over the past few years have helped in containing the emergence of new late payments, the extent of late payments that predate 1995 has been more extensive than initially thought.

Turning to the medium-term, in addition to fiscal consolidation, the focus is on improving the budgetary structure. On the revenue side, the new Income Tax Law would be introduced in the next couple of months. Revenue collection will also benefit from the ongoing substantial modernization of the Department of Zakat and Income Tax and of the Customs Department. Moreover, raising some charges and fees as well as introducing a tax on luxury items are being considered. On the expenditure side, in addition to further strengthening expenditure management, the focus will be on improving productivity in the public sector, better targeting of subsidies to enhance efficiency, and reducing the size of the public sector wage bill through privatization and by out sourcing services.

The Saudi Arabian Monetary Agency's (SAMA) policy, which is focused on maintaining low inflation and ensuring nominal exchange rate stability vis-à-vis the U.S. dollar, has served the economy well. Inflation remains very low and the interest rate spreads over U.S. dollar instruments have averaged about 24 basis points. At the same time, credit to the private sector has been growing at a healthy pace.

Turning to the financial sector, banks continued to perform strongly. Profitability rose and non-performing loans declined and were fully provisioned. Those developments reflect improved non-oil GDP performance, enhanced efficiency, introduction of new lending products, effective prudential regulations, and close supervision. To further enhance banking sector efficiency and growth, the authorities approved licenses for a United Arab Emirates bank, a Bahraini bank, and a Kuwaiti bank to open branches in Saudi Arabia in line with the decision to allow GCC members to operate in member states. Moreover, SAMA remains vigilant to ensure the highest standards of supervision and prudential regulations. To this end, my authorities have requested an FSAP mission.

My authorities remain at the forefront in the efforts to combat money laundering and the financing of terrorism. The regulatory and supervisory framework includes adoption of legislation to implement the 1988 UN decision against Illicit Traffic in Narcotics and Psychotropic Substances (1990), issuance of guidelines for prevention and control of money laundering activities to banks (1995), endorsement of the 40 Recommendations related to the prevention of money laundering issued by the Financial Action Task Force (FATF) (May 1999), and adoption of legislation to combat money laundering activities in the non financial sector (August 2001). Moreover, all fund transfers are required to be made through the financial system, making informal transfers illegal, banks are required to know their customers, maintain records of transactions for 10 years, and report suspected activities to law enforcement agencies. To strengthen the anti-money laundering and combating the financing of terrorism efforts further, a mutual evaluation under the auspices of the FATF is scheduled for April 2003.

Saudi Arabia's stock market has performed well last year despite the sharp drop following the September 2001 events. The Saudi All Share Index rose by 7.6 percent in 2001 and by a further 9.2 percent this year. Trading volume also increased substantially owing to the deepening of the market as well as the introduction last year of a new system (Tadawul), for instantaneous stock trading, clearing, and settlements.

The capital market will be deepened further by the expected implementation of the Capital Market Law (CML) in the near future. It has already been endorsed by the Supreme Economic Council (SEC), and the endorsement of the Shura Council is expected in the next few days. The CML aims at providing a unified legal and regulatory framework that should facilitate the issuance of new financing instruments including corporate bonds. In addition, an insurance law that sets the framework and regulations for the insurance industry has been approved by the Shura Council. In this connection, SAMA will be responsible for supervising activities in this sector.

Saudi Arabia remains fully committed to an open exchange and trade system. In this connection, external tariffs were reduced last year from 12 percent to 5 percent. My authorities are also continuing the negotiations to join the World Trade Organization (WTO). In addition, increased integration within the GCC and the implementation of the Arab Free Trade Area are on track. On external development assistance policies, Saudi Arabia continues to provide substantial assistance to developing countries bilaterally, and through regional and multilateral institutions, despite budgetary pressures. Saudi Arabia's bilateral assistance will remain highly concessional, untied, and focused primarily at enhancing growth and poverty reduction in recipient countries.

Substantial progress has been achieved this year in improving the statistical database. In addition to revising and rebasing the GDP statistics, comprehensive labor, wage, and demographic surveys were completed in 2001, and a detailed base on labor and population will be available soon. My authorities are also progressing well on the compilation of balance of payments statistics in line with the fifth edition of the balance of payments manual.

Against this background, it is most disappointing and counterproductive that a reference to Article VIII section 5 was mentioned in the report especially as my authorities have provided the staff with all the available information on official foreign assets as well as the foreign assets of commercial banks and AGIs. These data, which are updated monthly, with a very short lag, are available on SAMA's website. As for the non-financial private sector's International Investment Position (IIP), the staff has been informed on many occasions that there is no system in place to collect such information. Indeed, my authorities have requested in the past, the staff to come up with some estimates of these data. The reference to Article VIII section 5 also raises questions regarding the uniformity of treatment as it appears to be mentioned almost exclusively in countries in our region, although there is a lack of comprehensive data in a majority of the membership.

That said, my authorities remain convinced that collecting a comprehensive set of good quality data is important to the conduct of economic policy. Therefore, they will continue their efforts to improve data collection and dissemination in all areas including the international investment position.

In conclusion, on behalf of my authorities, I thank the staff for a useful and constructive Article IV discussion on Saudi Arabia's recent economic performance and prospective economic outlook. My authorities attach particular importance to the views of the Executive Board, Management, and the staff regarding the policies and prospects of the Saudi Arabian economy.

Mr. Barro Chambrier submitted the following statement:

We commend the Saudi authorities for their continued efforts to diversify the economy, promote the role of the private sector, and deepen structural reforms. Given the high dependency of the economy on oil, these efforts are very appropriate. In this regard, we note that the fall in oil prices was an important cause of the weakening of the economic and financial position in 2001 and that the macroeconomic situation for 2002 remains under pressure. However, inflationary pressures continue to be absent, reflecting prudent monetary policy, and the external current account remained in surplus, helped by the rise in non-oil exports.

The challenges for the Saudi authorities are to place the economy firmly on the path of high growth and to improve employment opportunities for the fast-growing population. As Mr. Al-Turki notes in his statement, his authorities are firmly committed to addressing these challenges and have already put in place a comprehensive program of reform which builds on the openness and flexibility of the Saudi economy. The strategy relies on the development of a strong private sector as the engine of growth, and we welcome the importance that the authorities are giving to the creation of the appropriate institutions. In this respect, Box 4 gives an excellent outline of the measures already implemented or envisaged. The measures seemed well prioritized. However, there are a number of policy measures, in particular as regard the labor code, and fiscal measures that are as important and we encourage the authorities to speed up the implementation of these measures. These must now be followed by an acceleration of the privatization process. We share the staff's view that the process will benefit from a clearer statement to the market of the timetable and steps that will be taken to execute the strategy. The planned reduction in the corporate income tax and the acceleration of depreciation of assets will certainly help to attract foreign direct investment. We also commend the authorities for steps taken to reduce discriminatory practices between domestic and foreign investors, and the provisional of concessional credit to foreign investors, and the rules governing the ownership of real estate.

The issue of job creation is appropriately receiving the full attention of the authorities.

We welcome the multi-pronged approach that is being followed by the authorities, as described by Mr. Al-Turki in his statement, to help develop the skills that are required by the private sector. We also encourage the authorities to reform the labor market to ensure that wages are market-determined and to ensure competitiveness. Other issues, such as those regarding income taxes and the need to reduce civil service employment, as noted by the staff should also be given consideration.

A strong and efficient financial sector is critical to the success of the authorities' development. In this context, we welcome the commitment of the authorities to continue opening up of the financial sector to foreign competition, and the importance given to an effective supervision of the sector. Similarly, it will be important to implement the legal reforms that underpin the Capital Market and the Insurance Sector be implemented. Development of the secondary market in government paper and the establishment of a primary market in corporate bonds will also contribute to the development of a strong financial sector, and expand private sector investment. We also welcome the steps that have been taken to control money laundering and to regulate the informal lows of Funds.

Macroeconomic policies also require the authorities' full attention. Although not of serious concern presently, the fiscal account situation may worsen over the medium term, in particular, if oil prices were to come down sharply. In the circumstances, we agree that the Budget contains inherent structural weaknesses that need attention. Some of the structural measures outlined in Box 4 will help, but more direct actions may be needed. In particular, the rising share of current outlays is an issue that needs to be addressed. Therefore, we commend the authorities for the fiscal measures envisaged to bring the Budget to balance over the medium-term. We also appreciate the determination shown by the authorities to undertake concrete measures to strengthen expenditure management and minimize extra budgetary allocation. However, additional measures may be needed and we agree with the staff that an early strengthening of the budget structure is needed to reduce the vulnerability to terms of trade shocks and to eliminate the built-in deficit bias.

The authorities' monetary stance has remained prudent, and contributed to maintaining the stability of the exchange rate. We think that the cautiously accommodative monetary policy stance for 2002 is appropriate. Like the staff, we agree that the peg to the U.S. dollar is appropriate under current circumstances.

Finally, we would like to commend the Saudi Arabian authorities for their excellent record as regard ODA, and for providing highly concessional financial assistance to many developing countries, including HIPCs.

Mr. Toyama and Ms. Sekine submitted the following statement:

First, we want to commend the staff for an informative report and to thank Mr. Al-Turki for his helpful statement.

We applaud the authorities for having implemented reforms since 1998 that aim at reducing vulnerability to oil price shocks and at enhancing employment opportunities. The economic performance over the past few years is encouraging and various steps taken along the structural front are proof of the authorities' strong commitment to reforms. The real GDP and fiscal performance decelerated in 2001, however, owing to the reduction of oil revenue from OPEC-mandated production cuts and stagnant non-oil revenues. This is an indication that the Saudi economy has to accumulate further reform measures before reducing vulnerabilities inherent in its oil-reliant economy, and we deem it essential for the authorities to persevere with these reforms to achieve the dual goals mentioned above.

The fiscal balance returned to deficit status in 2001 after it had achieved a surplus in 2000 for the first time in 15 years. While the current oil price trend might improve the fiscal balance in 2002 more than was projected, as was stated in the staff's statement, the baseline scenario in Table 2 and Appendix IV provides an important yardstick for policy management, stating that if adjustment measures are not taken, the fiscal deficit will linger and domestic debt will continue to rise. We support the authorities' efforts indicated in Mr. Al-Turki's statement to strengthen non-oil revenue by adopting the Income Tax law, modernizing the tax and customs departments, raising charges and fees on luxury items, prioritizing expenditures, and reducing extra budgetary spending. We also encourage introducing a VAT and promoting Civil Service Reforms. Concerning oil revenue, in paragraph 43 the staff indicates that the authorities should incorporate mechanisms to save and appropriately allocate oil price windfalls in order to smooth out shortfalls. We would like to ask the staff if there are any mechanisms presently under discussion with the authorities, as we recall that the possibility of establishing a stabilization scheme was taken up at the Board two years ago, and even those Directors who thought such a scheme would be helpful recognized that it requires careful analysis.

We welcome the current performance in the financial sector. Owing to stricter credit policy and risk management, banks are well capitalized, profitable, and supervised satisfactorily. We are pleased to note that the uniform standards of loan classification and provisioning are being discussed, as credit to the private sector is growing. The recent development for the AML framework is also commendable. We encourage the authorities to adopt Capital Market Law and Insurance Law, as they will help develop the capital market, diversify asset portfolios, and enhance flexibility of private sector activities. Concerning the exchange rate system and monetary policy, we agree with the staff that the peg to the U.S. dollar is working well for the Saudi economy, but the authorities should be guided by the evolving adjustment requirements in the future. While the GCC integration is in process, we would like to ask the staff about the impact of the GCC monetary union on the economy.

We support the authorities enhancing trade liberalization through WTO accession. The reduction of regional and global trade barriers will help vitalize exports and support the growth of domestic industry.

In order to reduce reliance on oil and achieve sustainable economic growth, public sector reform, private sector development, and promotion of employment will be essential. We commend the authorities for promoting a series of privatization measures since 1999. With legal complexities and administrative bottlenecks, restructuring and privatization must be carried out step by step, but it is of the utmost importance to continue moving forward. In this context, it is encouraging to read Mr. Al-Turki's statement that the privatization of telecommunications and restructuring of the utility sector are successfully in process, which will also mitigate the burden on fiscal balance as well as reduce debt. The measures included in the New Privatization Strategy are welcome, and we expect they will create momentum in promoting reforms and attracting foreign investors. We support the authorities encouraging FDI inflows by improving access to foreign investors and curtailing a "negative list." We also expect to see developments in negotiations on the Gas Initiative, as this will not only increase FDI and capital flows, but also will permit further exploitation of resource reserves, develop technology, and create employment. We support the authorities making efforts to enhance employment opportunities by providing education and training through HDRF, fostering Saudiization of the labor force, and changing the legal and institutional labor framework. We support the staff's thinking that these balanced policies should bring about adequate Saudiization and enhance non-oil private sector growth.

Recent developments in the statistical area are welcome. Compilation of adequate data will help the authorities take appropriate measures. From this standpoint, we look forward to the authorities' taking steps to adopt the GDDS.

With these remarks, we wish the authorities all the best in their future endeavors.

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

We thank the staff for a substantive report on recent economic developments and prospects in Saudi Arabia and Mr. Al-Turki for his comprehensive statement. Saudi Arabia's greatest challenges remain the diversification of its economy away from oil and gas, and the creation of jobs for a rapidly expanding labor force. Furthermore, it must meet these challenges with a declining per capita oil wealth while maintaining its Islamic and Arab character. The authorities have continued to pursue sound macroeconomic policies and have moved decisively on structural reforms to encourage foreign investment, enhance the role of the private sector, and address demographic pressures. As a result, Saudi Arabia has kept inflation low, reduced the budget deficit to manageable levels, repaid its foreign debt, and has financed much of the infrastructure needed to modernize the Kingdom. We warmly commend the authorities for these achievements and encourage them to stay the course in implementing their development strategy.

We note that fiscal performance in 2001 weakened in the face of lower oil prices and overspending. As a result, there was an increase in government domestic debt. This year, the fiscal position is expected to remain under pressure and could worsen over the medium-term, if there is a fall in oil prices. We welcome the authorities' determination to avoid the re-emergence of fiscal imbalances and to improve the budget structure by redirecting outlays away from wages to well-targeted social spending, training, and education. We strongly support the plan to broaden the non-oil revenue base through the introduction of a VAT, possibly as part of a coordinated tax effort within the Cooperation Council of the Arab States of the Gulf (GCC). We also support the provision of Fund technical assistance to help the Saudi Arabian authorities modernize revenue administration and prepare for a VAT.

As the world's largest oil producer, Saudi Arabia's medium-term outlook remains vulnerable to large unpredictable swings in oil revenue, including those arising from the interaction between OPEC and market forces. Given the uncertainty attached to the evolution of global oil prices, perhaps the staff could comment on whether fiscal policy in Saudi Arabia should be developed within a medium-term framework that uses a conservative long-run oil price for both revenue and expenditure. Moreover, what degree of fiscal adjustment is needed to help bring Saudi Arabia's non-oil fiscal deficit in line with its estimated permanent income from oil and gas wealth?

We note that Saudi Arabia liquidated a substantial amount of its foreign investment to pay for the budget deficits arising from the Gulf War. It has since been able to retire its Gulf War foreign debt partly at the expense of increasing domestic borrowing. Public sector domestic debt now stands at over 90 percent of GDP; most of it is held by two government pension funds. Perhaps the staff could comment on whether this level of debt is sustainable, especially in periods of low oil revenues.

We are pleased that Saudi Arabia's financial sector is sound and that banks are well capitalized and provisioned, and closely supervised by the Saudi Arabian Monetary Agency (SAMA) in line with international best practices. A credit bureau has been established to improve credit risk assessment further in the banking sector. We commend the SAMA for developing a comprehensive framework to combat money laundering and the financing of terrorism, which pre-dates the September 11 events.

The development of domestic sources of financing is key to supporting growth in the non-oil sector. Several initiatives have already been taken to deepen the Saudi capital market, and we look forward to early approval and implementation of the capital market and insurance laws. We also look forward to the authorities' decision to participate in an FSAP, which will help identify remaining vulnerabilities in the financial sector.

Saudi Arabia has maintained a stable peg of the Saudi riyal exchange rate within an open exchange and trade system. A continued strong fiscal position and a sound banking system are essential to support this arrangement, while further structural reforms would improve the competitiveness of non-oil exports. The latter should receive a boost from the recent reduction in tariffs which, as stated in Mr. Al-Turki's statement, is indicative of the authorities' commitment to an open trade regime.

The passage of the new investment law has improved the climate for private sector development and is helping to attract foreign direct investment. We welcome the intention to narrow the long "negative list" of areas where foreign investors are excluded and to streamline administrative procedures. We look forward to the finalization of agreements under the major Gas Initiative that would spur additional foreign investment in the upstream gas sector. We welcome the strategy to restructure state companies and encourage the authorities to develop a clear timetable for executing the privatization strategy. Proceeds from privatization should be used to reduce government debt.

Saudi Arabia offers many potential tourist attractions, particularly for Islamic tourists. Tourism appears to be one promising area where the government could encourage investment and help create jobs. Perhaps the staff could expand on the Kingdom's efforts at promoting tourism.

Saudi Arabia's efforts to join the WTO are critical to attracting foreign investment, particularly in the power, petrochemicals, and telecommunications sectors, and to creating new markets in the future. Bilateral trade agreements have been reached with 11 countries, including Brazil. We encourage Saudi Arabia's trading partners that have not yet reached agreement to make progress on the basis of the revised offers that have been presented, so as to clear the way for Saudi Arabia's accession to the WTO.

We are pleased that the authorities are making progress on improving the flexibility of the labor market, and welcome their focus on training and education to increase job opportunities for Saudi nationals in the non-oil private sector, while applying flexibly the Saudiization policy. The plan to transfer benefits between the pension fund and the social security system and the extension of social security benefits to Saudis in the private sector should help encourage mobility away from the public sector, and should be supported by civil service reform and realignment of public sector benefits to those in the private sector.

The global oil market is being subjected to rising volatility amidst concerns of a further deterioration in the security situation in the Middle East region. Saudi Arabia's vast oil reserves give it a strong strategic interest in stabilizing the world's oil supplies and in keeping oil prices at relatively moderate levels. We welcome the Kingdom's efforts to foster stability and predictability in the global oil market.

Mr. Shaalan submitted the following statement:

The Saudi authorities are to be commended for maintaining a broadly stable macroeconomic environment, in spite of the unstable conditions in the oil markets during the past year, which was further complicated by the aftermath of the September 11 events. The sharp volatility in petroleum prices has presented, and most probably will continue to present, challenges to the management of the economy and, in particular, the fiscal and external sectors. Nonetheless, the continued steady pursuit of a comprehensive reform strategy launched several years ago has contributed in a significant manner to the economy's strengthened resilience in a difficult global environment. Three factors stand out in underpinning the economic resilience that dampened the impact of the aforementioned exogenous shocks. First, the diversification strategy pursued over the years has been a major contributor to the efforts to address the economy's dependence on oil. Second, the prudent macroeconomic policies, particularly those aspects that focus on restraining expenditures in periods of high oil revenues, served the country well when oil prices were depressed. Lastly, the structural reforms, especially those in the legal and institutional areas, have buttressed progress in such key areas as labor, privatization—an important consideration in the country's clear emphasis on promoting the private sector—and the financial sector. These are a few of the issues the country is currently tackling.

It is thus clear that considerable reforms have been implemented or are under serious consideration. While I have no problems with the staff's comprehensive catalog of needed reforms, it must be realized that the capacity to put these reforms in place, and effectively so, will by necessity require time, but the process must begin. Second, and most important, I would like to have seen a practical sequencing of the reform agenda, and the interactions between those various components needed to enhance effective implementation.

Finally, on the state of the Saudi economy, note should be taken of the vulnerability indicators shown in Table 6 of the staff report which clearly display the characteristics of a healthy economy with a strong reserve position, low interest rate spreads, a capitalized and profitable banking sector, and low foreign debt.

This is not to say that Saudi Arabia is without challenges in the period ahead. The Saudi authorities are in fact fully cognizant of the changing global environment and are determined to speed up, as much as is feasible, the pressing fiscal reforms, and the host of policies needed to promote the private sector. Actions in these areas will be important pillars in addressing the problem associated with the employment of the projected labor force and raising its productivity in the medium term. In what follows, we will make a number of comments in these as well as other macro and structural areas.

Given the uncertainty in the oil market, ensuring a stable macroeconomic environment rests in large part on the ability of the authorities to continue the pursuit of a prudent fiscal policy. To this end, a specified time frame, supported by specific policies will be needed. The authorities' declared policy that unanticipated declines in oil revenues will be promptly matched by cuts in expenditure bodes well for maintaining discipline in the conduct of fiscal policy. Moreover, budget improvements will henceforth focus on the growth in revenues. In this regard, it is well to note that while the fiscal stance has weakened in 2001, a number of factors underlying the widening deficit were temporary in nature. Most notably, extra budgetary outlays were made to settle late payments accumulated in the early 1990's, the reasons for which are adequately outlined in the report and are considered to be non-recurring. For 2002, the authorities are strongly committed to containing expenditure increases in excess of the budget. I am encouraged that the projections for 2002 show that the outcome is likely to improve compared to last year.

For the medium term, the authorities have clearly indicated their intention to initiate fiscal reforms directed at attaining budget balance by 2005. We are pleased to note the efforts directed at fiscal consolidation through both revenue and expenditure measures. A key element in the effort to strengthen expenditure management is the plan to improve the efficiency of the civil service and to privatize some publicly provided services. With regard to the ongoing plans to improve revenue performance, I very much welcome the planned introduction of the new Income Tax law and improvement in the collection of revenues. I believe these as well as other planned measures provide a sound basis for improving public finances in Saudi Arabia. The authorities may wish to consider additional measures to enhance revenue performance in particular in case the planned reduction in the deficit does not materialize. I also welcome the authorities' decision to direct proceeds from privatization to the reduction of the public debt and interest payments in the budget. It is well to note here however, that an analysis of the public debt burden should take into account the fact that the public debt, while high, does not represent a source of vulnerability or financial risk to the economy as it is entirely domestically held and mostly owed to public entities.

The authorities' approach to monetary and exchange rate policy has proven over the years to be optimal for the Saudi economy. The strong peg to the U.S. dollar in a liberal exchange and trade regime has ensured a stable monetary environment in an economy that is otherwise subject to significant volatility associated with oil market uncertainties. For the medium term, the authorities are correct in pointing to the need to guide their policy by the evolving adjustment requirements of the economy as well as the planned Gulf Cooperation Council monetary union. With regard to the monetary stance, in the absence of inflationary pressures, I agree with the authorities' intention to pursue an accommodative monetary policy to support private sector activity.

On structural issues, reading the staff report gives a clear signal as to the determination with which the authorities have been liberalizing the economy. There is a clear recognition that improving the dynamism of the private sector is key to expanding the growth potential of the non-oil sector and reducing the unemployment rate among Saudis. In this regard, the approval of the privatization strategy should provide a major impetus to the divestiture program. This along with other measures taken in the legal, institutional, and administrative areas should help improve the environment for private sector activity and attract FDI flows. Given the global environment, unduly high expectations for this to materialize, may be unrealistic.

Within the emphasis to enhance the private sector to generate employment, we welcome the change in labor strategy. More attention is being accorded to education and training of Saudi nationals while introducing more flexibility to the policy of Saudiization. These efforts will help with the implementation of the Saudiization policy without unduly affecting the competitiveness of the private sector.

On oil market developments, the constructive role Saudi Arabia plays in helping maintain stability in the oil market, as mentioned in Mr. Al-Turki's comprehensive statement, is noteworthy. I support their efforts to enhance cooperation between oil producer and consumer countries to ensure that the inherent uncertainty in the oil market is not amplified. Setting up a permanent secretariat for the International Energy Forum in Riyadh as called for in the Osaka agreement would be conducive in this regard.

On statistical issues, significant progress has been made on many fronts, including national accounts, labor data, and the balance of payments. The authorities' continued commitment to improve the availability and publication of data further as attested by the issuance of the publication of economic and financial data guidelines in mid-2001 is welcome. With regard to the provision of information on the international investment position, I am surprised, once again, to see a reference to Article VIII, Section 5 in the introductory paragraph to section II. The discussion of this issue in paragraph 38 of the report makes it clear that Saudi Arabia is providing all available information on IIP leaving no doubt as to whether there is an issue of Article VIII Section 5 breach. We are confronted with a situation where, as Mr. Al-Turki rightly points out, the principle of uniformity of treatment itself is being breached.

Before concluding, I would like to express my appreciation for the Saudi authorities for their generous official development assistance, which has almost consistently exceeded the ODA target of 0.7 percent of GNP.

To conclude, I would like to commend the Saudi authorities again for the skillful management of the economy in a rather difficult time characterized by uncertainties not only in the oil market, but also with regard to the security situation in the region. I wish them success in facing the challenges ahead.

Mr. Rustomjee submitted the following statement:

The staff has produced a comprehensive document on the recent economic developments in Saudi Arabia and we wish to thank it for the detailed and analytical report. We would also like to commend the authorities for their efforts to implement their reform strategy and sound management of the economy.

We note the recent fiscal developments, which have resulted in the deterioration in the central government's position, shifting from a surplus of 3.2 percent in 2000 to record a deficit of 3.9 percent in 2001. The oil sector has been the major contributory factor as a result of a decline in oil revenues. At the same time, we note the 19 percent surge in over- expenditure by government financed from domestic sources. We appreciate efforts by the authorities to address this development through introducing a medium-term budgetary framework that seeks to curtail the overall budget deficit and to strengthen the fiscal position. The projected budgetary outlays envisage the near balancing of the budget by 2005 leading to possible surpluses in 2006-07. The increase of the current expenditure has been largely influenced by a high wage bill and interest charges. Efforts also to reduce reliance on oil revenues that have tended to induce a bias towards budgetary deficits are supported. We encourage the authorities' efforts to reform the tax laws to broaden the revenue base, improve revenue collection, and improve budget management through expenditure control and curtailing extra-budgetary expenditures.

We support the authorities' commitment to financial sector reform, opening the sector to increased competition, development of the capital market and creation of new institutions to meet the demands of the private sector. We note the observation of the staff on the prospects for an increase in interest rates from their historically low levels and their likely negative impact on economic growth. We commend the development of comprehensive guidelines to combat money laundering and Saudi Arabia's plans to forge a regional economic bloc with other neighboring states, which envisages the creation of a monetary union by 2010.

We note the authorities' continuing reliance on the oil sector, which renders the country vulnerable to short-term price fluctuations. The staff clearly recognizes this vulnerability and we note the projection of a difficult medium-term forecast, with envisaged fiscal and external sector pressures and the uncertainty pertaining to the vulnerability of oil prices. The diversification of the economy through support for private sector development and development of the non-oil sector is therefore laudable. We also support efforts by the authorities to address the looming unemployment problem and we commend them in implementing structural reforms necessary for growth and for attracting foreign direct investments. These efforts include, amongst other initiatives, programs to train Saudi youth, civil service reform, and labor market integration. Though these reforms are not expected to yield immediate returns, they will contribute to the increased skills for private sector development. The on-going efforts to harmonize and reform the industrial relations environment in the country will also serve to create a predictable environment for foreign direct investment flows into the country.

In this regard, we encourage the authorities to expedite the implementation of the reform programs. We also welcome the regional economic integration efforts, which envisage the creation of a common external tariff and a monetary union with some neighboring states.

We wish the authorities success in their challenging policy endeavors.

Mr. Oyarzábal and Mr. Beauregard submitted the following statement:

At the outset, we would like to thank the staff for the excellent set of papers prepared for today's discussion, and Mr. Al-Turki for his informative and well-written statement.

The Saudi Arabian economy performed well despite the global economic deceleration that took place in 2001 and during 2002 and increasing uncertainty in the region. In particular, it is encouraging that the non-oil sector of the economy has been growing steadily. On the monetary front, both inflation and interest rates are low, and the exchange rate regime has served well. It is noteworthy that vulnerability indicators have remained strong. Nevertheless, important challenges remain and the authorities ought to redouble their efforts to attend the structure of the fiscal accounts and to implement the structural reform agenda so as to induce more private sector participation in the economy. It is particularly important that the latter be addressed swiftly in order to provide the Saudi population needed employment opportunities.

The most important issue the authorities ought to address is the structure of the fiscal accounts. The excessive dependence on oil proceeds is understandable, being Saudi Arabia the largest oil producer in the world. However, ample swings in oil prices pose a challenge to the management of the fiscal accounts. The authorities' plan to boost other public sector revenues through the fiscal reform outlined in Box 4 is a step in the right direction, although I do not think it will be enough to reduce significantly the vulnerability of the fiscal accounts to swings in international oil prices. Could the staff elaborate more on the plan to introduce VAT system? Are there other measures that could be implemented to advance in this area? The staff's comments would be welcomed.

The increase in the fiscal deficit in 2001 and onwards calls for decisive action by the authorities. The financing of the deficit has been through increased borrowing from banks and also from the Autonomous Government Institutions or AGIs. First, the former reduces the amount of resources available to finance private sector activities, which by the way is also one of the objectives of the authorities. Second, the staff reports that the AGIs are also financing the government's increased deficit. At the outset, should not the definition of fiscal deficit include these institutions to have a broader indicator of the financing needs of the public sector? What are the revenue sources of the AGIs? The staff's comments will be welcomed. Furthermore, we are worried that the perception of an increase in both the fiscal deficit and the government debt could affect private sector investment in the future, thus curtailing efforts for boost job creation. Therefore, in order to be consistent with the overall strategy to offer the Saudi population more job opportunities in the private sector, we would like to encourage them to address the deteriorating fiscal situation. In this regard, we welcome the decision to use privatization proceeds to pay down government debt. Finally, given the large level of the public sector debt, we would have welcomed a thorough fiscal sustainability analysis.

We share the staff's opinion that to further advance in the privatization effort a timetable would be helpful. At the same time, we think the authorities have a point when they argue that the slow pace in this front so far accounts for complex legal issues that need to be addressed as well as the required introduction of regulatory practices, and the concerns of the possible impact on unemployment. This important effort needs to be done carefully and the authorities need to proceed with caution and with solid foot in their efforts to enhance private sector participation. It is interesting to note their concern on the possible impact on unemployment. Have the authorities developed a social safety net to cope with those cases where a reduction in the labor force is foreseen? The staff's or Mr. Al-Turki's comments would be welcomed.

It is very encouraging that the financial sector is in a very healthy position. This is important given the need to finance investment project by the nascent private sector. We commend the authorities and we encourage them to continue working in developing a capital market in Saudi Arabia. We think an FSAP could prove to be helpful in identifying further development avenues. We also take note of Saudi Arabia's efforts to combat money laundering and the financing of terrorism.

We very much welcome the authorities' efforts to promote employment opportunities to the Saudi population. Developing a skilled labor force is key in this regard. However, this is an endeavor that will take time. Meanwhile, we share the staff's word of caution to the authorities not to be too rigid in applying the Saudiization policy, in order not to jeopardize the competitiveness of the economy.

On the statistical issues, we welcome the progress achieved so far and we are confident that enhanced efforts will be carried on to further advance in this area. Finally, we commend the authorities for both, providing financial assistance to the poorest countries in the world and in maintaining a stable international oil market.

With these remarks, we wish the authorities well and all the best in their future endeavors.

Mr. Djojosubroto and Mr. Segara submitted the following statement:

We would like to thank the staff for its comprehensive report and Mr. Al-Turki for his informative statement. It is refreshing to note that despite the very difficult security situation in the region; recent economic developments in Saudi Arabia have generally been encouraging. Not only has the non-oil GDP growth exceeded 4 percent in the first half of 2002, but also monetary policy has been prudently managed, ensuring domestic price stability, while maintaining a strong external position. These are commendable achievements for the authorities. Nevertheless, many challenges remain.

We broadly agree with the thrust of the staff assessment. However, in assessing the economy, we need to consider the special characteristics of Saudi Arabia, as they may require special policy recommendations. First, the country is very dependent on oil and gas, which accounts for 85 percent of exports and 77 percent of government revenues. Second, most of Saudi's land is in the form of desert, with little opportunity for developing agricultural products. Third, Saudi Arabia is the center of Islam, and has a distinctive culture and law.

On fiscal sector, the budget has been significantly affected by fluctuations in oil prices. Moreover, when revenues decline, the authorities have difficultly adjusting expenditure downward, as about 90 percent of the total budget expenditure is classified as current outlays, of which more than 50 percent is for wage bill. Consequently, fluctuations in oil prices lead to large fluctuations in the budget balance, evidenced by the shift from a surplus of 3.2 percent of GDP in 2000, to a deficit of 3.9 percent of GDP in 2001

In this context, the staff's recommendation for the authorities to reduce the current expenditures during falls in the oil price seems like appropriate advice, but in practice there are so many administrative and social constraints that create downward rigidity of the current outlays. An alternative solution to counter the impact of oil price fluctuations on the budget could be to create an oil stabilization fund, to be used during periods of low oil prices and to be replenished when the oil price increases above target. We note that as one of the leading oil producing countries, Saudi Arabia can play a role as a price maker. However, there are clearly limits to this role, for example in the current circumstances, where. Mr. Al-Turki has rightly pointed out that oil price spikes cannot be ruled out. Accordingly, we wonder whether the establishment of an oil stabilization fund has been considered by the Saudi authorities, as we suggested in our statement during the last Article IV Consultation discussion. We would also be pleased to hear the staff's view on this matter.

Concerning the need for increased elasticity and buoyancy of non-oil revenue, we broadly agree with the staff's view. However, again the unique characteristics of the Saudi economy have to be taken into consideration. The introduction of VAT to a system that is sill very much dependent on zakat may need careful study and preliminary measures.

On the expenditure side, the staff's recommendation to reform the civil service in order to reduce the wage bill seems like appropriate advice. In reality, it is not easy to undertake such a reform as it is very sensitive issue and relates to the labor market and the policy to foster the Saudiization of the labor force. We are wondering whether this recommendation has taken the political and social implications into consideration. The staff's further comment is welcomed.

In connection to this, on the labor sector, we welcome the authorities' effort to provide more educational and vocational training, and change the institutional and legal framework to facilitate the substitutability of nationals for expatriate workers. However, we question the policy to encourage technology- and capital-intensive activities with the aim at reducing demand for unskilled expatriate workers. We are concerned that such a policy will reduce the number of job opportunities for unskilled labor, in particular, before the authorities are able to increase the number of skilled Saudi nationals.

Regarding Saudiization, we welcome the medium-term reforms aimed at developing new skills needed by the economy and developing an open and integrated labor market with market–determined wages. In this regard, the staff suggests that the needed reorientation of workers toward the private sector could be facilitated through accelerated privatization and subcontracting, combined with wage restraint in the public sector. However, as we said earlier, we are not convinced that modest measures would really result in a significant reorientation of workers toward the private sector, It is clear from the staff report that the government sector has a much better pay scale, benefits, job security, and social status than the private sector. At the same time, bold measures would have profound social and political implications.

With regard to structural reforms, we are encouraged by significant progress that has been achieved, as shown in Box 4 of the staff report. We agree that stimulating private sector investment including FDI is warranted to address the unemployment pressures and promote the diversification of the economy. In this regard, the staff suggests that the authorities establish a clearer timetable and steps for the privatization program. Unfortunately, it is not clear to us whether the enterprises that are going to be privatized are loss-making or profitable companies, as we could not find sufficient analysis of these companies in the staff reports. However, the motive would not seem to be financial, given the relatively small subsidies. In these circumstances, it seems to us that the most important objective should be to establish a solid economic framework, while moving away from over-reliance on the oil sector. In this connection, we are wondering whether privatization is necessary to ensure that government enterprises are run on a commercial basis, particularly, if the company has been a highly profitable one like Saudi Telecom Company. The staff's comment is welcome.

With these remarks, we wish the authorities the best in meeting the challenges ahead.

Mr. Zoccali and Mr. Pereyra submitted the following statement:

We commend the staff for a well-focused set of documents and Mr. Al-Turki for his helpful statement relating to the authorities´ comprehensive policy initiatives to achieve medium-term macroeconomic equilibrium, promote private sector-led growth, and reduce unemployment. We will confine our comments to fiscal policy, structural reforms and trade policy.

We welcome the authorities' reaffirmed determination to address fiscal imbalances in the medium term as the centerpiece of their overall economic reform program, keeping in mind the built-in deficit bias noted by the staff in its report. Bringing the fiscal deficit into balance mainly through a substantial reduction in the non-oil deficit, could produce a marked change vis-à-vis the projected deficit scenario of about 4.5 percent of GDP p.a. under an unchanged policy stance.

In particular, the introduction of a foreign corporate income tax, at a flat 30 percent rate, and of an income tax on expatriate workers included in the new Income Tax Law should serve to strengthen the tax revenue base. Other measures already being implemented include administrative improvements in tax collection (especially Zakat and the customs); the tightening of expenditure management through the use of performance contracts; the consolidation of a number of ministries and government departments; and the reduction of the wage bill through an increased role for the private sector in the provision of services give credibility to the effort. The issue of extra-budgetary allocations would nonetheless warrant due consideration.

The introduction of a VAT could substantially complement these ongoing fiscal initiatives. The medium-term adjustment scenario, provided in Table 5 of the main staff report, projects a sharp increase in VAT revenue following its introduction in 2005. While recognizing the revenue potential and the non-distorting nature of the measure helped by a relatively low rate, international experience shows that successful implementation still requires careful planning, an extensive public information program, and adequate enforcement capacity. We would welcome comments from the staff regarding the assumptions in terms of collection efficiency behind the medium-term VAT revenue projections and whether Fund technical assistance is envisaged to support the modernization of the revenue administration and the preparation for the VAT. To enhance public expenditure management, we would also attach importance to the introduction of a medium-term fiscal framework that provides, inter alia, for more explicit fiscal rules as a protection against temporary increases in oil revenues, as well as for more binding targets for subsidies and capital outlays.

The approval in June 2002 of the privatization strategy enhances the robustness of Saudi Arabia's effort to increase participation of the private sector in investment and employment generation in the non-oil sector and to secure, more generally, efficiency gains in the economy. In this regard, we note the considerable progress that has been made in the effort to privatize the telecommunications and power generation sectors, including a timetable for the divesting of the Saudi Telecommunications Company (STC). We also welcome the authorities´ careful consideration given to the preconditions and sequencing criteria—described in Appendix V—to ensure a successful privatization process. In particular, we concur on the importance of having in place a suitable legal and institutional framework to regulate the provision of services, accompanied by steps to further liberalize and develop the financial and capital markets, and to facilitate private investor participation, both Saudi and non-resident. Given that the privatization initiative is expected to yield considerable revenues, we commend the authorities on their intention to use privatization receipts to reduce the mounting government debt.

We are glad to learn from Mr. Al-Turki that the new Capital Market Law is expected to be approved in the near future. The broad scope of the new law, that aims to convert the stock exchange into an independent entity, provide a legal and regulatory framework for new financial instruments (corporate bonds) and activities (financing by specialized investment companies), and to develop a secondary market for government paper, could provide a sound basis for deepening the potentially large domestic capital market. In particular, we welcome the emphasis given to transactional transparency as reflected in the rules governing trading activities, codes of conduct for dealers, and new disclosure requirements. Additionally, the authorities´ request of an FSAP is timely and may serve to reinforce their efforts in this domain.

Saudi Arabia's adherence to international standards governing banking sector supervision and prudential regulation are noteworthy. A well-defined timetable for the introduction of uniform standards of loan classification and provisioning, as well as access to the new credit bureau's database would constitute an important contribution towards bank soundness, thereby building on the recommendations of the self-assessment conducted by the Saudi Arabian Monetary Authority (SAMA) in relation to the Basel Core Principles.

The current level of unemployment and rate of growth of the labor force, projected at 4.7 percent per annum in the medium term, indicates clearly that the labor market represents a potentially increasing source of social pressures. We welcome the authorities´ commitment to fostering an efficient market determination of wages by maintaining an open door policy for foreign labor, and for attempting to level employment conditions for national and expatriate workers. In addition to introducing wage restraint in the public sector, we attach utmost importance to improving the skills profile to help meet the growing technical and educational demands of the non-oil private sector and the desired Saudiization of the labor force. We would welcome further elaboration from the staff regarding the intermediate targets in the medium-term education reform, described in Box 5, to encourage the production skills required by the private sector.

Given the ongoing shift to encourage greater participation of foreign capital, we would also appreciate some further information on the mechanisms to improve the relation between employers and employees envisaged in the labor law announced for end-2002. We encourage careful consideration of the resource allocation impact associated with incentives for companies meeting the Saudiization requirements and the proposal to bridge the salary gap between expatriate and national workers.

The effectiveness of the Saudi authorities' commitment to greater capital market openness could be substantially complemented by greater progress in the area of trade reform. In this regard, we welcome the trend to lower agricultural subsidies. Perhaps the staff would care to comment on the remaining level of agricultural protection in terms of its impact on market access and the fiscal accounts. We encourage the authorities to press ahead with accession to the World Trade Organization (WTO) and to build on the bilateral trade agreements reached to accelerate trade integration. More specifically, regarding regional integration, we welcome the effort to advance the introduction of the common external tariff (CET) of the Cooperation Council for the Arab States of the Gulf (GCC) to January 2003.

Finally, we commend the Saudi authorities for the high level of financial assistance provided bilaterally and multilaterally to enhance growth and reduce poverty in developing countries, and wish them every success in their endeavors at this critical juncture of the reform process.

Mr. Mirakhor submitted the following statement:

Overall, recent performance of the Saudi Arabian economy has been positive. Addressing the twin challenges of faster growth and reduced vulnerability to oil price developments calls for tightened demand management and accelerated implementation of the authorities' comprehensive structural reform agenda. We commend the authorities' intention to achieve fiscal balance by 2005, along with a steady decline in the public debt to GDP ratio. The conduct of monetary policy has been prudent, delivering an enviable record on inflation and supporting the exchange rate peg. Recent articulation of the privatization strategy is a landmark development. A clearer timetable of execution of the strategy could boost confidence. We welcome recent steps taken in reforming the capital market and liberalizing the banking sector. The authorities' approach in dealing with the problem of high unemployment rightly focuses on skill development, higher productivity, and a shift to a more market-determined wage structure. The Saudi Arabian authorities are to be commended for their generous concessional assistance to developing countries, including HIPCs.

We thank the staff for a well-written report, and Mr. Al-Turki for his articulate statement. The overall performance of the Saudi Arabian economy over the past 12 months has been positive. Non-oil GDP growth appears to have recovered from last year's slowdown and could grow by more than 4 percent in 2002—an impressive outcome in the face of growing uncertainty surrounding the security situation and lower oil sector activity. The external current account is projected to remain in surplus, with a comfortable cushion of reserves, inflationary pressures are virtually absent, and the financial sector remains strong. The authorities deserve to be commended for the progress made since 1999 and for continued implementation of their comprehensive reform agenda. Less propitiously, however, the fiscal position has come under pressure, and government debt has increased, following a sharp decline in oil revenue and a welcome clearance of delayed payments. The authorities are fully cognizant of the need to rebalance policies and have signaled their determination to tighten demand management and to expedite implementation of their reform strategy. This is welcome as it prepares the ground to meet the twin challenges of accelerating growth and generating employment opportunities, on the one hand, and reducing the economy's vulnerability to oil price developments, on the other.

Central to the goal of effective demand management are early and durable actions to strengthen the fiscal position. The staff report indicates that reforms to-date have improved the fiscal structure, and that the authorities plan further progress in this area. We commend the authorities for their intention to aim for a fiscal surplus in 2005 and for the steps initiated in 2002 and those presently under discussion. The clearance of domestic arrears should strengthen the credibility of the fiscal policy. We note that the delayed payments being eliminated predate 1995-96 and that no new arrears have been accumulated. We welcome the measures taken to strengthen expenditure management and to avoid any new build-up of arrears. We agree with the authorities' view that, in order to make room for the needed increase in spending on education and health, the bulk of fiscal adjustment should fall on revenue mobilization. We are pleased to note from the staff statement that the recent increase in oil prices has improved the outlook for 2002. This underscores the dependency of macroeconomic developments on oil price fluctuations, which can go both directions. In this context, we wonder why the medium-term scenario did not refer to the likelihood of a higher oil price than in the baseline WEO assumption.

Monetary policy has been conducted with prudence and skill, and has delivered an environment free of inflationary pressures against the backdrop of a liberal trade and exchange system. On exchange rate policy, we agree with the staff that the peg with the US dollar is "appropriate under the current circumstances." We also take note of the authorities' view that, in the longer term, future exchange rate policy will be guided by the evolving adjustment requirement and the planned introduction of a monetary union among the GCC countries.

The recent articulation of a privatization strategy is a landmark development in terms of breadth and scope, and promises to boost investment, including FDI, and help reduce government debt. We welcome the steps taken by the authorities to ensure a level playing field for foreign and domestic investors. The authorities are right to give priority to the enactment of the required laws and institutional framework on the role of the private sector and liberalization of the financial sector before proceeding with privatization per se. However, there is merit in the staff's view that the market would react favorably to a clearer timetable of steps required to execute the authorities' privatization strategy. Early finalization of agreements under the Gas Initiative would also bolster market confidence and attract FDI in gas production and downstream activities.

We are pleased with the good performance of the Saudi financial sector as well as the strength of the banking system, which is well capitalized and well supervised and follows strict risk management practices. We join the staff in welcoming the steps taken to reform the capital market and to liberalize further the banking sector. Establishing a unified legal and regulatory framework under the new Capital Market Law should pave the way for the development of corporate bonds and support the envisaged expansion of private sector investment. We are pleased to note that the authorities are receptive to an FSAP exercise. We applaud SAMA's comprehensive and early action in the prevention and control of money laundering activities.

Addressing the persistence of the high unemployment rate among Saudi nationals is a major priority for the authorities. We support the approach taken which focuses on the development of skills, improving productivity, and a shift to a greater market-determination of wages. As the staff emphasizes, the challenge for the authorities is to balance the need for Saudiization of the labor force and enhancing non-oil growth and job creation.

The Saudi Arabian authorities are to be commended for their generous and highly concessional financial assistance to developing countries, including HIPCs.

Mr. Reddy submitted the following statement:

We would like to thank the staff for a set of well-written documents. The Saudi Arabian authorities have faced a challenging external environment since the last consultation. Growth has slowed, and the budgetary deficit has reemerged. In this testing situation, the authorities need to be commended for their skilful management of the economy. As pointed out by Mr. Al-Turki in his comprehensive statement, the growth of non-oil GDP is encouraging. Reserves are comfortable and external vulnerability indicators are reassuring

We welcome the intention of the authorities to achieve fiscal balance in a phased manner by 2005 by steadily reducing their budget deficit. The authorities' plans to merge various ministries and departments, incorporate all off budget activities into the budget, improve expenditure management, as well as reduce current expenditures are important steps to strengthen the budgetary system. The staff's suggestion to create a contingency reserve in the budget is worthy of consideration. On the revenue side, we note that one of the steps planned in the imposition of an income tax on expatriates, and we hope that the possible impact of this measure on competitiveness has been taken into account by the authorities.

The prospects for the medium term need to be buttressed through determined implementation of the ongoing reform strategy aimed at insulating the economy from oil price shocks as well as addressing unemployment pressures. We welcome the proposal of the Saudi authorities at the International Energy Forum aimed at fostering producer consumer cooperation to ensure a more orderly oil market. The authorities continued commitment to their economic reform agenda outlined in Box 4, would foster diversification, nurture an improved environment for private sector growth, as well as create additional employment opportunities for Saudi nationals. As Mr. Al-Turki highlights in his helpful statement, much work has been done during the recent past in laying the legal and institutional foundations for private sector led growth. Such reforms, to be implemented successfully need to be consensus driven, and therefore we agree with the authorities that this process may be time consuming.

We complement the SAMA for their prudent monetary policy, which has successfully maintained the peg to the dollar while ensuring price stability. The banking sector has remained strong and well supervised.

Capitalization is well above minimum requirements. The level of non-performing assets is stable and has been provided for more than adequately. We are also encouraged that the authorities are taking steps to liberalize the banking sector and develop the capital market by putting the necessary legislation in place.

Structural reforms continue to remain the most significant part of the authorities' agenda. The need to provide employment outside the public sector to a growing work force remains critical. We agree that the steps outlined in Box 5 to enhance implementation of the Saudiization policy would need to be approached in a flexible manner to ensure competitiveness as well as minimize its fiscal impact. The authorities are to be commended for the ambitious Gas Initiative, successful implementation of which will not only ensure significant strengthening of the infrastructure sector but also foster the development of local suppliers and contractors.

We wish the authorities success in their policy endeavors.

Extending his remarks, Mr. Shaalan asked—in connection with paragraph 11 in the staff report—whether Article VIII, Section 5 was applicable only to the provision of information to the Fund or whether it was also applicable to the dissemination of information. If it were only applicable to the provision of information, why did the staff use the word "dissemination" in paragraph 11?

Extending his remarks, Mr. Mirakhor made the following additional statement:

I thank the staff for their statement. I have a question on the second paragraph where staff indicates that the price of oil will increase to US$25.51 instead of US$21.50 which was projected earlier. The statement continues indicating that "the staff estimates indicate that such a price development will result in the fiscal deficit declining to 1.2 percent of GDP, while the current account surplus will rise to about 5 percent of GDP." I am a little confused because footnote 8, page 12 of the staff report, states that "a price path of US$5 a barrel below that underlying the above forecast would, under unchanged policies, cause the budget and external current account deficits to increase by 5 percent and 7.5 percent of GDP." It therefore appears that every dollar change in the price of oil will result in roughly a 1 percent change in the fiscal deficit and 1.5 percent change in the current account. Thus, if that is the case, then a change in the average price of the WEO crude oil price from US$21.50 to US$25.51 leads to a four dollar change, which, according to this simple arithmetic, should mean a 4 percent reduction in the fiscal deficit. Given that and noting that the staff has assumed that the fiscal deficit would be 3.7 percent for 2002, it appears to me that actually it would end up with a fiscal surplus of 0.3 percent, not a deficit of 1.2 percent, and that the current account surplus should rise to 7.5 percent, not to 5 percent. Therefore, I wondered if the staff could clarify that.

The next sentence in the staff statement reads, "The medium-term projections are expected to remain broadly unchanged." It appears that this is counterintuitive because, after all, the medium-term projections are based on 2002 turnouts, the base year, and it seems that if there is such a significant change in both the current account and the fiscal deficit, there should be some change in the medium-term projections as well.

While I am on the medium-term projections, it would have been helpful and appropriate if the medium-term outlook would have also taken into account the impact on the budget and the current account of the coming on stream of the gas project because imports would have declined and revenues would have increased.

Another question relates to paragraph 3 of the staff report where there is a reference to weak confidence, and frankly, I have read both the background paper and the staff report, and I could not identify where the judgment on weak confidence comes from. This is an economy where there is virtually no inflation, the real exchange rate is stable, there are large reserves, a strong net foreign asset position, an impressive list of structural reforms that have been implemented, as evidenced in Box 4, external viability indicators are very strong, spreads are very low—about 24 basis points over U.S. dollars, the stock market is growing, there is an increase in transparency and availability of information to the public, and a strong financial system is in place. I also noticed that there is a difference in judgment on what happened in 2001, paragraph 3 of the staff report and paragraph 3 of the background paper. However, paragraph 3 of the staff report attributes the slower growth to lower confidence and lower investment; paragraph 3 of the background paper explains the slower growth in terms of a sharp reduction in agriculture and by lower consumption-driven activities, which is not reflected in paragraph 3 of the staff report. I am worried that if this is reflected in the summing up, and then reflected in the PIN, which the authorities have agreed to publish, it may create a misimpression. Thus, I would appreciate it if the staff could address these issues.

Mr. Shaalan also expressed concern over the references to weak confidence contained in the staff report in light of all the strong indicators highlighted in the report.

The staff representative from the Middle Eastern Department (Mr. Iqbal), in response to Mr. Mirakhor's question, replied that the price increase to $25.51 dollars per barrel was related to the WEO oil price not the Saudi Arabia oil price. The Saudi Arabia oil price was about $2 below the WEO oil price. As a result, the calculations contained in the staff statement, which were based on the WEO price assumption, were correct.

Mr. Mirakhor suggested that the staff statement be corrected in that light in order to avoid any misunderstandings.

The staff representative from the Middle Eastern Department (Mr. Iqbal) remarked that business confidence in Saudi Arabia had declined after the events of September 11, 2001. The authorities and the market participants in Saudi Arabia had all agreed that those events had had a temporary impact on confidence. However, the effect had not been a long-lasting one given the very strong fundamentals of the Saudi economy as reflected in the economic indicators. The background paper did not provide details as to the reasons for the drop in confidence as it had a wider dissemination than the staff report, and the staff wanted to avoid any misunderstandings in that regard and therefore decided to keep the references in the background paper on confidence entirely factual.

Mr. Mirakhor observed that the background paper was more expressive and clearer as to the reasons for the drop in confidence. It cited that the weak performance of the non-oil sector was largely attributable to a general decrease in growth in the construction, trade, hotel, and restaurant sectors, government services, and a sharp drop in agricultural growth.

The Acting Chair (Mr. Sugisaki) remarked that the reference to weak confidence in paragraph 3 of the staff report was in line with the assessments of most economic agents in the aftermath of the events of September 11, 2001.

Mr. Szczuka added that data on investments indicated that there had been a drop in private investment in Saudi Arabia, and as such was a reflection of weakened confidence in the prospects of the economy by the private sector in the country. Moreover, that factor was more important for growth than the drop in agriculture, which played only a marginal role in Saudi Arabia.

Mr. Mirakhor responded that investment could have declined for reasons other than a drop in confidence. Therefore, it was inappropriate to attribute the reduction in investment to confidence without any evidence.

The issue that needed to be addressed was why was there no explanation in the staff report as to the reason for the decline in confidence, especially as all indicators were pointing to the opposite direction, Mr. Mirakhor continued. The lack of an explanation could cause confusion.

Mr. Al-Turki agreed that the reference to weak confidence contained in paragraph 3 of the staff report did not seem to have any factual basis to it.

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

> There have been a large number of questions from Executive Directors. The issues broadly cover eleven areas that I will try to address.
>
> On the issue of developing the budgetary policy in a medium-term context under cautious oil price assumptions, the staff is fully supportive of that approach. In fact, the authorities have started looking at it with the

intention of ensuring effective expenditure management and the generation of non-oil revenue. This particular strategy will require putting in place a strengthened expenditure management mechanism and taking care of any temporary shortfalls that may emerge because of the volatility of oil prices. The advantage of a medium-term profile is that fiscal rules can be implemented to ensure effective responses to any unanticipated terms of trade shocks, and the staff is fully supportive of this approach.

This brings me to the issue of what would, under these circumstances, be considered a viable non-oil deficit. This is a very complex issue in the context of a country like Saudi Arabia, which is becoming increasingly diversified. Oil continues to be an important variable in its economy and continues to be a dominant source of revenue and exports. However, in light of the pace at which diversification is taking place, we have to look at it in a much more complex fashion than simply in terms of whether the non-oil deficit is consistent with the permanent income from oil and gas wealth.

On the basis of very simple assumptions with regard to the level of oil reserves—which will probably last longer than a hundred years at the present level of production, and that does not count the yet-to-be-discovered but known oil reserves in place—and gas reserves, assuming that the oil price will remain at about $20 per barrel in real terms, the permanent income from oil wealth will far exceed the non-oil deficit even under an unchanged policy stance. However, that is not the issue. In the case of Saudi Arabia, the issue of sustainability of the non-oil deficit is very much a function of the overall macroeconomic and growth strategy, which, in turn, depends on what it is that the authorities wish to achieve. In particular, a sustained growth of the non-oil sector of the economy and accelerated growth in the non-oil sector to attain a more efficient allocation of resources would itself have a positive impact on the non-oil deficit. Under these circumstances, what needs to be analyzed is the optimal level of the non-oil deficit. The staff report has tried to do it under the adjustment scenario, which considers a reduction in the non-oil deficit of 10 percentage points of GDP over the medium term to 2007. This can certainly be achieved through increased growth in the economy, higher non-oil revenues, and strengthened expenditure control and management. The staff's other concern in this regard is not whether the non-oil deficit is declining rapidly enough, but as to what extent can steps be taken that will reduce vulnerability to volatile oil prices. This, in turn, is very much a function of fiscal planning over the medium-term combined with the introduction of fiscal rules that will allow the government to be able to respond quickly to unanticipated adverse changes in oil prices.

This brings me to the third issue that has been posed, and that is whether the current level of debt is sustainable under low oil prices. Saudi Arabia is a very special case, as Mr. Shaalan in his statement has noted. The bulk of its debt is owed to the autonomous government institutions (AGIs), which are in very large surplus and will remain in surplus and continue to accumulate assets through 2020. This is not meant to imply that the government can continue to draw upon those resources. Nonetheless, on a purely technical level, sustainability is not an issue. If one were to look at the obligations to non-AGI creditors, they are about 35 to 40 percent of total debt, which, from a very narrow technical point of view, are sustainable. The anticipated nominal growth of non-oil GDP in the economy is projected to be about 6 percent per year, which exceeds the rate at which debt will be accumulated, and also exceeds the rate of charge on this debt. This, of course, does not mean that attempts should not be made to reduce it, and the important consideration here is how we go about reducing that debt. Our focus has been—and that is also what the authorities are trying to do—on diversifying the economy, generating growth of the non-oil sector, introducing more efficient allocation of resources through privatization and autonomization, as well as by introducing prices that are consistent with market forces. The opening of the economy and efficient allocation of resources as determined by market forces will, by itself, reduce the requirements for debt reduction as far as the economy is concerned. The most critical element of this approach would be boosting non-oil growth in a sustained fashion.

There was a related issue with regard to the possible use of an oil stabilization fund. Directors will recall that this issue has been discussed for the last two or three years in the Board. The staff still remains of the view that, for Saudi Arabia, there is no pressing need to have an explicit oil stabilization fund. To begin with, oil stabilization funds have had mixed results elsewhere in the world. The requirements for having an efficient, self-sustaining oil stabilization fund are as onerous as having fiscal rules. However, once fiscal rules are in place, an oil stabilization fund is not really necessary. In addition, Saudi Arabia is in a very special position, being the largest exporter of oil in the world. Any predetermined target oil price that will be required for managing an oil stabilization fund will have a negative impact on the oil market. I would strongly urge not to think in terms of an oil stabilization fund as a panacea. It is an instrument, but its effectiveness very much depends on how well it is used. That does not mean that the government should not have a practice of making sure that strict fiscal rules are in place that allow for accumulation of assets when oil prices exceed the expected price or the targeted price and also allow for drawing down on those assets in order to avoid adversely affecting the stability of expenditure itself. However, all this can be done without necessarily establishing an oil stabilization fund.

The other issues that have been raised in this regard relate to increasing the mobilization of non-oil revenue. The authorities have already started the process of establishing a value-added tax. Fund technical assistance has been provided in the past to strengthen the tax and customs administration, establish the large taxpayers unit, implement computerization, and an Income Tax law is in the pipeline. The value-added tax is expected to be in place by 2005 or 2006, given the long gestation period that is required to establish the institutional, administrative, legal, and other infrastructure needed for this purpose. The amount of revenue it will generate depends upon the coverage as well as the pace at which it will be implemented. The figures for revenue from VAT that are provided in the adjustment scenario are based on the assumption that the tax rate would be 10 percent and apply to goods both imported and domestically produced. However, I wish to emphasize that these are computed numbers that will change depending upon the pace at which the VAT is implemented and how it is implemented. There are certainly going to be challenges with respect to the establishment of institutions and administrative structures to put it into effect. The introduction of a temporary sales tax that the authorities have been considering on luxury goods can provide a transition to the introduction of VAT. Improvement in the utility rates and charges as well as in other user charges can be an important source of revenue because they will tend to improve resource allocation and facilitate privatization.

The issue was also raised about incorporating the AGIs' accounts in the fiscal accounts in order to determine the overall fiscal position of Saudi Arabia. I agree that it is always better to have an overall view of the public sector, especially in economies where the public sector is playing a fairly important role. My guess is that if we were to incorporate the AGIs and other public sector entities, the overall consolidated results would show a much better picture than is being shown by the narrowly defined government. However, in order to be able to do that, one will have to have fairly extensive access to information. The staff is of the view that the authorities should consider incorporating all AGIs and other institutions into a consolidated format in order to see where the public sector stood.

The issue was also raised about what are the sources of the contributions to the two basic AGIs—the General Organization for Social Insurance, and the Pension Fund. The former applies to the private sector as well as some state enterprises, and the latter applies only to the government. The contributions to these institutions are up to 18 percent of wages, half of which is contributed by employers and the other half by employees. They are both in large surplus and are going to continue accumulating assets for at least the next two decades. It must be realized that the average age of Saudis at this moment is about 20 years.

Several questions have been posed on the labor market and the employment issues. The staff feels that the current balanced approach to Saudiization is the right approach, and the authorities are flexible with respect to its implementation. They are quite cognizant of the fact that a policy that did not pay attention to the skill requirements of the private sector in particular would be counterproductive. The official strategy, in a long-term context, is focused on developing the skills that are required by the private sector, and thereby generating opportunities for the indigenous manpower in the private sector. This will require two things to happen. First, generation of skills that pushes out the supply curve for labor for the private sector, second, and at the same time, there will be a need for a shift in the demand for domestic labor by the private sector which will require reduction in the reservation wage in line with the market conditions. The success of the strategy will therefore require increased market competition, generation of the skills, and effective implementation.

The possibility of introducing a social safety net is an attractive proposition; however the authorities have to be very careful to make sure that the establishment of such a net does not add to the burden on the budget. There is room to move toward a situation where the contributions are made by employers and by employees as well, so that it becomes self-financing. It could be thought of in terms of a public works program, which would enable the hiring and training of workers who could potentially be absorbed in the private sector.

While there are no explicit intermediate targets with respect to the generation of new skills, the authorities are implementing two parallel strategies. First, the private sector is being encouraged to establish its own training institutions and vocational schools, in order to be able to provide skills that it requires. The government itself is pursuing the second strand of the strategy which aims at establishing new infrastructure for education and training, including more teachers, in order to be able to shift education away from traditional areas into more technical and skill-oriented areas. However, this will take time. In the medium term, the focus is to increase the supply of workers that are needed in the private sector for some very critical skills, both in the service and the manufacturing activities. We should be able to report next year on how this strategy is being implemented when two years of implementation will have taken place, and we will have a clearer view of where things are going by that time. This is one area where progress is significantly better than what one would have expected because the authorities are determined to be able to address the lack of skills in the country. In fact, much of the increase in current expenditure that has occurred has been on education and health.

On the issue with respect to the Gulf Cooperation Council's (GCC's) monetary integration, the GCC countries have been in the process of integrating since 1984. It is a deliberative but cautious attempt to make sure that the integration is clearly thought through and is based on a consensus among the six member countries. These countries have already accelerated the implementation of the customs union and by January 1, 2003, the common external tariff will be in place. Various steps have also been taken to allow for the free movement of labor and capital as well as the provision of resident status to member countries' firms. The monetary union will be the final part of all these attempts at full integration. The most important benefit that will likely materialize from the monetary integration is going to be a reduction of the transactions costs and increased confidence, which will allow unhindered financial flows under a unified exchange system. Certainly, the efficiency of the financial sector will be significantly improved, facilitating competition. Of course, there is going to be a downside in the sense that countries will tend to lose some control over their monetary policies. However, to the extent that there is consensus on the establishment of the needed institutions such as a common central bank, such losses can be minimized.

On the issue of tourism, the Supreme Commission for Tourism was established in 2000 to speed up tourism in two broad areas. One, religious tourism, which is the hallmark of Saudi Arabia, being the center of the Muslim world, and second, the opening up of new areas, such as historical sights—and there are some fabulous places in Saudi Arabia to visit. The focus of the Supreme Commission for Tourism is to streamline the flow of information and the administrative procedures in order to make it easier for tourists to come to the country, including relaxation of visa requirements as well as establishing standardized practices and procedures to be followed by all tourist agencies. Finally, there has been a very large increase in hotel facilities, which also will improve tourism. The figures are a bit difficult to come by, but in the year 2000 there were about 20 million tourists, of which about 15 million came for religious purposes. The tourism sector accounts for over 5 percent of GDP and any growth in this sector will have an impact on the private sector and on non-oil sector growth in the economy.

Finally, the issue of the agriculture subsidies has to be looked at in the historical perspective. There was a time when agriculture subsidies were so huge that other countries used to smuggle their wheat and barley into Saudi Arabia and then reexport from there because of the benefits they could acquire by doing so. Today, there are no subsidies on barley anymore. There are some subsidies on wheat, but subsidized wheat is not allowed to be exported anymore. The total agricultural subsidies amount to approximately $5 billion, which is less than 0.6 percent of total GDP in 2001. Thus, a very fundamental shift has occurred as far as agricultural policies are concerned, which has had a positive impact not only on the efficiency of resources used, but has also resulted in a very significant reduction in the exploitation of scarce underground water.

Mr. Al-Turki remarked that the authorities were providing all available detailed information with regard to the AGIs. That information was also updated more frequently than the fiscal accounts, and it was unclear as to what type of additional information the Fund required in that regard.

The staff representative from the Middle Eastern Department (Mr. Iqbal) agreed that the authorities had provided information with regard to the two largest AGIs. However, the staff had explained to the authorities that it would need more information on all other state enterprises and public sector entities in order to be able to make a definitive judgment in the fiscal area. It was important to have an overview that took into consideration both the revenue generating as well as the expenditure-inducing activities in the public sector and compare them.

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

> I would like to make a clarification on the point made by Mr. Al-Turki in his statement and then respond to Mr. Shaalan's question.
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> Regarding the reference to Article VIII, Section 5 in the staff report, I would like to provide some background as to why this issue was addressed in this year's Article IV consultation with Saudi Arabia. At the time of the preparation of the Article IV consultation, we were not clear as to the comprehensiveness of the IIP data provided by the authorities, especially for the government or the public sector IIP. As you know, it is difficult for many countries to provide data on the private sector's IIP, so our major concern was the comprehensiveness of the public sector IIP. The staff representative from the Middle Eastern Department just explained the rationale for the need to get an overall picture of the government sector, and therefore we were concerned about the IIP data provision. This was against the background where a similar case had arisen in a country outside this region. That case was brought up in the Article IV discussion for that country and the Board had an opportunity to discuss this issue. Therefore, we thought that this issue should also be discussed with the Saudi authorities as well during the Article IV discussions, and the mission did have discussions with the authorities on this matter.
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> We understood from the authorities that, as is explained in paragraph 38 of the staff report, they provide all the information on official foreign assets, but provide the private sector's IIP because they do not have the capacity to do so. Therefore, the authorities are not in breach of their obligations. Rather, they are in compliance with their obligations under Article VIII, Section 5. Nonetheless, we thought that it would be useful and in fact warranted to report the discussion the mission had with the authorities in a transparent manner. I want to emphasize that there was no intention at all on the part of the staff to give an impression that the country is not in compliance. It was in fact the contrary; we wanted to make it clear that the country was in compliance with the Articles.
>
> On the question of uniformity of treatment, the staff places importance in assuring uniformity of treatment, and I can assure you that we will pursue

> this question about the compliance of Article VIII, Section 5 if there are countries where the comprehensiveness of the data is in question, especially for the public sector IIP. I would again emphasize that for many countries, the private sector's IIP is difficult to compile. We will encourage the authorities in these countries to compile this data, but what we are most concerned with is the non-provision of the public sector IIP or the government sector IIP. Therefore, in cases where we have some concerns in these areas, we will pursue this issue regardless of the region or the size of the country.
>
> On the broader question of the application of Article VIII, Section 5, I would like to remind Directors that there will be an opportunity to consider this issue in the near future.
>
> Regarding the second sentence of paragraph 11 in the staff report, Mr. Shaalan asked for a legal interpretation and why this sentence was written in such a way. I cannot provide a legal interpretation, but the way I read the second sentence of paragraph 11 is that in addition to the usual items discussed, which are described in the first sentence, there were two other issues discussed with the authorities. One is the transparency, availability, and dissemination of economic information. The other issue is cooperation under Article VIII, Section 5. I think the sentence is written in such a way so that it does not say dissemination under Article VIII, Section 5.

Mr. Shaalan remarked that in light of the staff representative's explanation, it was inappropriate to include a reference in the staff report to dissemination in the context of Article VIII, Section 5.

Mr. Al-Turki expressed disappointment that the staff doubted the authorities' efforts to provide the IIP of the public sector. The authorities were providing all available information in that regard on a monthly frequency and with less than a month lag. That applied not only to the public sector, but also to the main AGIs. The only AGI that was not included did not undertake any foreign investment, and the staff was aware of that fact.

Mr. Cho made the following statement:

> At the outset, we commend the authorities for their leading role in stabilizing the world oil market. Nevertheless, it has not relieved the Saudi economy from the uncertainties in the market. Earlier, Mr. Mirakhor rightly raised the question about the impact of the possible windfall gains on the fiscal deficit and the current account. I do not want to prolong that discussion, but in my view this is more evidence of the Saudi economy's vulnerability to price shocks. Perhaps the Kingdom's economy is exposed to even greater vulnerability to oil price shocks owing to its role as a stabilizing force in the oil market because it is expected to take up the largest share of any necessary changes in oil production in order to assume its leadership as rightly noted by Mr. Toyama and Ms. Sekine. We sincerely hope that the Saudi authorities will

continue to play this role, particularly given the current rising uncertainties in the world oil market. The authorities are better prepared to take up this role as their economy is better placed in weathering oil price shocks. In this sense, we welcome the steady progress of reform in the Saudi economy and the Gas Initiative.

That said, we note that the challenges that the Saudi economy is facing are not insignificant. The macroeconomic and financial positions are projected to weaken amidst rising uncertainties in the oil market as well as recent security concerns in the region. The economy still has to cope with the unemployment problem, especially for the young. This would also suggest that reforms should be accelerated. We agree with the thrust of the staff report, and so we will limit our comments to only a few areas for emphasis.

As many previous speakers, our first and foremost emphasis lies in the prudence in fiscal policy. We welcome the authorities' concerted efforts in boosting non-oil revenue and bringing fiscal spending under better control. Nonetheless, we note that the staff's baseline scenario clearly shows that the authorities' current plan for revenue raising measures and spending restraint is not sufficient to fulfill their own aim of a balanced fiscal position by 2005. Much bolder supplementary measures appear to be inevitable. In presenting its adjustment scenarios, the staff is suggesting accelerated implementation of the income tax, introduction of a general sales tax, followed by a VAT, and an upward increase in utility rates on the revenue side. We certainly share the staff's view that these are the necessary measures to be adopted sooner rather than later. The staff is also stressing that the new measures under the new Income Tax law should be applied to Saudi workers as well as to expatriate workers. We endorse this view because tax or other charges increase the bias against expatriate workers and would adversely affect competitiveness of the private sector. In a similar vein, we would like to express caution against a proposed increase in fees and charges in passports, work permits, and exit and entry visas as their main targets are likely to be expatriate workers.

On the expenditure side, the staff is also suggesting the need for stronger restraint with regard to increases in current expenditures, particularly the wage bill and subsidies. In light of the fact that the wage bill continues to account for more than half of the country's total expenditures during the projection period, we share the staff's emphasis for the need for more concerted action, including civil service reform. In this regard, we take note of the authorities' plan to merge various ministries and departments, and hope that this will be a step toward more substantial civil service reform beyond the strengthening of expenditure management.

Moving on to the Saudiization policy, we welcome the authorities' intention that the policy will be pursued in a flexible manner, as the staff has stressed earlier, with a better targeted incentive toward maintaining the open

> policy with regard to foreign labor. We note that a number of institutional changes are being considered to reduce the gap between the reservation wage that the native workers perceive in seeking jobs in the private sector and the actual wage in the market. While we agree with the proposed changes in principle, we would like to recall the staff's concern that the way of reducing this gap should not be through increasing market wage rates, but rather by deflating the reservation wage toward the equilibrium that is determined in the market. For example, the introduction of the minimum wage would be a step in the right direction for the sake of workers' rights, but an overly high minimum wage is likely to increase market wages, and thus undermine the competitiveness of the private sector. Similarly, the extending of social security benefits to nationals working in the private sector should not be undertaken in a manner that increases the burden on the budget, which is likely to be transferred to the burden on the private sector, resulting in cost increases in employing workers.
>
> Finally, we would like to stress the need for further developing financial market. In particular, we see greater potential in the Saudi stock market given that it is already the largest market in the gulf region despite the fact that only seven companies out of 7,000 existing ones are listed. In this regard, we welcome the newly added impetus by the authorities on the country's privatization program, not only because privatization matters for efficiency and fiscal revenue, but also because of its contribution to the enriching of the country's stock market.
>
> With these remarks, we wish the authorities every success.

Mr. Al-Turki remarked that Saudi nationals were subject to Zakat, which was an Islamic tax, and thus there would be no discrimination between them and foreign—or guest—workers, as the tax on foreign workers would take that fact into account.

The authorities were not considering introducing a minimum wage in the private or public sectors, Mr. Al-Turki explained. Therefore, the reference in paragraph 32 of the staff report was misplaced. In addition, the reference in paragraph 12 that the authorities were targeting a balanced budget in 2002 was also incorrect.

The staff representative from the Middle Eastern Department (Mr. Iqbal) agreed that the reference in paragraph 12 was incorrect, and a correction would therefore be issued.

Mr. Szczuka made the following statement:

> As noted by most authors of the written statements and by the staff, the Saudi Arabian authorities have been pursuing a reform strategy that appropriately aims at reducing their economy's vulnerability to oil price fluctuations and at increasing the role of the private sector. The authorities should be congratulated for the consistent implementation of this strategy

despite a changing external environment. Even if the speed of the reform process may not satisfy everybody's expectations, it can be in part explained by the time needed to introduce institutional changes and by the need to overcome capacity constraints. I would also like to recognize several other positive features of the Saudi Arabian economy, such as the absence of inflationary pressures, the soundness of the banking sector, and the strength of the external position, as confirmed by the high level of reserves and the reassuring vulnerability indicator. Saudi Arabia's efforts to stabilize the world oil market should also be duly acknowledged.

However, despite their correct orientation, the reforms initiated in 1998 have not yet resulted in a major reduction of the Saudi economy's dependence on oil revenues or on any substantial augmentation of the private sector's role. The oil sector continues to generate about 90 percent of export proceeds and close to 80 percent of fiscal revenue, while the private sector still produces only about 40 percent of the GDP. These shares have barely changed since 1997. This leads to a conclusion that not only more time but probably also a bolder approach to reforms may be needed to achieve more tangible results. It is also worth noting that despite the officially pursued diversification of the economy, the strongly promoted Gas Initiative may actually further increase Saudi Arabia's dependence on hydrocarbons and their price fluctuations. In what follows, I would like to focus briefly on the crucial challenges posed by fiscal policy and labor market trends.

The persistence of relatively large fiscal deficits—with the notable exception of the surplus recorded in 2000—and the very high level of public debt clearly call for strong actions to change the structure of public finances in order to ensure medium-term fiscal sustainability. Like Messrs. Oyarzábal and Beauregard as well as Steiner and Rambarran, I was a bit disappointed that the staff has not presented a more detailed debt sustainability analysis. The staff has, however, prepared an alternative fiscal scenario and recommended several specific measures to improve the fiscal position decisively. As I broadly endorse most of the staff's recommendations, I would welcome Mr. Al-Turki's and/or the staff's explanations whether the authorities would be willing to follow the staff's alternative scenario and whether the proposed additional revenue measures could be considered feasible in light of the tradition, culture, and religion of the country. The staff's baseline scenario clearly shows that without a strong and comprehensive adjustment effort, Saudi Arabia will risk perpetuating the fiscal imbalance with all its negative effects on the public debt levels and the external accounts. In order to assess the fiscal position appropriately, I would also welcome some clarification of the relation between the budget and the autonomous government institutions. The staff report was written before we heard today's explanation from the staff in this regard. However, I am still not completely satisfied with the staff's response. The autonomous government institutions play a crucial role in the financing of the fiscal deficit and are also expected to assume a major role in advancing the privatization process, as indicated by the expectation that they will purchase 10 percent of the shares in the telecom company. Like Messrs. Oyarzábal and Beauregard, I wonder how the assets and the financial position of the AGIs should be treated when calculating the general government balance and debt levels, and I also wonder why if the staff has the data on the two major institutions they are not presented in the staff report or in the statistical appendix. We have data on the production of dried onions and eggplants, but we do not have data on the major fiscal institutions, so that is probably a mistake that should be corrected.

Another largely missing piece of information is the data on the actual scale of the government's obligations resulting from the so-called late payments. Mr. Al-Turki's indication that the extent of such obligations may be larger than initially assumed is quite worrying and reinforces the need to strengthen the control of public expenditure and the need to avoid any further extra budgetary spending. While higher-than-projected oil prices will help to reduce this year's budget deficit, some press reports also suggest that the planned expenditure levels will yet again be significantly exceeded. I would like to ask the staff to comment on this alleged overspending. As Mr. Yagi and some other speakers, I also wonder whether this boom/bust pattern in fiscal expenditures does not call for giving more consideration to establishing some form of an oil stabilization fund, but I also agree with the staff that firmer fiscal rules within the medium-term fiscal framework could also be a good substitute for this. The contingency reserve that is recommended by the staff should be seen as the very least in this context.

The relatively large and growing unemployment as well as the fast growth of the Saudi labor force require strong action on the part of the authorities. I support all the measures aimed at improving the skills of Saudi workers and better matching them with the needs of a modern economy. However, such measures can bring tangible results only in the medium and long term, and some additional short-term measures are needed to reduce the segmentation of the labor market and to promote the employment of Saudi nationals in the private sector. I welcome the restrictions already imposed by the authorities on new job creation and wage growth in the excessively large public sector, and I support the authorities' plan to restructure the civil service in order to increase its efficiency. I also support the various proposals aiming at the equalization of the non-wage benefits and the liberalization of rules governing the employment of Saudi nationals. However, I agree with those speakers who stressed the need to ensure that the policy of Saudiization of the labor force does not lead to reducing the competitiveness of Saudi products on the international market. In fact, every effort should be made to increase labor and capital productivity, because sustainable medium-term growth of Saudi Arabia's non-oil economy would hardly be achievable without a significant increase in the virtually stagnant total factor productivity.

Before leaving the labor market area, I would like to ask the staff whether it has calculated what levels of GDP growth would be needed to absorb the fast-growing supply of labor and which sectors of the economy could generate the largest number of new jobs, because the oil sector, which has about a 1.8 percent share of total employment, is not capable of it nor is the heavy industry sector, which is also promoted as another major source of jobs. The very low participation rate among women is also one of the many peculiarities of the Saudi Arabian labor market, and I wonder whether the authorities have any strategy to promote the employment of women, which of course would create additional pressures in the labor market.

One last issue that I would like to raise before concluding is that I would like to ask the staff to explain the reasons for the reported decrease of SAMA's net foreign assets by about $9 billion in the first eight months of this year. I also wonder whether the staff could offer any comment on the press and market reports suggesting the ongoing reallocation of Saudi private commercial assets from the U.S. to some other capital markets. Are there any reliable estimates on the size of such assets accumulated by the Saudi private sector abroad and does the "investment income" line in the balance of payments statistics, indicating a range of incomes between three to six billion dollars over the last few years, fully reflect the profits from placing these assets abroad?

As we started the discussion today with some issues on the wording of the staff report, perhaps I could add some more examples where the staff could probably be more careful in drafting the report. In paragraph 31 of the report there is a statement that privatization will spur growth and thus employment opportunities, which is a cliché in a sense because privatization quite often leads to a reduction in unemployment. Then on page 21, Box 5, there is a statement that privatization is also likely to intensify unemployment pressures. The staff should decide what effect privatization will have. The same inconsistency exists with regard to the treatment of the reform process. In paragraph 30 of the background paper, there is a reference to the burgeoning reform process. Then in the staff report, in the executive summary on page 4, there is a statement that progress on the structural front remains cautious. I am not sure what cautious progress is, though I understand it has been gradual. Thus, either it is burgeoning or it is cautious or gradual, so there is some contradiction between these two statements.

With these comments and questions, I wish the Saudi authorities every success in advancing their reform effort.

After adjourning at 12:55 p.m., the meeting reconvened at 2:30 p.m.

Mr. Wei made the following statement:

At the outset, let me join previous speakers in congratulating the authorities for their impressive economic performance in recent years. I would like to thank the staff for an excellent set of papers providing an in-depth assessment of Saudi Arabia's recent economic achievements and outlook. I would also like to thank Mr. Al-Turki for his insightful and comprehensive statement. The robust growth of the non-oil sector and the very low level of inflation are particularly admirable. As I share many of the comments in the written statements and made by the previous speakers, I would like to make a few comments here for emphasis.

On macroeconomic policy, I join the staff and other Directors in commending the authorities for skillfully steering the economy through the rough times during 1998 and early 1999 when oil prices plummeted. The authorities adopted the correct strategy to reduce the vulnerability of the economy by consolidating the fiscal position, maintaining exchange rate stability, and ensuring the soundness of the financial sector. Prudent macroeconomic management, combined with the subsequent rebound in oil prices, has strengthened the country's economic fundamentals considerably. We have already seen a turnaround in the fiscal and current account performance. All in all, we are confident that the medium-term outlook for both the fiscal and external positions has become even more favorable than projected in the staff report.

On fiscal policy, I join Mr. Mirakhor, Mr. Shaalan, and others in commending the authorities for their intention to aim at attaining budget balance by 2005. In this regard, the fiscal reforms that have been initiated this year will certainly help in achieving the authorities' objective. We welcome the measures stated in paragraph 18 of the report. In the meantime, we agree with others that additional tax measures could be considered by the authorities to ensure the ambitious fiscal objectives are achieved. We agree with the staff that the implementation of VAT should be accelerated and income tax be expanded by the inclusion of more income earners.

On monetary policy, we commend the authorities for their skillful policy management in a very difficult international environment, enabling the economy to grow sustainably under very low inflation. We also support the authorities' exchange rate regime by pegging with the U.S. dollar. We understand that on the medium-term perspective, the authorities will need to steer their policy according to the economy's evolving adjustment requirements as well as the planned Gulf Cooperation Council monetary union. Could the staff comment on the progress in establishing the union. On the banking sector, we learn from the staff report as well as Mr. Al-Turki's statement that the financial industry has continued to perform strongly, with profitability rising and NPLs declining. We join others in welcoming the authorities' decision to conduct an FSAP in order to enhance the soundness of the sector further.

On the structural front, the authorities are totally determined and committed to reforming the economy, as pointed out by Mr. Al-Turki in his helpful and comprehensive statement. In recent years, crucial steps have been taken to liberalize the economy. These include the corporatization of the strategic telecommunications and energy sectors and the introduction of a legal framework for foreign investment in certain sectors so that foreign investors can compete with their domestic counterparts on an equal footing. I would like to join the staff in encouraging the authorities to liberalize and open up the economy further, notwithstanding the fact that the country already features a high degree of openness and market orientation. I am sure that once the issue of Saudi Arabia's accession to WTO is resolved, a completely new window of opportunity will be unleashed providing greater impetus for the economy. That said, like Mr. Shalaan, I agree with Mr. Al-Turki that given the resource constraints and ambitious reform program, the policymaker has no choice but to prioritize his tasks.

On oil, there is little doubt that neither the oil producing countries nor the oil consuming countries would welcome large swings in oil prices. I recall that there was a great deal of consensus on the need for more and regular dialogue between the two. Mr. Al-Turki echoes this point in his statement emphasizing that the Saudi authorities will continue to make their utmost efforts to promote cooperation between the oil producing and oil consuming countries. His sentiment is also shared by Mr. Oyarzábal and Mr. Beauregard in their statement. In this connection, the proposed permanent secretariat for the International Energy Forum in Riyadh will certainly facilitate such cooperation.

Finally, I would like to join other Directors and speakers in applauding Saudi Arabia for providing generous and concessional financial support to the developing countries.

With these remarks, I wish the authorities continued success in their future endeavors.

Mr. Ísleifsson made the following statement:

At the outset, I would like to thank the staff for a set of comprehensive documents and additional information this morning, and Mr. Al-Turki for his informative statement. As I am in agreement with the thrust of the staff appraisal, I can limit my intervention to a few selected issues.

The strategy to accelerate non-oil growth in order to create a better employment environment for the growing Saudi population and thus making the economy less vulnerable to changes in oil prices is indeed challenging but necessary. While the Saudi Arabian authorities have followed a fairly comprehensive reform strategy over the past years, as noted in the staff report, macroeconomic developments have recently come under pressure, not least owing to fluctuations in oil prices and budgetary overspending. Although information from the staff point to a smaller than expected fiscal deficit this year owing to a stronger oil market, according to the staff paper the fiscal deficit excluding oil revenue nevertheless remains at about 25 percent of GDP.

The large swings in the oil price and the current uncertain political and economic outlook indeed underscores the need for a consistent medium-term reform strategy in order to decrease the dependency on revenues from the oil sector through diversification of the economy. In this respect, I welcome the authorities' plans to target a steady reduction in the budget deficit, aiming at reaching a balanced budget by 2005. Furthermore, I am encouraged by the new Income Tax Law. In order to boost tax revenue further, especially over the medium term and in view of current efforts to spur employment opportunities for the Saudi work force, the authorities should consider the staff proposal to extend income taxation also to Saudi income earners. Further, I support the plan to broaden the non-oil revenue base by the introduction of a VAT. In this respect, Fund technical assistance can be put to good use in preparing for such tax. While these measures will hopefully bring about a marked increase in non-oil revenue, the fact remains that the large non-oil deficit is projected to remain at around 20 percent of GDP in 2007.

A number of countries that are heavily dependent on revenues from harnessing natural resources, including in my own constituency, have found it useful to supplement fiscal policy with a stabilization fund where revenues are invested abroad in order to isolate the domestic economy from the effects of fluctuating prices of the natural resource. As noted by Mr. Toyama and Ms. Sekine, I would also be interested in hearing from Mr. Al-Turki or the staff whether mechanisms to "save and appropriately allocate any oil price windfalls" as it is put in paragraph 43 in the staff report are being contemplated by the authorities.

Turning to structural reforms, further efforts in this area will be important to facilitate growth in the non-oil sector and to boost employment opportunities. Further efforts seem to be needed to step up the apparently slow pace of privatization. In this respect, it would be interesting to hear from Mr. Al-Turki or the staff whether the authorities plan to come up with a more precise timetable on further privatization. As regards labor market reforms, I agree with the staff that it is appropriate for the authorities to address the unemployment problem mainly in the longer-term context through developing skills that are required by the private sector rather than by accelerated and mandatory Saudiization. As Mr. Szczuka, I would be interested in any measures envisaged to enhance the role and opportunities for women in the Saudi labor market.

More could also be done to enhance the generally low level of foreign direct investment. In this respect, Saudi Arabia's efforts to join the WTO are critical. Furthermore, as in any economy, acknowledging the rule of law and respect for property rights are crucial elements of a strategy to pave the way for increased private investment and entrepreneurship. In this regard, although further efforts are needed, I am encouraged by the authorities' measures to reduce discriminatory practices and their efforts to ensure a level playing field for domestic and foreign investors. I also welcome the proposed reform of the capital market and the efforts to liberalize the banking sector further. In this regard, I am encouraged by the fact that the authorities have requested an FSAP, which surely will be beneficial in mapping out the remaining weaknesses in the financial sector. In the statistical area, the staff identifies various points where improvements can be made. I welcome the authorities' commitment in this area and urge them to take measures in this region including measures to adhere to the GDDS. I also welcome the authorities' efforts to combat money laundering and the financing of terrorism.

Finally, on transparency, while noting that the authorities have agreed to issue a PIN after the board meeting, I am disappointed that they have not decided to consent to the publication of the staff reports and would urge them to reconsider their position in this regard.

With these remarks, I with the authorities' success in their policy endeavors.

Ms. Adam Gust made the following statement:

We would like to thank the staff for its informative report and additional information presented this morning in the course of responding to Directors' questions and Mr. Al-Turki for his helpful and informative interventions from this morning. I will keep my intervention relatively short and focus on only a few issues.

First, there appears to be tension between the government's efforts to move toward an outward-oriented and private sector-led growth strategy and some of the current and planned labor market policies. There is also tension between what was reported in the staff report on the authorities' Saudiization policy and what Mr. Al-Turki noted in his statement. The staff report notes the authorities' willingness to apply flexibly the Saudiization policy but Mr. Al-Turki notes in his statement that a more determined implementation of the policy is being pursued. One thing that the two statements share in common is that in both, there is reference to the authorities' desire to ensure the competitiveness of the private sector.

The Saudiization policy and the proposed introduction of an income tax on expatriates needs to be carefully calibrated and sequenced in order to ensure that private sector growth is not hindered. People respond to incentives and setting onerous rules may lead to unintentional consequences. The authorities' planned efforts to increase the skill level of the Saudi work force along with proposed changes to reform the civil service and public benefits should go much further towards promoting the hiring of Saudis in the private sector than any arbitrarily assigned quotas.

With respect to ensuring competitiveness in the private sector, we agree with the staff that a clearer statement to the market of the timetable and steps that will be taken to execute the privatization strategy would be helpful.

Second, we agree with the staff and Mr. Toyama, Mr. Szczuka, and some other Directors, that the authorities should incorporate mechanisms to save and appropriately allocate oil price windfalls in order to smooth out shortfalls. Whether this comes in the form of a well-managed and designed oil stabilization fund or a fiscal rule that is faithfully applied, the important thing is to have a mechanism in place to deal with fluctuations in the price of oil.

Third, I was going to make a point about how the authorities should undertake a more concerted effort to reduce domestic debt levels from the current level of about 95 percent and encourage the authorities to implement their planned strategy to use revenues from the sale of state enterprises to reduce government debt and resist the temptation to put these funds towards other uses. I still think that aggressively paying down the debt burden would reduce interest payments on the debt as well as the structural rigidity of the budget. However, in light of the information from the staff this morning about the impact that the inclusion of information on Autonomous Government Institutions (AGIs) would have on the overall picture of the public sector, I would like to make the point that data transparency and dissemination for AGIs is extremely important. While we thank Mr. Al-Turki for his information this morning where he reported that the authorities are currently providing information to the staff on two AGIs, we support the staff in its request for access to information on all AGIs.

This leads me to my fourth point, which is that we, along with the staff and other Directors, welcome the improvement in, and availability of economic data. We support the authorities' request for Fund technical assistance to compile data on Saudi Arabia's international investment position, particularly with respect to the position of the private sector. We encourage the authorities to also provide information on the consolidated public sector accounts, participate in the GDDS and to publish the staff report.

Last, though Saudi Arabia has increased its rank in the United Nation's Human Development Report by 11 places since 1990, it is still ranked only

71st, quite a bit lower than some of its neighbors. For instance, Bahrain is ranked 39th, Kuwait: 45th, United Arab Emirates: 46th, and Qatar: 51st. In light of the statement by the staff representative from the Middle Eastern Department this morning that government expenditures on health and education has been increasing, we encourage the authorities to pursue efforts to continue to raise human development indicators in Saudi Arabia.

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

Mr. Prader made the following statement:

Like other Directors, we appreciate the prudent macroeconomic policies of the Saudi authorities and the important role of Saudi Arabia in the stabilization of the world oil market. We also value the Saudi efforts to establish a dialog between producers and consumers of energy. Still, the authorities face a difficult task. On one hand, the current account is in surplus, but on the other, the fiscal deficit is growing, as are public debt and unemployment. Now it is time to implement the new development strategy for reducing Saudi Arabia's vulnerability to oil shocks and speeding non-oil growth with increased private sector investment, which will also create job opportunities for the rapidly growing Saudi work force.

I will touch on some issues related to development in the near and medium terms.

Fiscal adjustment will be needed to ensure a sustainable fiscal position in the medium term. The baseline scenario supposes that even after implementation of present and future measures the overall fiscal deficit will still be 4.5 percent of GDP in 2003- 2007. I support the authorities' target of balancing the budget by 2005, but as we know from the European debate on the Stability and Growth Pact, 2005 can be a very ambitious target. I urge the authorities to start immediately, instead of taking their time and postponing the beginning of their efforts. We encourage the authorities to take revenue measures and to continue cutting government spending mainly by eliminating extra budgetary outlays and improving the structure of the budget. The directive to minimize extra budgetary outlays is a good starting point.

Now for the sustainability of the public debt. Based on the baseline scenario, public indebtedness will increase from 92 percent of GDP in 2001 to 95 percent of GDP in 2007. The deficit excluding oil revenues will also remain high, averaging about 23 percent of GDP during the forecast period. This deficit is mostly financed by domestic borrowing. To finance the public debt, do the authorities intend to supplement the proceeds of privatization with foreign borrowing?

A major task--and challenge--for the authorities will be to put the economy on a sustainable path and create a climate favorable to the private sector development and foreign investment needed to create job opportunities for the fast growing population. This will require vigorous implementation of comprehensive structural reforms. The authorities have already taken important steps to increase Saudi Arabia's attractiveness to foreign direct investment, but much remains to be done in the elimination of administrative hurdles and the establishing of institutional and legal frameworks. We also encourage the authorities to reduce their "negative list" for FDI.

As to economic diversification, we take note of the efforts to increase economic growth by promoting tourism. This effort is commendable but may be faced by a number of obstacles, such as regional instability, administrative procedures, and not least cultural constraints in a country that accepts economic globalization and is a major factor in its growth, but which wants to shut out the effects of the concomitant cultural globalization.

The authorities' commitment to continue opening up the financial sector to foreign competition is most welcome. We learn from Mr. Al-Turki's statement that the capital market will be further deepened by the provisions of the Capital Market Law. However, as Box 3 shows, the capital market is presently limited to the stock market and the primary market for government bonds. Other segments of a capital market do not yet exist. We hope that passage of the Capital Market Law will also lead to improvements in these areas.

Comprehensive institutional and structural reforms will be needed to reduce unemployment. Box 4 of the staff paper clearly shows that the authorities intend to do this. An important step toward increasing labor mobility and rationalizing employment procedures is the Labor Code, which is also awaiting approval. We learn from the staff paper that Saudi workers work primarily in the government sector, at higher wages. We would like to know more about the authorities' intentions toward restraining the "large and rising" public sector wage bill and improving civil service efficiency. In this connection, the staff appraisal welcomes the plans to streamline the various ministries and departments in an effort to reduce current expenditures. However, judging from Mr. Al-Turki's statement there is already one new ministry and one new fund. In other words, what is the implementation record so far?

The Saudi authorities have also significantly improved their economic and statistical database. Nevertheless, here too, much remains to be done. There seem to be some differences of views between the staff and Mr. Al-Turki's statement. One area marked for improvement by the staff concerned information on Saudi Arabia's international investment position. The authorities are happy with their reporting of the foreign investment position, which is based on international accounting standards. However, the staff complains that these reports provide little detailed data. They also noted that though the authorities are willing to seek information on corporations' foreign investment positions and share it with the staff; there is as yet no regular system to do this on a consistent basis. Mr. Al-Turki has noted in his statement that in the past the authorities have asked the staff to make estimates of some of these data. I would appreciate the staff's comments on this issue. We do heartily encourage the authorities to adopt all the necessary steps for subscribing to the Fund's GDDS.

Finally, we applaud the authorities' provision of generous assistance to developing countries and to the HIPC Initiative.

Mr. Brooke made the following statement:

As the staff and other Directors, I welcome the gradual progress that the Saudi authorities have been making in implementing their reform agenda. Nevertheless, there remain a number of significant challenges ahead. In particular, we feel that the staff were right to focus on fiscal and labor market developments in the Article IV report.

I was pleased to note from Mr. Al-Turki's statement that his authorities are committed to delivering a balanced budget and a reduction in the debt-to-GDP ratio over time. Given the risks associated with Saudi Arabia's high public debt level and the weaknesses identified by the staff in the structure of the budget, this is clearly the appropriate focus for fiscal policy. As other Directors have noted, the key to improving the situation will be to reduce the budget's sensitivity to oil market fluctuations. This, in turn, will enable fiscal policy to play more of a countercyclical role than it does at present. We are pleased to note, therefore, that the authorities are demonstrating the determination to tackle these tough decisions. We hope the recent increase in oil prices and the associated improvement in the budget deficit will not lessen the authorities' efforts in this area. Rather, we took note of the concerns raised by the staff's medium-term fiscal projections and feel that it presents a powerful case for accelerating the planned budget reforms. Overall, therefore, we agree with the staff on the need for the authorities to introduce more rigorous and binding fiscal policy rules, to increase non-oil revenues, to improve and strengthen their public expenditure management arrangements, to introduce a medium-term budget planning framework, and to outline a timetable for their intended declines in the debt-to-GDP ratio. We also support the staff's calls for the production of consolidated public sector financial accounts and the elimination of off-budget expenditures. In this regard, I would like to associate myself with the comments of Mr. Beauregard and Mr. Szczuka about the benefits that could have been achieved from a more comprehensive debt sustainability analysis. Nonetheless, that being said, I note the staff's comments about the very healthy net asset position of the

AGIs. I welcome the authorities' intention to improve the tax collection arrangements, and I would be interested to hear whether there are any estimates about the amount of the shortfall in tax collection that currently exists in order so we can see how significant this action is likely to be.

Turning to the labor market, as the staff and the authorities recognize, the key medium-term challenges continue to be, first, how to increase labor force participation and, second, how to generate sufficient growth in private sector activity to absorb the rapidly expanding labor force. In this regard, we agree with many of the reforms being implemented by the authorities. Nevertheless, with unemployment already at around 10 percent, one cannot help wonder whether or not the envisaged reforms will impact quickly enough to prevent unemployment from rising further. The staff's analysis suggests that the current pace of reform implementation will not be sufficient, and we tend to share this concern and see merit in the authorities accelerating the reform process. However, to validate this, we feel that it would have been helpful to have some medium-term projections of labor market prospects and a discussion of the sensitivities surrounding such projections. This may have helped to persuade the authorities of the arguments in favor of accelerating their reforms. As the staff rightly highlights, the key issue here is to implement policies that will increase wage flexibility and deliver a level playing field between private and public sector employment opportunities. We therefore support the proposed measures outlined by the staff in paragraph 48 of the staff report. We also join it in urging the authorities to undertake a careful examination of the likely costs of the proposal to extend social security benefits to workers in the private sector.

On monetary policy, as others, we agree that monetary union among the GCC states will present a number of significant challenges that deserve close scrutiny by the authorities and the staff. In particular, given Saudi Arabia's existing monetary policy approach and its high debt level as well as the weaknesses of its budget structure, there will need to be careful consideration of the policy framework, information sharing arrangements, and the mandate of any common central bank. We look forward, therefore, to a fuller discussion of these issues by the staff at the appropriate time.

On other issues, turning to product market reforms, we strongly support the authorities' privatization plans and their proposed reforms to improve the climate for foreign direct investment. Here again, some acceleration in the pace of implementation seems warranted and a published timetable of privatizations would help to ensure that sufficient investor interest is generated.

We welcome the authorities' actions to prevent money laundering and counter the financing of terrorism, and support their request for an FSAP.

We join other Directors in welcoming the ongoing improvement in Saudi Arabia's data collection, but urge the authorities to seek to reach full compliance with the GDDS requirements in the near future. Going beyond this, we agree with the staff and those Directors that have highlighted that fuller collection of private sector capital account data would be beneficial, not least as an input into the forthcoming FSAP.

Finally, we would like to thank the staff for the background paper. We felt that the descriptions of planned and implemented reforms were comprehensive and very helpful. That being said, we felt there was some scope for perhaps some fuller analysis of the appropriate sequencing and likely impact of many of these reforms. However, given their long duration and long impact, I am sure we can come back to this next year. We wish the authorities every success in their challenging reform agenda.

Finally, I agree with Mr. Ísleifsson and Ms. Adam Gust about urging the authorities to publish the staff report.

Ms. Lundsager made the following statement:

Mr. Al-Turki's statement focuses right from the start on what we think is the most important issue: generating productive jobs for a rapidly growing population. The staff papers, including the background papers, highlighted labor reforms and growth in the non-oil sector, providing some insights on economic drivers in this economy, and on impediments to its diversification. The need for significant structural reforms is obvious. We appreciate that the authorities are focused on this, but believe a faster pace of reform is needed given the rapid population growth.

Accelerating non-oil growth is key and the authorities' policy effort since the last Article IV consultation has been geared to achieving this objective. Those policies continue the deliberate, perhaps even too measured, opening of the Saudi economy to foreign investment and private sector participation starting in 1998. Noteworthy, were the measures taken to advance private sector participation in the utility sector and other privatization plans. However, the staff report makes clear that foreign investment is slow to materialize. This could be for a number of reasons: continuation of some restrictions on inward investment, limited policy and data transparency, a built-in bias towards fiscal deficits that could impact local financing thus crowding out private domestic and foreign investment, and certain labor market policies that limit employer flexibility, highlighted in the background paper.

Economic policy implementation and fiscal policies in particular would benefit from greater transparency. For example, as we have noted in our last several Board statements on Saudi Arabia, the lack of data on the consolidated public sector makes it very difficult to assess the urgency of fiscal reforms. In the report, the staff indicates that the authorities felt attempts at an early fiscal consolidation would be difficult on account of pressures for more spending on health and education to address the rapid increase in population. However, given the absence of certain fiscal data, it is difficult to weigh the cost and benefits of delay. The authorities' argument for delay and the quality of Fund surveillance might have been strengthened by a more complete reporting of the fiscal sector. Most importantly, transparency of fiscal resources and demands at all levels and areas of government activity could help generate public understanding of fiscal limitations and national priorities.

In any event, the seven-percentage point swing in the fiscal balance from a surplus in 2000 to a deficit in 2001 is eye catching. Granted, the dip in oil revenues and the payment of arrears from 1995-96 explain a good portion of the reversal, but those explanations also highlight a fundamental fiscal vulnerability to volatile oil prices. This vulnerability points to the need to maintain fiscal flexibility and limit current expenditures such as wages. The staff's medium-term baseline scenario also strongly supports the case for expenditure restraint. We would also urge that any windfall oil revenues be allocated to debt reduction.

A segmented labor market hampers the creation of jobs. To remove this obstacle, the authorities' seek to integrate the labor market with market-determined wages and boost productivity. The implementation of contemplated measures such as the integration of the social security system and the pension fund and the provision of educational and vocational training to meet the skill requirements of the private sector will be very helpful.

Other current and considered reforms run counter to the above objectives for labor market reform. Saudiization, harmonization of the private- and public-sector minimum wages at the higher public-sector wage, and implementation of income taxation on expatriate workers distort incentives to hire and work in the Saudi private sector. Fortunately, the authorities have implemented Saudiization in a flexible manner. However, it would be better to rescind the policy, thereby providing potential employers greater clarity on their cost structure. Complementary to that would be a civil service reform that reduces the role of the government in generating employment.

Touching briefly on a few other points, we join other directors in noting the strength of the financial sector but would echo Mr. Cho's and Mr. Prader's points on broader capital market development. We welcome the trade liberalization measures already taken and the strong commitment to joining the WTO. We should also note that the Saudi authorities have been very supportive of international efforts to block the funding of terrorists and have taken several steps to protect their financial sector. In addition, many of my comments have touched on the need for more transparency—I strongly urge the authorities to make rapid progress to subscribing to the GDDS. I welcome Fund TA in this area.

Finally, Mr. Al-Turki, you will not be surprised at my disappointment that your authorities do not consent to publication of the staff and related reports. In our opinion, the reports offer many comments and suggestions that could add to the domestic debate on both shorter-term and medium-term policy priorities. We hope you can change your authorities' view on this.

Mr. Harzer made the following statement:

We thank the staff for its well-focused and candid papers and Mr. Al-Turki for his informative and insightful statement.

The authorities' two-pillar reform strategy aimed at reducing the economy's heavy dependence on the output and price of oil and creating employment opportunities by fostering private sector-led growth of the non-oil sector remains appropriate. Progress since its inception in 1998 is encouraging. However, the staff report makes a convincing case for significantly speeding up and intensifying the implementation of the reform program. Several aspects of the economic outcome in 2001 underpin the urgency of this call: the deterioration of the general government's budget balance, weak non-oil revenue performance, the budget's still growing dependency on oil revenues, and an increasing public debt stock. In this context, I welcome Mr. Al-Turki's assurance that his authorities are aware of the need to improve the structure of the budget and to increase employment opportunities for the growing Saudi Arabian labor force. It is all the more crucial that this reform commitment be maintained even if the current upward oil price trend prevails. We share the staff's views that without significantly strengthening reform efforts, continuing macroeconomic imbalances may lead to reduced growth of the non-oil sector, thereby endangering the authorities' employment objectives. Against this background, I have a few specific remarks on issues raised in the staff papers.

In order to reach a sustainable non-oil fiscal balance and to reduce the budget's built-in deficit bias in the medium term, we urge the authorities to stick firmly to the staff's adjustment scenario that calls for elimination of fiscal deficits by 2005. The authorities' efforts already underway in this area and described in Mr. Al-Turki's statement are commendable. However, we support the staff's view that additional measures are indispensable in order to increase the elasticity and yield of non-oil revenue. Those measures should comprise an extension of the income tax to all income earners and speeding up of all tax measures currently under consideration, including the VAT, as well as of the phasing out of implicit and explicit subsidies. Furthermore, a freeze of the wage bill, as assumed under the adjustment scenario, would not only contribute to the necessary reduction of current expenditures, but also would provide incentives for highly-qualified workers and professionals to move from the public sector to the private sector. As an oil stabilization fund or alternatively appropriately designed fiscal rules could be a valuable tool to soften the impact of the budget's structural deficiencies, as other Directors, we noted with interest the staff's call for a mechanism to save and appropriately allocate oil price windfalls to smooth out shortfalls. Such a mechanism is all the more worth considering given the still disappointing progress in diversifying budget revenues.

On monetary policy, the envisaged establishment of a monetary union among GCC countries raises many questions. While in general participating countries may benefit from a monetary union in several ways, the necessary preconditions have to be in place for its smooth function. As to the advantages, what would be the expected benefits of a monetary union for the Saudi Arabian economy, given the fact that Saudi Arabia would clearly dominate such a monetary union from an economic point of view, and therefore the classical transaction cost aspect mentioned earlier by the staff representative from the Middle Eastern Department would be of less importance. The staff's comments would be welcome.

In the area of structural reforms, we note that the authorities have so far concentrated their efforts on developing the legal and institutional framework for long-term reform. While we acknowledge that such reforms are a time-consuming and ongoing process, for the sake of a much-needed increase in FDI inflows, it is now critical that the execution of concrete privatization projects, which so far has been slow, is pushed forward, and that the momentum set by the recently approved new privatization strategy is kept. In this regard, the reference in Mr. Al-Turki's statement of the authorities' plan to divest 30 percent of STC is encouraging. As the staff rightly points out, the success of privatizations as well as of efficient private sector development in general critically depends on the capacity of the domestic financial markets to absorb the sales of government property and to offer flexible financing alternatives for private sector business besides bank credits and self financing. While the authorities are obviously aware that foreign participation is an indispensable precondition for developing an efficient financial market, as well as for the realization of increased privatization proceeds, we urge them to ensure a level playing field for domestic and foreign investors. In the medium term, this should include further curtailing the "negative list" for FDI and unrestricted access for international investors to the government bond market as well as to the yet only rudimentary corporate and commercial bond markets.

On the Gas Initiative, even if a full price pass through based on the internal rate of return demanded by the international oil companies may prove politically difficult in the short term, in the medium to long run it is the only sustainable alternative. This is so because private sector-run projects have to yield full cost coverage at least. At the same time, this does not exclude the provision of well-targeted support to the neediest families, which would limit negative budgetary implications of the Initiative.

Regarding Saudi Arabia's still highly-divided labor market and the correction of its prevailing distortive incentive structures, we note from Mr. Al-Turki's statement that in implementing the Saudiization policy, precautions will be taken to avoid a weakening of the private sector's competitiveness. While reducing the disparity in benefits by integrating the social security system with the pension fund is a step in the right direction, I am pleased to learn from Mr. Al-Turki's earlier comments that there are no plans to narrow the salary gap between foreign and Saudi workers by introducing a minimum wage in the private sector. We concur with the staff's view that wage restraint in the public sector combined with a reduction of overall public sector employment are key in order to achieve the intended reorientation of workers toward the private sector.

Finally, we welcome the authorities' consent to the publication of a PIN, which is a step in the right direction toward increased transparency. In the same vein as other speakers, we would encourage the authorities to reexamine their decision not to consent to the publication of the staff papers.

Mr. Vittas made the following statement:

I would like to begin by commending the authorities for their success in maintaining macroeconomic stability, in a rather difficult global environment, and for the progress they have made in recent years in implementing a rather ambitious program of structural and institutional reforms. This has enabled the Saudi economy to sustain a broadly satisfactory macroeconomic performance last year, despite the sharp drop in the average price of oil and the decline in oil output decided by OPEC. It is encouraging that the non-oil sector appears set to stage a solid recovery this year, despite the deterioration in the investment climate endangered by geopolitical uncertainties and the unsettled security situation in the region.

As regards policies for the future, I support the thrust of the authorities' economic strategy, in particular the emphasis they place on the pursuit of further market-oriented structural reforms to promote economic diversification led by the private sector. It is of course desirable to intensify the implementation of the reform program. In this regard, the provision of further TA by the Fund can play a useful role in alleviating some of the existing administrative, institutional, and legal constraints to change. At the same time, the authorities need to sustain recent progress toward the elimination of discriminatory practices in the treatment of domestic and foreign investors, as a level playing field may be essential for the success of their efforts to attract FDI and technical knowledge.

In order to be successful in stimulating private sector activity, structural reforms will also need to be underpinned by continued adherence to stability-oriented financial policies. For the reasons alluded to by Mr. Shaalan I do not consider the size of the fiscal deficit and the public debt to represent significant sources of vulnerability at present. In particular, I do not believe that concerns about MT debt sustainability are warranted. Nevertheless, I share the view that it is important for Saudi Arabia to achieve a substantial improvement in its fiscal position over the medium term to facilitate the crowding in of private investment and contribute (indirectly) to a strengthening of the competitive position of the non-oil sector.

I am therefore pleased to note that the authorities are committed to eliminating the overall budget deficit by 2005. In order to strengthen the credibility of this commitment and facilitate fiscal planning, I would encourage the authorities to adopt a rules-based medium-term fiscal policy framework. The framework should preferably incorporate an explicit MT target for the non-oil budget deficit, rather than the overall fiscal balance, as well as a time path for its attainment, broadly along the lines envisaged in the staff's illustrative adjustment scenario. This would help to lower the economy's vulnerability to short-term variations in oil prices and would also foster in the longer run the expansion of non-oil activities.

As is clear form Mr. Al-Turki's statement, the authorities recognize that fiscal consolidation will need to be accompanied by strong measures to address structural weaknesses in the budget, such as the inelasticity of non-oil revenues and the growing proportion of spending accounted for by current outlays. In this context, I welcome the measures that are being introduced to strengthen revenue administration and expenditure management, to increase productivity in the public sector and to avoid the emergence of new arrears. I also welcome the authorities' intention to introduce in the very near future a new income tax law. However, I agree with the staff that it would be appropriate to extend this new tax to Saudi income earners as well. I also agree with the staff that it is desirable to introduce a temporary sales tax on domestic and imported goods, which could be replaced in due course by a comprehensive VAT.

On monetary and external policies, I share the judgment that maintenance of the current peg to the US dollar is appropriate, at least for the time being, and commend the authorities for the constructive role they are playing in promoting further economic and monetary integration in the region. However, monetary integration raises a number of difficult issues that need to be carefully studied. Like Mr. Brooke, I would welcome a fuller discussion of these issues in future staff reports.

On structural policies, I welcome the recent announcement of a new privatization strategy and the steps that are being taken or contemplated to deepen the domestic capital markets, increase the flexibility of the labor market, and enhance the qualifications and employability of the native labor force. However, as I have already indicated, the speedy implementation of the privatization program and a successful campaign to attract increased flows of FDI may require continued progress in reducing discrimination in the treatment of domestic and foreign investors.

Before concluding, I would like to commend the authorities for the continued good performance of the domestic banking sector, the constructive role they have played in the international campaign against ML and the financing of terrorism, the steady progress they are making in improving statistics and transparency practices, and for their excellent record in providing assistance to developed countries on highly concessional terms. I support their request for an FSAP mission and welcome their decision to undertake a mutual evaluation under the auspices of FATF.

I wish them success in their future endeavors.

Mr. Palei made the following statement:

I thank Mr. Al-Turki for important clarifications on the authorities' position on key policy issues and the staff for an informative and thought-provoking set of papers on Saudi Arabia. I was especially intrigued by the presentation of the medium-term fiscal outlook in Appendix IV of the staff report, which illuminates the main policy challenges for the authorities and highlights the differences in the views of the staff and those of the authorities.

In Saudi Arabia, the monetary and exchange rate policy seems to work well. Somewhat higher growth of credit to the private sector is not a cause for concern as there is spare capacity in the economy. The price level is relatively stable. In 2002, owing to abundant oil revenues the fiscal accounts can still be close to balance. Thus, the macroeconomic situation is stable and I do not believe it would be appropriate at this stage to question fiscal or debt sustainability in Saudi Arabia.

Having said that, I am of the view that the staff is correct in emphasizing the structural weaknesses of the mechanism of fiscal adjustment to negative shocks. As the staff notes at the very beginning of Appendix IV, the baseline scenario reflects their understanding of the impact of the fiscal measures currently in place or under consideration of the authorities. The result of this forecast is not reassuring, with fiscal deficit remaining close to 4.5 percent of GDP and without any decline in the high level of the government debt. It appears that most of the assumptions used by the staff in this analysis are very reasonable, and I tend to share their conclusion that early steps are called for to better insulate the economy from the swings in oil prices as well as to stimulate further the growth of private sector and restructuring of the non-oil economy.

In Appendix IV, the staff illustrated the existing risks: a reduction in oil price of about US $5 per barrel to about US $16-15 would widen the fiscal deficit in Saudi Arabia by additional 5 percent of GDP. We all know that it is hard to predict the oil prices, but such a price scenario does not appear entirely unrealistic. I happened to read the report on Saudi Arabia issued just a week ago by one of the leading energy consultancies, PFC, and, quite curiously, in their baseline scenario, for 2004 and 2005, the authors use the price of US $15 per barrel. What would be the authorities' fiscal response in this hypothetical situation? Under the current setting the authorities would have to cut fiscal expenditures in response to any significant dip in oil revenues, as they, indeed, intend to do now. Although there is room for expenditure cuts, especially for trimming the subsidies, it is not limitless. The authorities themselves say that drastic expenditure cuts would be difficult given the pressures in the areas of health and education. The staff is correct when its point to the benefits of lessening the volatility of expenditures. They make a compelling case for having more stable expenditures. Such a stability is needed for implementation of essential social programs, it is necessary to assure foreign and domestic investors in long-term growth prospects of the economy, and, consequently, to generate employment growth.

Hence, I agree with the staff that to deal with unforeseen circumstances early steps on the revenue side are called. Changes in the tax structure usually take time and a lot of efforts before they can bear fruit, and the costs of delays could probably be avoided if the authorities decided to embark on a more ambitious fiscal reform now. The strategy of more decisive fiscal consolidation proposed by the staff seems to be realistic, and the authorities, in my view, should seriously consider some of the specific measures on the revenue side listed in paragraph 19 and in Appendix IV of the staff report.

I welcome the intensive policy dialogue between the authorities and the staff on the risks and possible remedies in the fiscal area. They are certain to pay off when the environment for implementation of reforms changes. In this respect, I call on the staff to continue close cooperation with the authorities and fully endorse their plans to provide additional technical assistance.

My position on the need for prompt fiscal reform does not contradict my general view that, since 1998, following the strategy associated with Crown Prince Abdullah, the Saudi Arabia has already made significant progress toward diversification of its economy. Overall, this strategy appears to be successful. For example, in the area of privatization, I am more optimistic than the staff with respect to the future privatization proceeds, which could drive the level of the government debt down and significantly improve the efficiency of the economy. While the progress in privatization admittedly was rather slow, if privatizations in the telecommunications and in the electricity sectors are successful, they could set the stage for a much more dynamic process of divestment in other sectors.

It would also be fair to say that more ambitious structural reforms aimed at privatization and at fostering the non-oil sector could lessen somewhat the pressure on the fiscal side. To facilitate the growth of non-oil economy and to stimulate private initiative, the authorities should continue to build expeditiously the necessary legal and institutional foundations necessary for efficient operation of market forces. Transparency and availability of information is also an important ingredient in this process and I commend the authorities for the achievements in this area. As the staff and other Directors have commented extensively on these issues, I will not elaborate further on these issues and will stop here.

I wish the authorities continued success in implementation of their ambitious reforms.

Finally, today we have heard various interpretations of the meaning of the reports' text, in particular on the cooperation in provision of the data, on confidence effects, and on progress with privatization. Some editorial changes, not to adjust the message presented by the staff, but to avoid possible misunderstanding by the future readers could be useful.

Mr. Requin made the following statement:

At this stage of the discussion, given the high number of grays issued and statements made by other speakers, I would like to focus my comments on a few points:

My first point is related to budgetary and fiscal issues. I would like to associate myself with comments made by other Directors in their grays such as Mr. Barro Chambrier, Mr. Toyama and Ms. Sekine, Mr. Oyarzábal and Mr. Beauregard. The medium-term outlook drawn by staff in the baseline scenario, which is not particularly a lax scenario as expenditures appear to be already tightened, shows a persistent deficit maintaining the public debt at a very high level. This prospect calls for the authorities to step in early, so as to protect economic balances from external shocks, notably in case of a sharp decline in oil prices. The budget strategy proposed by staff in the adjustment scenario should be taken into consideration even if I understand it tackles many social and political challenges. From a strict financial standpoint, an early implementation of the VAT and income tax reforms is desirable, considering the shorter the period between the reduction in external tariffs and the increase in internal revenue, the lesser the impact on public finances. The authorities should also consider applying this income tax reform to nationals in the near future. The authorities' decision to consider the introduction of a tax on luxury items, as referred to by Mr. Al-Turki in his buff, can be seen as a positive sign of further developments.

From reading the staff report, another matter of concern arises regarding internal arrears. I would like to know if staff believes that current budgetary procedures are impeding the reappearance of such extra budgetary spending. Frankly, it is quite surprising to see that payments related to a six-year-old fiscal exercise have yet to be settled.

Concerning structural reforms, I have nothing to add except that the various provisions implemented to create a favorable environment for private sector development and foreign direct investment are relevant. The extent of the reforms already achieved, as outlined in Box 4, and above all the pace of achievement are commendable, and I thank Mr. Al-Turki for the latest information provided in his buff on this issue. Enhancing the growth potential of the Saudian economy is key to enable the absorption of demographic pressures. Speeding up the structural reform would certainly help to contain the rise of the unemployment rate. So I invite the authorities to pursue and intensify their efforts.

On the economic strategy pursued by the authorities, my sole question will concern the Gas Initiative in a context where other countries in the region are implementing similar strategies. Maybe staff could tell us if economic studies confirm that world demand is likely to absorb this additional supply and if the gas price that ensures investment equilibrium provides a security cushion with respect to current and past market sensitivities. Considering the amount of investments planned (25 billions dollars over 10 years), I think it is a matter of importance.

On the privatization process, I welcome the strategy outlined by the authorities in the staff report as well as their decision of divesting 30 percent of the Saudi Telecom Company. But I would also like to point out that the privatization process cannot probably be implemented without upward adjustments in utility prices.

My third observation deals with regional integration. As the implementation of a regional external tariff is on course, and the creation of a single currency by 2010 under consideration, I think it would also be interesting to initiate studies on further labor market integration at the regional level among GCC countries. A greater freedom of circulation for workers, as well as the elimination of existing market segmentation, could result in a better functioning of the labor market. This being said, I fully support the current authorities' policy focused on vocational and technical training.

As stated by Mr. Al Turki in his buff statement, I notice that regional integration is also gaining ground in banking activities with the new licensing of foreign regional banks in Saudi Arabia, which is a heartening evolution. Given the lack of depth and liquidity of capital markets, not only in Saudi Arabia but also in other GCC countries, I think there is probably room for further integration in this area through strengthened association or stock exchange mergers.

This topic provides me the opportunity to introduce another question related to financial risks. I noted staff's comments about the origin of capital market growth as summarized in Box 3. I understand the growth is spurred by both real and monetary effects such as good corporate profitability, better market functioning and downward drift in interest rates. Nevertheless the growth since 1998 seems particularly high, as shown figure 6 page 43, with an annual growth rate around 15 percent far higher than the non-oil economy's rate of growth. The rise is also continuous, even after mid-2000 in a period when stock exchange indexes have been dwindling throughout the world, which is quite unusual. The pace of growth has even been increasing since 2001. I would like to be sure there is no asset bubble under creation; maybe staff could elaborate a little more on the real economic factors underlying this evolution?

On statistical issues, I note that there have been improvements in the preparation and sharing of economic data within the Fund. I would like to know if staff is satisfied with the quality and the accuracy of data provided on autonomous governmental institutions or is there still some room for improvement. I associate myself to comment made by others directors regarding additional transparency and production of a consolidated public sector review.

My last remark will concern AML/CFT issues. As other Directors, I would like to commend the authorities for their swift and resolute implementation of an AML legislation.

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

There were a few issues raised by Mr. Szczuka. The first was about the issue of debt sustainability. The Fund had undertaken a fairly extensive exercise two years ago, and we will update the analysis as part of next year's discussion. The fundamentals have not changed and the conclusions have not changed either. As I indicated earlier, debt levels remain quite manageable.

On the issue of the alleged overspending in 2002, we have also seen the press reports, but there is no evidence available from the authorities to indicate that there has been a dramatic increase in expenditures. Perhaps

Mr. Al-Turki can shed some light on this issue, but the staff does not have any additional information on that matter.

With regard to the issue of the press reports on the movement of assets, again, we have not found any evidence of that at all. We have looked at the exchange rate differentials and have also analyzed capital flows. There are no signs of large capital movements into or out of the riyal.

On the issue of the growth of the labor force, the official estimate is that the labor force will increase, on average, at the rate of 4.7 percent a year. How much investment will be required to absorb it is something that has not been worked out at this moment, and perhaps the World Bank will be in a better position to provide an idea of exactly how much investment will be required for that purpose.

The issue of the reported reduction in SAMA's net foreign assets—about $9 billion in the first eight months of 2002—has to be looked at in the context of two developments. First, given the seasonality, typically in the spring and summer, there is an outflow of foreign assets. A recouping of assets should be expected in the next four months. Second, there is also some movement toward a rebalancing of the asset position of the private sector. There was a substantial inflow of resources in the past, and the private sector could very well be rebalancing it. It is difficult to tell because presently we do not have adequate information on that issue.

Mr. Wei had raised the issue about the progress of the monetary union. Last year the heads of state of the GCC countries agreed to establish the monetary union by 2010; by 2005 agreements will be reached on performance indicators needed for convergence purposes. The preliminary preparatory move has been initiated on developing convergence indicators. The initial step in that direction, as I indicated earlier this morning, was the establishment of a common external tariff that will go into effect in 2003.

Mr. Harzer raised the issue about the monetary union and the transactions cost, and whether they will be significant in the case of Saudi Arabia. I agree, given the size of Saudi Arabia, the transactions cost benefits may not be that significant. However, this has to be looked at in the context of all the six countries as a group, and it will tend to have a significant benefit for the region as a whole.

Mr. Requin has sought information about whether the budget procedures are adequate to avoid a reemergence of late payments. It should be recognized that all the late payments that have been discussed in the staff report emerged in 1995/1996 at a time when expenditure management practices were not that strict. Since then, the government has significantly intensified expenditure management practices. In fact, early this year, the

Crown Prince had instructed the government to put together comprehensive mechanisms to prevent this from happening again, and I do not see any reason why late payments should reemerge. Of course, there may be some old late payments that may still be in the system, and they will be taken care of as they appear.

On the issue of the Gas Initiative—whether there is enough global demand to absorb this additional gas that will be produced—one should recognize that in the case of Saudi Arabia the Gas Initiative is intended for domestic use and not for export. It will be used for water desalination, generation of electricity, and as feedstock for petrochemicals. Thus, I do not see any problem with regard to it affecting the global market in gas or hydrocarbons.

As regards developments in the stock market, it grew until about July, and since then it has gradually declined by 3 to 4 percent. There are two factors underlying the pickup in asset values. First, interest rates are low, and so there is an incentive to move toward the stock market. The P/E ratios are very high, but this certainly is not a reflection of an asset bubble. Second, there has also been an inflow of resources that have gone into the stock market, particularly in activities where returns are very high, including cement and utilities, among others.

With regard to Mr. Prader's question on the consolidation of the government institutions, perhaps Mr. Al-Turki would be a better judge of that. We do not have any independent information at this moment of significant movement in that direction.

Regarding the issue of controlling wages, the authorities have continued to pursue a tight budget with respect to wages. The increase in wages has been restricted over time, and this year the increase remained close to the inflation rate, which in turn remains low. I do not see a mechanism whereby a substantial containment of wages per se can go into effect in the short run. It is something that will happen over time.

Mr. Al-Turki made the following concluding statement:

Let me first thank Executive Directors for their interest in the economic conditions in Saudi Arabia and for their valuable comments and remarks which I will convey to my authorities. The views and advice of this Board are highly appreciated in Saudi Arabia. I also would like to thank the staff representative from the Middle Eastern Department and his team for the set of papers prepared for today's discussion and for the answers to Directors' questions and remarks.

I will add a few brief remarks on some of the major issues raised in the discussion. First, on the pace of structural reform, my authorities are very determined in their structural reform efforts. A good look at this Article IV report, especially Box 4, shows the progress made in this regard. My authorities are also cognizant of the fact that things could still improve. Their focus is almost exclusively on doing things right rather than doing them quickly. In this regard, one has to be mindful that changes do take time. It is also important to realize that change has to have the necessary public support. In a society that works on consensus, public support does take time.

On doing things right, I believe we have come a long way in enhancing the necessary legal and regulatory foundations for structural reform. In this regard, I fully agree with Mr. Toyama and Ms. Sekine's statement that, while it is of utmost importance to continue moving forward, given the legal complexity and administrative bottlenecks, structural reform should be carried out step by step. Mr. Shaalan also raised the same point, and rightly stressed the importance of proper sequencing and the necessity of assessing interaction among different reforms to ensure their effective implementation, a point I believe was also raised by Mr. Brooke. That said, I want to assure my colleagues that the authorities' effort and commitment will continue with the same determination.

On the oil revenue stabilization fund, the staff representative provided a comprehensive answer. I will add that my authorities are fully aware of the importance of smoothing out fluctuations in oil revenue. They have been actually doing just that for a long time through accumulating domestic and foreign assets when the oil price is high and liquidating part of these assets when the oil price is low. Nonetheless, a formal setup for a revenue stabilization fund requires at least two important elements. First, a number of prerequisite measures regarding fiscal policy must be in place to ensure the success of the stabilization fund. These include a flexible budgetary structure and a transparent fiscal rule for transfer of resources to and from the fund. However, if these measures, which are important in their own right, are already in place, then the value and benefit of a formal revenue stabilization fund are simply not there, a point that was raised by Ms. Lundsager, I believe. Second, the operationalization of a stabilization fund requires redefining a threshold price of oil above which additional revenue is transferred to the fund and below which revenue is withdrawn from the fund. This means that Saudi Arabia's oil policy will focus on trying to achieve the objective of the stabilization fund. Here, regardless of whether Saudi Arabia is a price taker or setter in the oil market, and here I agree with Mr. Djojosubroto that there are limits to the role of any one country in the oil market, our oil policy has never been directed to a narrowly defined objective. Rather, it has always been and will continue to be directed toward ensuring stability of the market at a price reasonable for both producers and consumers. In a country with about 3.5 to 4 million barrels a day of excess capacity and with excess capacity that has been maintained at above 2.5 million barrels a day over the past ten years, it seems we are trying to serve the objective of our oil policy well, and that the announcement of a targeted price by Saudi Arabia will have some impact on the market, no matter how limited that impact is. Finally, the experience of a number of countries with a formal oil stabilization fund has not been very encouraging so far at least. Therefore, all in all, the idea of a formal oil stabilization fund may not be practical or sensible in the case of Saudi Arabia for the time being.

On the issue of the publication of the Article IV staff report, my authorities remain of the view that the Article IV consultation discussions represent a very unique opportunity for a frank, open, and candid exchange of opinions of recent economic developments and future policy options. They also place substantial weight on the report itself as a document for enhancing official internal dialogue regarding alternative policy scenarios. Publication of the report, in their view, will compromise the candidness of the discussion and lead at best to a less beneficial report. Before any of these views and positions change, we do not see merit in the publication of the report. Having said that, I will convey the view of the Board on this important point to my authorities who, as I have said, highly value the views of this report.

I believe the remaining points were covered by the staff representative, and I just want to thank my colleagues again for their constructive comments.

The Acting Chair (Mr. Sugisaki) made the following summing up:

Executive Directors broadly agreed with the thrust of the staff appraisal. They commended the Saudi authorities for their skillful and consistent pursuit, over the past several years, of a comprehensive policy strategy encompassing structural reforms and sound macroeconomic policies. This strategy aims at accelerating the growth of non-oil sectors, which will be key to generating employment opportunities for the rapidly growing Saudi labor force and reducing the economy’s vulnerability to oil price fluctuations. The strategy has appropriately focused on the development of legal and institutional foundations for market-based resource allocation by aiming to promote the role of the private sector, encourage foreign direct investment, privatize state enterprises, introduce labor market reforms, and widen and deepen the financial sector. Directors considered that the slowdown in economic growth and swings in the fiscal balance in recent years—against the backdrop of volatility in global oil markets and increased regional security concerns—further underscore the importance of determined pursuit of the Saudi policy strategy in order to encourage investment, promote economic diversification, and accelerate job creation. They therefore welcomed the authorities’ plans to tighten demand management and expedite structural reforms in the period ahead, notwithstanding the recent increase in oil prices.

Directors commended the authorities' resolve to strengthen fiscal policy, which will be key for sound macroeconomic management going forward. In this regard, they welcomed the authorities' plans to gradually achieve budget balance or a small budget surplus by 2005. Directors recommended that these plans be implemented as part of an overall medium-term macroeconomic strategy, and be governed by explicitly defined fiscal rules to protect against downward rigidity in expenditure. They also welcomed the ongoing and planned steps being taken to achieve the medium-term fiscal objectives, but urged the authorities to stand ready to take further measures if necessary. Directors encouraged the authorities to examine the usefulness of introducing a specific mechanism to save and appropriately allocate any temporary unanticipated increases in oil revenues in order to smooth out shortfalls. In addition, improving the structure of the budget will be crucial for increasing the effectiveness of demand management and reducing the volatility of fiscal outcomes, and Directors urged the authorities to take early concrete steps in this direction.

Directors stressed that the reduction in the budget deficit will require both a broadening of the non-oil revenue base and a reduction in expenditure. On the revenue side, they urged the authorities to expedite the implementation of the proposed income tax and its extension to Saudi income earners, the upward adjustment of fees and charges, and the introduction of the planned value-added tax (VAT). Some Directors suggested that the introduction of a sales tax might be useful as an interim measure pending the implementation of the VAT. Directors also urged the authorities to accord continued high priority to strengthening and modernizing revenue administration.

Directors welcomed the authorities' strong commitment to reduce expenditure and improve budget management through a series of measures, including the merger of various ministries and departments. They endorsed the view that public expenditure and budget management reform should be expedited through increased focus on performance contracts and accountability, targeted reductions in government employment under a well-defined civil service reform, introduction of time-specific and targeted subsidies, rationalization of social expenditures, and better planning of capital outlays. Directors also supported the call to identify the sources of extra budgetary spending and to take steps to eliminate such spending, and welcomed the authorities' determination to avoid any further occurrence of late payments.

Directors commended the authorities' articulation of a comprehensive privatization strategy, and were encouraged by the recent cabinet approval to divest 30 percent of government ownership in the telecommunications company. They urged the authorities to underpin the strategy by establishing a clearer timetable of steps required to execute it, as this would contribute to catalyzing private investment, including foreign direct investment (FDI).

Directors supported the authorities' decision to use part of the proceeds from privatization to reduce the public debt.

Directors also welcomed the specific steps being taken to reduce the barriers to inflows of FDI, and urged the authorities to continue moving in this direction, including by narrowing the "negative list" for FDI, streamlining administrative procedures, and finalizing agreements under the Gas Initiative. The planned reduction in the corporate income tax rate and the introduction of accelerated depreciation of assets will be helpful in encouraging FDI. Directors suggested that the authorities consider introducing a simple, nondiscriminatory, and broad-based tax on both domestic and foreign businesses, which, combined with liberalization of rules governing access to the domestic financial and capital markets, should provide a further boost to FDI.

Directors commended the authorities for their effective supervision of the banking system, which has resulted in well-capitalized, well-provisioned, and financially sound institutions. They noted that the banking system has continued to diversify its asset portfolio in line with evolving market conditions, and stressed the importance of continued financial sector reform in promoting private sector investment. In this regard, Directors welcomed the authorities' commitment to continue opening up the financial sector to foreign competition in order to help ensure efficient mobilization and allocation of resources for private sector development. Early implementation of plans to strengthen banks' credit risk assessment and introduce broadly uniform standards of loan classification will help to enhance the efficiency of the banking system. They also welcomed the ongoing steps to remove legal constraints on the introduction of longer-term financing instruments—notably mortgage finance—which, given the rapidly growing population, should help spur non-oil growth. Directors also emphasized that early approval and implementation of the Capital Market and Insurance laws will be crucial for clarifying the legal and regulatory framework for the growth of the financial sector and the development of secondary markets. They welcomed the authorities' decision to undertake an FSAP exercise, which will help to identify vulnerabilities, if any, in the financial sector. Directors commended the authorities for developing a comprehensive framework to combat money laundering and the financing of terrorism, and welcomed the additional steps taken by the authorities in this area, including regulation of the informal flows of funds.

Directors supported the authorities' decision to address the unemployment problem through training and education to increase job opportunities for Saudi nationals, while applying the Saudiization policy flexibly. They recommended that this strategy be supported by measures aimed at bridging the gap between local and expatriate labor costs as well as between costs in the government and private sectors. Steps such as the proposed transfer of benefits between the pension fund and the social security system as well as the extension of the social security system to small enterprises in the private sector should be helpful in this regard. In addition, reforming the civil service and realigning public sector benefits to those in the private sector should help promote mobility of workers to the private sector and reduce labor market segmentation. Some Directors cautioned that the introduction of the proposed income tax on expatriate workers should not erode private sector competitiveness.

In the absence of inflationary pressures, Directors endorsed the authorities' intention to pursue an accommodative monetary policy to support private sector activity. They also endorsed the authorities' policy of maintaining a pegged exchange rate arrangement within an open exchange and trade system, but stressed that a strong fiscal position and a sound banking system will remain the essential foundations in support of this arrangement. Directors welcomed the significant progress toward economic and financial integration among members of the Gulf Cooperation Council (GCC), noting that the target date for introducing the customs union has been brought forward to 2003. They noted the initiatives toward the planned monetary union among GCC members by 2010, and suggested that the many challenges relating to policies and policy frameworks associated with monetary union will require considerable further reflection and analysis. With regard to trade policy, Directors expressed the hope that the remaining bilateral agreements with trading partners will be reached soon to enable Saudi Arabia's early accession to the World Trade Organization (WTO). They welcomed the authorities' commitment to an open trade regime, and their recent lowering of import tariffs, which they considered helpful for promoting the development of a competitive non-oil sector.

Directors commended the constructive role Saudi Arabia has played in helping to maintain stability in the international oil market. They supported the authorities' continued efforts to enhance cooperation between the oil-producing and oil-consuming countries to ensure that the inherent uncertainty in the oil market is not amplified.

Directors welcomed the continued progress in the compilation, development, provision, and dissemination of economic data, and looked forward to further improvements, particularly with respect to oil sector data and consolidation of public sector accounts. They encouraged the authorities to start compiling data on the international investment position of the nonfinancial private sector. Directors also encouraged Saudi Arabia to participate in the IMF's General Data Dissemination System.

Directors endorsed the view that Fund technical assistance will have an important role to play in supporting Saudi Arabia's reform efforts, particularly in the areas of tax administration, the financial sector, and data collection.

Directors expressed their appreciation to the Saudi authorities for their generous development assistance to low-income countries, which has consistently exceeded the United Nations target of 0.7 percent of GNP, and under the Initiative for Heavily Indebted Poor Countries.

It is expected that the next Article IV consultation with Saudi Arabia will take place on the standard 12-month cycle.

3. BURUNDI—2002 ARTICLE IV CONSULTATION; AND PURCHASE TRANSACTION—EMERGENCY POST-CONFLICT ASSISTANCE

Documents: Staff Report for the 2002 Article IV Consultation and Use of Fund Resources—Request for Post-Conflict Emergency Assistance (EBS/02/174, 9/24/02; and Cor. 1, 10/4/02); and Statistical Annex (SM/02/306, 10/2/02)

Staff: Beaugrand, AFR; Fetherston, PDR

Length: 1 hour, 30 minutes

The staff representative from the African Department (Mr. Beaugrand) submitted the following statement:

The following information has become available since the issuance of the staff report (EBS/02/174) on September 24, 2002. It does not change the thrust of the staff appraisal.

Negotiations on a cease-fire continued throughout most of September, but appeared to run into difficulties in the latter part of the month. Preliminary agreement was reached with one faction of the CNDD-FDD (Conseil national pour la défense de la démocratie—Forces pour la défense de la démocratie) and one faction of the Palipehutu-FNL (Parti pour la libération du peuple hutu—Forces nationales pour la libération), but progress in the discussions with the other rebel factions remained elusive. Following a two-week suspension, cease-fire negotiations resumed on October 7, 2002 in the context of a heads of state regional summit in Dar es Salaam (Tanzania).

Recent data on developments through August 2002 suggest no significant change in macroeconomic trends. In particular, prices continued to decline in July–August, and the 12-month change in consumer prices was 1.9 percent through August 2002, compared with 2.1 percent through June. It is likely that inflation picked up in September as a result of the exchange rate depreciation of end-August and the increase in the prices of petroleum products (by 8–9 percent), which the authorities implemented on September 10, 2002.

The Bank of the Republic of Burundi (BRB) has been conducting weekly foreign exchange auctions (except on one occasion in early September, because of a lack of funds). Following the initial depreciation, the exchange rate has remained broadly stable at about FBu 1,070 per U.S. dollar, compared with FBu 885 in mid-August. The exchange rate differential with the parallel market has also remained broadly constant at 20 percent (in foreign currency terms), compared with some 30 percent in mid-August. The BRB expects the exchange rate differential to narrow further once it steps up sales on the auction market, following the disbursement of external assistance. The first tranche (US$20 million) of the World Bank's Economic Recovery Credit (approved on August 29) is due to be released soon, once the loan agreement has been ratified by Burundi's National Assembly.

Mr. Rustomjee and Mr. Campos submitted the following statement:

Introduction

On behalf of my Burundi authorities, I would like to express gratitude to management and the staff for their ongoing constructive engagement with Burundi, as well as for their work in conducting the Article IV consultation, and in assisting in the request for Post-Conflict Emergency Assistance. The discussions have provided a valuable opportunity for the authorities to take a critical look at their own macroeconomic policies and the recommendations provided by staff are effectively helping the authorities in their efforts to address the challenges facing the economy.

After a decade of a devastating armed conflict, which has claimed the lives of more than 250,000 people and has left about 1 million people displaced, the prospects for peace and national reconciliation in Burundi are extremely encouraging. Following the signature of the Peace and Reconciliation Agreement in Arusha, Tanzania, by 18 political parties in August 2000, a government of national unity was appointed in November 2001. In addition, the National Assembly was expanded to include representatives of other ethnic and political affiliations, and several commissions to facilitate national reconciliation, and social integration were created. To achieve a social compromise it was decided that during the transition period, a Tutsi ethnic person will chair the Presidency of the Republic until May 2003 and a Hutu ethnic individual will then take the lead until October 2004.

Notwithstanding the signature of the Agreement, sporadic rebel activity by two groups has continued. The national unity government is, nevertheless, committed to establishing conditions conducive to lasting peace. Cease-fire negotiations between the government and both rebel factions are underway with the support of the international community including some African countries. Recent conversations with the most prominent group, the

Palipehutu-NFL, were adjourned on September 26, 2002. At that time, the South African Deputy President, who is serving as facilitator for the talks, has declared that "the amicable atmosphere in which the discussions took place, and the commitment displayed indicates that the two parties are serious about finding a solution." It is expected that the parties will finalize agreements soon.

The implementation of the Agreement is taking place against a background of serious economic difficulties, in particular a sharp fall in the terms of trade, while donor assistance has remained at modest levels. Since 1992, GDP per capita has fallen by almost 30 percent in real terms while social conditions have seriously deteriorated. With a GDP per capita of US$110 Burundi ranks today among the five poorest countries in the world. It is estimated that two-thirds of the population live in absolute poverty. In addition, there is a serious HIV/AIDS problem affecting 12 percent of the population, while the illiteracy rate is estimated to have deteriorated.

Recent Economic Developments

The authorities began addressing macroeconomic imbalances through the implementation of a staff-monitored program (SMP) in the second half of 2001, aimed at reviving the economy and increasing the fight against poverty. Quantitative targets for end-September and end-December 2001 were, however, not observed while three of the nine structural measures were not implemented. Indeed, the precarious security situation induced an increase in military spending, which, combined with a substantial shortfall in donor assistance as well as the hiring of new teachers and health professionals, resulted in a higher-than-expected fiscal deficit. The overall budget deficit in 2001 was about 5.2 percent of GDP, while broad money growth accelerated to 15 percent, mainly reflecting an expansion in net government credit.

However, despite the nonobservance of the SMP targets, the authorities continued to maintain overall adequate control of macroeconomic indicators. The fiscal situation broadly followed the projected framework during the first half of 2001, and has only deteriorated toward the end of the year owing to the security situation. Also, although revenues were below the target level, they have remained relatively high at about 20 percent of GDP. In addition, inflation in 2001 fell sharply to 4 percent from 24 percent in 2000, and has turned negative in the first half of 2002. Furthermore, the authorities continued in 2001 to tenaciously honor their monthly debt payments to the Fund and the Bank, and this despite a severe shortage of foreign exchange and limitations in servicing the entire external debt. At end-July 2002 Burundi's outstanding use of Fund resources was less than 1 percent of quota (SDR 640,000), as compared to 29 percent of quota at end-1997 (SDR 22.2 million), and it is scheduled to be fully repaid by the end of 2002.

Notwithstanding the global slowdown, in 2001 real GDP grew by an estimated 2.1 percent, mainly on account of a rebound in agricultural output and reconstruction activity. However, Burundi's terms of trade continued to deteriorate, as world prices of coffee, the main cash crop, have declined in the international markets to the lowest levels in a decade. Coffee exports, which were valued at US$77 million in 1997, accounted for less than US$20 million in 2001. Low export revenues compounded with important delays in the disbursement of external assistance lead to an overall balance of payments deficit of US$ 33 million, accounting for 5 percent of GDP. In addition, due to the scarcity of foreign exchange, the national currency depreciated by about 11 percent in 2001, while the parallel market premium has generally remained at 30-35 percent. In these circumstances, the central bank resorted to administrative measures to contain pressures on the exchange rate, including the introduction of a positive list of imports eligible for foreign exchange and restrictions on invisible payments.

Economic and Financial Program for 2002-03

To address Burundi's economic and financial difficulties and to establish the basis for a significant improvement in living conditions, the authorities have prepared a program for 2002-03, for which they are requesting IMF support under the emergency post-conflict assistance policy. The program is realistic and coherent, includes a comprehensive structural reform agenda and stems from the political and social choices underscored in the Arusha Peace and Reconciliation Agreement. Its main objectives are to (i) address the urgent needs for humanitarian assistance and the implementation of the peace process; (ii) ensure a minimal functioning of basic infrastructure; (iii) strengthen the institutions that are essential for economic activity; and (iv) pursue economic liberalization to increase efficiency, stimulate supply, and promote growth and welfare. To achieve these objectives the authorities will aim at achieving macroeconomic stability, promoting growth and poverty reduction, and strengthening the management of public finances by encouraging fiscal transparency and good governance. Accordingly, the economy is expected to grow by 3.6 percent in 2002 and by 5 percent in 2003. Another key element of the program is to keep the inflation rate at about 8 percent in 2002 and 2003.

The success of the program would very much depend on its fiscal strategy, which will focus on expenditure and revenue measures designed to reduce the overall government deficit in 2002 and allow for a further reduction in 2003. In line with the revised 2002 budget adopted by the National Assembly, budget expenditure takes into account the costs of setting up the transitional institutions including the Senate and the expanded National Assembly, increases in health and education outlays and for the reintegration of refugees, as well as increases in the military wage bill and subsidies to the coffee sector. For 2003, the authorities are expecting a peace dividend through lower military spending and increased donor support, as well as a reduction of coffee sector subsidies, which will allow an increase in the civil service bill and the implementation of an ambitious public investment program focused on labor-intensive projects to rehabilitate and rebuild social and economic infrastructure.

The monetary program will be consistent with the inflation and external objectives. The central bank will implement an adequately restrictive monetary policy to avoid excess liquidity and contain inflationary pressures. The control of public spending and the elimination of the coffee sector deficit will ensure a controlled expansion in reserve money and allow the central bank to strengthen its control over monetary aggregates. On the exchange rate policy the authorities have already taken a major step defined as prior action. The central bank has, as of August 28, 2002, eliminated all restrictions on merchandise and related services eligible for foreign exchange on the auction market that had been in effect for the last two years. In addition, the central bank will henceforth permanently hold regular weekly foreign currency auctions without pre-imposed ceilings on bids. With these measures, a convergence of the official and parallel market exchange rates is expected in the near term.

Regarding structural measures, the authorities will concentrate their actions on liberalizing external trade, improving budget auditing mechanisms, reforming the civil service, as well as implementing poverty reduction measures. The government has also prepared a program of public enterprise privatization, and plans to withdraw gradually from the coffee and tea sectors. However, the authorities intend first to concentrate on improving the management of public enterprises and, as economic and security conditions normalize, gradually implement privatization of the state-owned enterprises.

Concluding remarks

My Burundi authorities believe that the economic and financial policies included in the program are adequate to address the difficulties faced by the country and, to support it, they are requesting a drawing from the IMF under the Fund’s emergency post-conflict assistance policy in an amount equivalent to SDR 9.625 million (12.5 percent of quota). However, the financing gaps under the program are projected at US$50 million in 2002 and US$183 million in 2003. Most pressing needs include the areas of humanitarian aid, reconstruction, and capacity building. In this context, strong support from the international community remains critical to sustain the recovery process and consolidate the progress made under the Arusha Peace and Reconciliation Agreement.

As program implementation proceeds during the next few months, the government plans to request further support from the Fund, in the same amount, by early 2003. Satisfactory implementation of the program would in turn open the way for adopting a medium-term program aimed at reducing poverty and promoting strong and sustainable economic growth, which could be supported by an arrangement under the Poverty Reduction and Growth Facility (PRGF), and debt relief from the Paris Club and other creditors, from which Burundi has never benefited.

Mr. Daïri submitted the following statement:

Key points

- The authorities' efforts in turning a difficult situation around deserves maximum support from the international community;

- The immediate challenge is to consolidate peace and stability. The prospects for achieving a broad and durable settlement have improved considerably, and we hope that the remaining factions will join the process;

- We welcome the cautious fiscal stance under the program, supported by prudent monetary policy and exchange rate flexibility;

- Normalizing relations with external creditors by meeting debt service obligations and clearing arrears is a bold initiative by the authorities requiring positive reciprocal response;

- While attending to short-term concerns, medium-term vulnerabilities should be recognized in order to begin laying a foundation for their mitigation;

- Despite potential risks, including, in particular, the fragile security situation and vulnerability to coffee prices, the authorities' strong commitment to the program is encouraging;

- Fund support is vital for catalyzing efforts aimed at mobilizing financial assistance. We, therefore, support the authorities' request for post-conflict emergency assistance. We hope that a strong track record would pave the way for a PRGF-supported program and an early decision point under the HIPC Initiative.

We thank staff for a well-written report and concur with the thrust of their appraisal. We also thank Mr. Rustomjee for his comprehensive statement. Burundi is emerging from a protracted civil conflict, which exacted a heavy toll on human and material resources. Under very difficult circumstances, including a sharp decline in the terms of trade, the authorities have demonstrated determination in addressing their dire situation in the context of the staff-monitored program and the new program, for which they request post-conflict emergency assistance.

The immediate challenge is to consolidate peace and stability. Despite past setbacks, the recent reopening of negotiations with rebel forces, in conjunction with other initiatives, has enhanced "the prospects for peace and national reconciliation," and we hope that the remaining factions would join the process. Promoting economic stability and growth demands equal attention and the authorities have taken important steps in this direction, including a strong start to program implementation. The cautious fiscal stance envisaged for 2002-03, while allowing social needs to be addressed, is noteworthy. The authorities should be commended for improving revenue collection in difficult circumstances and for the strong revenue-enhancing initiatives envisaged, particularly regarding tax and customs administration. Improved revenue will allow the scaling back of tariffs in line with the COMESA CET system. Efforts to control expenditure, in spite of pressing reconstruction needs, are also significant. The prospect of declining security outlays and rising social sector spending is to be welcomed. Plans to set monthly ceilings on expenditure commitments and to strengthen transparency and accountability in budget management are important steps toward ensuring the attainment of budget targets.

We welcome the authorities' commitment to a prudent monetary policy, to be coordinated with fiscal and exchange rate policies. Monetary policy capacity is to be duly strengthened by focusing attention on containing inflation and building reserves, while reallocating credit from the government to support private sector recovery. Plans to ensure orderly functioning of the foreign exchange market and the commitment to a flexible and competitive exchange rate regime are well thought out. We welcome the modest narrowing of the exchange rate differential and agree with the staff that, if exchange liberalization is to proceed smoothly, it must be buttressed not only by strong macroeconomic policies, but also by adequate external financial support.

Structural reforms should focus on creating enabling conditions for growth. Planned reform of the coffee sector, geared to restoring profitability after 5 consecutive years of loss, is appropriate. Enhancing competitiveness, streamlining producer pricing, and reducing processing costs are important steps to this end. Private sector development should also receive utmost attention to enhance economic efficiency. While it may take some time to resume the privatization program, disrupted by the conflict, close monitoring of SOEs will be essential to promote efficiency in their operations. In the reform of civil service, necessary to promote efficiency, caution is required to preserve social stability. In particular, appropriate social safety nets will be required to protect vulnerable groups. Trade liberalization initiatives, including reduction of import tariffs, non-tariff barriers, and export duties, should strengthen competitiveness.

While attending to short-term concerns, medium-term vulnerabilities should be recognized in order to lay a foundation for their mitigation. Vulnerability to coffee prices, in particular, is a major source of concern and calls for stronger efforts at economic diversification. The burden of debt service is also extremely high, compounded by a substantial level of arrears. Normalizing relations with external creditors, including by meeting debt service obligations and clearing arrears, is a bold initiative that requires positive reciprocal response. We welcome pledges by multilateral and bilateral creditors in the form of concessional loans, grants, and debt relief to cover financing gaps in 2002 and 2003.

Given the very low per capita GDP and the effects of the conflict, we are surprised by the limited attention to poverty issues in the staff report and hope that they would receive due attention in future. Meanwhile, we welcome the preparation of the interim PRSP, which is expected to provide more impetus to poverty alleviation.

Although the statistical base seems to have been broadly preserved, further improvement in data quality and reporting frequency is needed. It is also pleasing to note that a reasonably functioning administration remains in place, in spite of the protracted conflict, and that TA will be sought to further strengthen institutional capacity.

Despite potential risks, including, in particular, the fragile security situation and vulnerability to terms of trade shocks, the authorities' strong commitment to the program is encouraging. However, the support of the international community will be critical in mitigating these risks and putting Burundi's economy on a sustainable growth path. In particular, Fund support will be vital for mobilizing international assistance. We, therefore, support the authorities' request for post-conflict emergency assistance. We hope that a strong track record would pave the way for a PRGF-supported program and early decision point under the enhanced HIPC Initiative.

Mr. Ondo Mañe submitted the following statement:

At the outset, we would like to thank the staff for a well-written report and Mr. Rustomjee for his informative preliminary statement. After facing a difficult situation during the past ten years due to the civil war that started in 1993 and a sharp deterioration in the terms of trade, Burundi's economy is showing some signs of rebound. Economic activity has begun to recover, inflation decelerated in 2001 and financial stability is being restored, thanks to the Arusha Peace Agreement of August 2000, which provided a basis to start rebuilding the country, promote stability, and resume economic growth. At this juncture, Burundi's overall situation remains fragile and there is no doubt that a concerted effort is needed to buttress the recovery and consolidate the progress made thus far.

Notwithstanding the delay in concluding an all inclusive cease-fire to end the nine-year civil war, we believe that there is a window of opportunity to realize the promise of the Arusha Peace and Reconciliation Agreement. Also important is a rapid conclusion of the ongoing negotiations between the Burundian and the Congolese authorities that could lead to the withdrawal of the Burundi's forces from the DRC. This will be critical to promote dialogue, reconciliation and peace in the Great Lakes region. The strong prior actions implemented by the authorities, notably in the area of exchange liberalization provide a sound basis for initiating economic reforms and addressing economic imbalances in Burundi. Thus, in light of the authorities' determination to restore peace and carry out economic reforms, we support the request for a drawing under the post-conflict emergency assistance policy.

Fiscal policy

We support the cautious fiscal stance adopted by the authorities in the revised central government budget approved by parliament in August 2002, as this budget allows essential social and security needs to be addressed, while improving the primary surplus and the overall government deficit in 2002 and 2003. On the revenue side, we commend the authorities for their efforts to maintain revenue at nearly 20 percent of GDP. To this end, we welcome the authorities' decision to strengthen tax and customs administration through the tightening of controls over exemptions and the establishment of a large taxpayer unit in Bujumbura. It is important to note that these improvements will give more room for maneuver to the authorities in 2003 to begin reducing tax ahead of the adoption of the common external tariff of COMESA.

On the expenditure side, we support the authorities' efforts to contain spending, while ensuring the delivery of key public services and improving public expenditure management.

Indeed, rebuilding key health and education systems in the aftermath of the civil war is of paramount importance for poverty reduction, especially in the rural areas. In this context, we welcome the planned reduction of military and security-related expenditures and other measures to keep the wage bill under control, so as to make more room for high priority outlays. The focus of the investment budget on poverty-reducing areas such as schools and hospitals and roads is also encouraging. Together with improvements in expenditure control, these measures will help improve the effectiveness of public expenditures.

Monetary policy

Monetary policy rightly focuses on keeping inflation low over the medium term and preserving the external value of the currency. However, in short term, we are of the view that the main challenge facing the authorities is to restore the orderly functioning of the foreign exchange market and facilitate external adjustment. In this context, we welcome the measures taken recently by the authorities to narrow the differential between the official and parallel market exchange rates. While we agree on the importance of adequate mechanisms for the allocation of foreign reserves, we concur with the authorities that rapid liberalization might put excessive pressures on the exchange rate. Thus, we support a gradual approach to exchange rate liberalization. In the longer run, we encourage the Banque de la République du Burundi (BRB) to improve its capacity to monitor and control bank liquidity and to develop more flexible monetary policy instruments, so as to improve the effectiveness of its policies. In the financial sector, while it is encouraging to note that the banking sector remains sound, it is also important to improve the capacity of BRB to conduct banking sector supervision.

Structural policy

In the structural area, we concur with the authorities that building the conditions for peace and reconciliation are the prerequisites for the resumption of economic development. Thus, we support their dual objectives of structural reforms aiming at taking steps in line with the Arusha agreement to promote national reconciliation, while taking urgent measures to provide an enabling environment for private sector development. In this regard, we welcome the authorities' efforts to set up a national commission to assist victims and take preparatory steps to establish an auditing court. We also support the measures underway to improve the financial performance in the coffee sector and restore its competitiveness and we encourage the authorities to stand ready to adopt further cost-cutting measures, if needed, to ensure that the deficit of the coffee sector is eliminated fully in the near term. It is also important to note that since the coffee sector is a major contributor to rural employment and export earnings, it can play a major role in poverty reduction. In this context, we encourage the authorities to further strengthen farmers' organizations and the restructuring of the sector. Finally, we encourage the authorities to proceed with civil service reforms and accelerate the privatization program, and take measures to promote the diversification of the economy once normal conditions and business confidence have been restored.

With these remarks, we wish every success to the authorities in their reform efforts and are hopeful that they will build a strong track record which would lay the ground for a PRGF-supported program.

Mr. Guinigundo and Mr. Jang submitted the following statement:

Key points

While it is regrettable that the staff-monitored program was unsuccessful due to a continuation of hostilities and the holding back of donor support, the authorities did implement all the prior actions. As such, we support the proposed decision.

It is clear that the authorities should make every effort to ensure the success of the peace settlement in order to mobilize much needed external assistance.

While the current fiscal stance seems to be heading in the right direction, the authorities should further strengthen expenditure management and tax administration.

It is important to contain inflationary pressure by limiting broad money growth within the programmed target. The recent shift to a more flexible exchange rate regime is welcomed.

Private sector development will be essential for achieving higher growth rates.

It is regrettable that a prolonged ethnic conflict has kept Burundi's economy in the cellar, with real GDP declining by almost 30 percent compared to the 1993 level. While the authorities implemented a staff-monitored program (SMP) in consultation with the Fund staff in 2001 to stabilize the macroeconomic situation, we note that its implementation was unsuccessful due to a continuation of hostilities and holding back of donor support. However, we are pleased to learn that the recent initiation of a cease-fire negotiation will provide a good opportunity to implement the national reconciliation and reconstruction measures envisaged in the Arusha peace agreement.

Most importantly, the authorities have implemented all the prior actions contained in the MEFP as at end-August 2002. With the prospect for peace, the way should be clear to allow the country greater flexibility to increase social spending, accelerate economic growth, and to reduce poverty. We see a major role for the international community in assisting Burundi pursue reconstruction in line with Fund assistance.

Against this background, and the fact that the authorities have completed the strong prior actions, notably in the area of exchange liberalization, we support the proposed decision.

Nonetheless, the economy is facing difficult challenges ahead due to: (i) the volatility of coffee export prices, which provide 80 percent of total export earning; (ii) the fragility of the peace process; and (iii) the variability of external financial assistance which hinges on the progress in the peace process and on which the country's medium- and long-term economic prospects largely depend. It is, therefore, incumbent upon the authorities to exert every effort to keep advancing the peace process.

Fiscal policy

While the actual fiscal deficit in 2001 exceeded the SMP program level by 3.5 percentage points due to increased military outlays, we welcome the authorities' decision to raise social spending on health and education to 4.5 percent of GDP. This is done in the context of fiscal consolidation in the 2002 budget which would involve priority spending. While the authorities should be commended for setting monthly ceilings on expenditure, the authorities should not at this time allow any increases in government wages and should start phasing out subsidies to the coffee sector (even gradually). It is also critical for the authorities to strengthen the mechanisms for expenditure control in order to ensure transparency. In this regard, the authorities' plan for establishing an independent auditing court is welcomed. This will no doubt help in the tracking and monitoring of social and poverty reduction expenditures, and will enhance public confidence and support for the overall program.

On the revenue side, it is encouraging that, as a result of the authorities' efforts to improve tax administration, the ratio of revenue to GDP is high by regional standards. We encourage the authorities to further strengthen tax administration to help achieve fiscal consolidation. However, we are concerned about the possibility of a larger financing gap in 2002-03. In the event that international financial assistance falls short of expectation or is delayed, it would be prudent to have a contingency plan to cover the gap, including a basis for prioritizing expenditures to depoliticize the budget process. Do the authorities already have such a contingency plan in place?

Monetary and exchange rate policies and trade policy

It is important for the authorities to contain inflationary pressure by strengthening monetary policy. To this end, the authorities are encouraged to limit broad money growth within the programmed target and to reduce net bank credit to the government. In addition, the authorities should have additional market-based policy instruments to control bank liquidity. We would appreciate some comments from the staff about the prospects for using indirect instruments in Burundi. Efforts to strengthen bank supervision are also needed to ensure banks observe prudential requirements.

> The recent shift to a more flexible exchange rate regime by liberalizing the foreign exchange market is welcomed. It will certainly help improve competitiveness in the coffee sector and will allow a narrowing in the exchange rate differential between the official and parallel markets. While Burundi maintains a very restrictive trade regime, we are pleased to learn that measures are underway to join the COMESA.
>
> Other issues
>
> Private sector development will be essential for achieving higher growth rates and alleviating poverty once the peace process is finally completed. In this situation where the prospects for the coffee sector are rather uncertain, the economy should promote other possible sources of growth while adopting parallel measures designed to reduce production costs and improve productivity.
>
> Despite Burundi's difficult situation, it is encouraging that the government managed to achieve substantial progress in preparing an I-PRSP. We hope the I-PRSP will indicate poverty reduction targets and action plans based on a broad-based consultative process to enhance consensus building and country ownership. We look forward to Burundi's progress toward the preparation of a PRGF-supported program and an early decision point under the HIPC Initiative.

The staff representative from the African Department (Mr. Beaugrand) made the following statement:

> To complement the statement that was distributed yesterday, I would like to note that the Heads of State meeting held in Dar es Salaam on October 7 achieved encouraging progress in the Burundi peace process. Two rebel factions signed the cease-fire and two other factions were given 30 days to work out an agreement in the spirit of the August 2000 Arusha framework. The Heads of State also confirmed former President Mandela as the facilitator of the cease-fire negotiations, assisted by Vice President Zuma of South Africa and President Bongo of Gabon. In the staff's view, the Dar es Salaam summit was a significant positive step toward a comprehensive cease-fire agreement.
>
> Let me also thank the Swiss chair for pointing out an error in Table 1, page 26, of the staff report. The amount of IMF credit at end-September 2002 should have been SDR 0.64 million rather than SDR 10.27 million, as indicated. This error stemmed from the fact that we had earlier hoped to submit the request for emergency assistance in September, which proved overly tight, given the Executive Board schedule leading up to the Annual Meetings.

Mr. Rustomjee welcomed the staff's update on the summit, which was encouraging. The Burundi authorities had made sustained efforts and faced great challenges in reaching the current juncture—discussion of post-conflict assistance—and were looking forward to the outcome of the discussion. They had completed all the relevant prior actions, as indicated in the staff report.

Mr. Josz made the following statement:

> I will first comment on the proposed decision to provide post-conflict assistance to Burundi and then turn to the content of the program.
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> In 1995, the Board agreed to provide emergency assistance to post-conflict countries in the following circumstances (I quote from the Summing Up of Executive Board Meeting 95/82 of September 6, 1995):
>
> "Where the country's institutional and administrative capacity was disrupted as a result of the conflict, so that the member is not yet able to develop and implement a comprehensive economic program that could be supported by a Fund arrangement, but where there is nonetheless sufficient capacity for planning and policy implementation and a demonstrated commitment on the part of the authorities;
>
> "Where there is an urgent balance of payments need to help rebuild reserves and meet external payments and a role for the Fund in catalyzing support from other official sources;
>
> "And where Fund support would be part of a concerted international effort to address the aftermath of the conflict situation in a comprehensive way."
>
> From the staff papers and Mr. Rustomjee's statement, I conclude that the conditions for providing post-conflict emergency assistance to Burundi have been met.
>
> The civil war that has cost the lives of over 250,000 people, displaced a million more, and has also disrupted Burundi's administrative and institutional capacity. Despite these self-inflicted wounds and the collapse of coffee prices, the authorities have managed, with only minimal external assistance, to keep inflation, the exchange rate, and the fiscal and current account deficits within reasonable limits—an outcome achieved at least partly by accumulating domestic and external arrears.
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> Also noteworthy given these difficult circumstances is the relative success of tax collection, which yielded revenues equal to 20 percent of GDP in 2001. This strong tax effort was motivated partly by the scarcity of external financial support. The stability of Burundi's macroeconomic situation, the

varied and detailed data provided by the authorities to compile the Statistical Annex, and the implementation of 6 out of the 9 structural performance indicators under the 2001 Staff-Monitored Program attest to the survival of some capacity for planning and implementing policies. The swift completion of all the prior actions of last August's post-conflict program, and Burundi's impeccable payment record to the Fund and World Bank, confirm the authorities' determination to implement Fund and World Bank-supported programs successfully.

The authorities face financing gaps of $50 million this year and $183 million next year as they struggle to cover their import needs and regularize their relations with external creditors. The Fund has a clear role to play in catalyzing the necessary external financial support, as is shown by the recent decisions about Burundi by multilateral creditors and bilateral donors. On August 29, 2002, the World Bank Board approved an Economic Rehabilitation Credit of $54 million, of which the first $20 million tranche will be disbursed as soon as the Fund approves its post-conflict emergency assistance to Burundi. This Fund assistance will also unlock program loans and grants from the European Union, Belgium, France, and other bilateral donors, as part of a concerted international effort to support Burundi's reconstruction and development. In view of the authorities' substantial progress toward concluding a post-conflict program with the Fund, the Belgian authorities have decided to provide grants of about $13 million, most of which will be disbursed to Burundi before the end of the year.

Finally, the Fund's post-conflict assistance to Burundi is one element of a concerted effort to restore peace and stability to the Great Lakes region. Thanks to the tireless efforts of African heads of state, Burundi is slowly but surely catching up with last summer's substantial progress toward restoring peace in the Democratic Republic of Congo. A Peace and Reconciliation Agreement was signed in August 2000. A national transition government has been in place since November 2001. The World Bank and the United Nations are supporting Burundi's peace process with a program to disarm and demobilize the many armed forces that have been ravaging the Great Lakes region for much too long.

Now let me briefly comment on the content of the program.

The program for 2002-03 correctly focuses on the need for a stricter budget implementation, tighter monetary conditions, and more flexible exchange rate management, together with emergency measures to reduce the deficit of the coffee sector. Strong implementation of this program will prepare the ground for a PRGF-supported program to be launched by the middle of 2003.

Last August's liberalization of Burundi's foreign exchange market was welcome. But the reasons for the persistence of a substantial premium between the official and the parallel markets even after the depreciation of the Burundi franc on the official market are obscure. An explanation from the staff would be welcome.

Stronger control of public revenues and expenditures, including military spending, is clearly needed. The plan to create an independent auditing court (Cour des Comptes), agreed at the end of 2000, was most welcome, but is taking far too long to carry out. The authorities really should submit the necessary legislation to parliament long before next March, as currently planned.

Burundi's very large military expenditures, equivalent to 8 percent of GDP or 40 percent of the government's revenues excluding grants, should be reduced as quickly as the demobilization of the armed forces permits.

Finally, there is what I strongly hope is a typographical error in Table 21 of the statistical annex that cries for correction. According to this table, the authorities will allocate about one-fifth of their budget to secondary and post-secondary education but absolutely nothing to primary education. This flatly contradicts the expectation that the budget's allocations should benefit the poorest. The Belgian authorities have just finished deciding to pay the arrears owed to the teachers since 1992, to assist the transitional government in preserving social peace. They would be appalled to learn that education expenditures are now targeted to benefit only the better off. Some clarification by the staff would be welcome.

To summarize, Burundi is presently at a critical juncture. It is time to consolidate the gains made in the effort to reconcile its two major ethnic groups, undertaken at the behest of African heads of state since 1995. The Fund's post-conflict emergency assistance will catalyze additional external support and assist the concerted effort to restore peace and rebuild the country, provided that all parties persevere with Burundi's national reconciliation, and that the authorities continue to implement stability-oriented macroeconomic policies and begin to implement market-oriented structural reforms, while redirecting their spending away from military activities and toward growth-enhancing and poverty-reducing activities.

Mr. Duquesne made the following statement:

At the outset, let me thank the staff for a well-written and informative report and Mr. Rustomjee and Mr. Campos for their very helpful statement. Allow me to insist on my thanks to Mr. Rustomjee. I understand that this meeting is probably the last one he will attend, especially devoted to a country of his constituency. We will have other occasions to demonstrate our fidelity to Mr. Rustomjee. I just want to say that he personally deserves full gratitude from the countries of his constituency for the work he has done for them, in relation with colleagues in his office.

We welcome today's discussion on the proposed emergency assistance to Burundi, which follows the approval by the World Bank of the Economic Rehabilitation Credit last August. This is a very important step for the country, more than two years after the conclusion of the Arusha agreement and a little less than a year after the transitional coalition government took office in November 2001. The proposed program will enable to unlock the contributions committed by the donor community during the conferences in Paris and Geneva, held respectively in December 2000 and December 2001.

Like Mr. Josz in his eloquent statement, and the three Directors who issued preliminary statements, we believe that it is crucial, at this critical juncture, to support the authorities in their efforts to consolidate peace and stability and establish the conditions for the resumption of economic growth within a sustainable macroeconomic framework. A joint effort by all partners, and primarily by the World Bank and the Fund, is indispensable to cope with the vast reconstruction program, provide basic infrastructure services, restore the most vital administrative capacity, and pursue the reform agenda.

No doubt, the security situation remains very fragile. Progress will need to be monitored carefully. The summit held on Monday seems to have produced some results as recalled by the staff. We do hope that the dialogue between the authorities and the rebel groups will come to fruition according to the timeframe agreed during this meeting and put an end to a devastating conflict, which has caused terrible hardship on the population and, moreover, constitutes a threat to the stabilization efforts within the Great Lake region.

Similar caution and close monitoring are also warranted with regard to the efforts to sustain a sound macroeconomic framework. Implementation under the staff-monitored program was rather disappointing on a number of fronts. While some positive achievements can be noted in terms of contained inflation, increased revenue, and swift completion of the prior actions, the authorities clearly need to firm up the conduct of the program.

This entails strict adherence to the objectives set under the program in terms of reduction in military expenditures, which are expected to be lowered to 5.6 percent of GDP by 2003.

Strengthened management of public financial resources, enhanced transparency, and further liberalization of the exchange rate system will be key to ensure efficient use of the expected donor inflows. Maintaining a cautious fiscal stance and prudent monetary policy will also be important to help contain inflationary pressures, which might arise from the recent devaluation and possible further depreciation.

Finally, restructuring of the coffee and tea sectors and improvements in the business climate will help reach the growth objectives. The high vulnerability of the economy to commodity price fluctuations also hints at the need for diversification of the export base.

In light of the important risks and vulnerabilities identified, we find the program structure and the proposed two-tier drawing schedule to be appropriate. The staff is right in stressing the need for a strong track record of performance which, together with the positive conclusion of the peace process, will be indispensable to allow consideration of a second post-conflict drawing in early 2003, and pave the way for a PRGF-supported program and access to the HIPC Initiative.

Needless to say, France stands ready to support the Burundi authorities in this process, through both financial and technical assistance. To that effect, an economic and financial mission to Burundi is indeed scheduled in the coming days.

Let me conclude by wishing the authorities all the best in their difficult and challenging endeavors.

Mr. von Kleist made the following statement:

At the outset, I would like to join Mr. Duquesne in his appreciation for the work of Mr. Rustomjee. It is quite appropriate that today's Board agenda, Botswana in the morning and now Burundi, represents the broad, one might even say, extreme, spectrum of countries Mr. Rustomjee has so effectively represented in the Board.

We face a difficult decision on Burundi today. Burundi has seen years of severe conflict followed by a peace agreement two years ago that has still not been fully implemented. Most recently, violence flared up again. We have strong reservations against lending monetary resources to a country that is stuck somewhere between ongoing civil war and lasting peace. We have a number of concerns, especially that, under the given circumstances, additional financial resources could be used to increase military spending. The staff and the authorities have to take utmost care to ensure that this does not happen and that the Fund's resources will be used efficiently. Without any doubt, the risks of program failure are high, as the staff also acknowledges in paragraph 46 of the paper.

In the report, the staff argues that an approval of Burundi's request would help catalyze assistance from other sources and would contribute to consolidation of the peace process in Burundi, and it describes the current situation as a window of opportunity. The implementation of the staff-monitored program in 2001 was only partly successful, but we note that the recent strong implementation of prior actions does provide a basis for initiating economic reforms and addressing economic imbalances in Burundi.

We agree that the authorities can be commended for vigorously implementing the prior actions, which underlines their determination to reach the program's targets. We welcome the progress made in the area of exchange liberalization and the tackling of inflation. Moreover, we do realize that Fund assistance, rigorously controlled and transparently spent, has the potential to advance the peace process and thereby stabilize the economy.

In weighing the pros and cons of supporting the proposed decision, we have decided to put our faith in the assessment of the staff and management, and disregard our own strong reservations. We therefore support the proposed decision, and wish the authorities every success in achieving lasting peace and in improving the economic prospects of Burundi.

Mr. Liu Fushou made the following statement:

Like previous speakers, we thank the staff for a well-written report, and Mr. Rustomjee for his comprehensive statement.

After a difficult period of conflict during 1993–2000, and a sharp deterioration in the terms of trade, the authorities have demonstrated determination in addressing their difficult situation in the context of the staff-monitored program and the new program, for which they are requesting post–conflict emergency assistance. Economic activity has begun to recover; inflation decelerated in 2001; and financial stability has been restored. The strong prior actions implemented by the authorities, notably in the area of exchange liberalization, provided a sound basis for initiating economic reforms and addressing economic imbalances in Burundi. We agree that, given the fact that currently Burundi's overall situation remains fragile, there is no doubt that a concerted effort is needed to buttress the recovery and consolidate the process made thus far.

We welcome the updated information provided by the staff. In light of the authorities' determination to restore peace and carry out economic reforms, we support their request for post-conflict emergency assistance. Like Mr. Daïri and other previous speakers, we hope that a strong track record will pave the way for a PRGF–supported program and an early decision point under the HIPC Initiative. That said, we will limit our remarks to a few areas for emphasis.

On fiscal policy, we support the cautious fiscal stance approved by the authorities in the revised central government budget, which was approved by parliament in August 2002. On the revenue side, we commend the authorities for their efforts to maintain revenue at nearly 20 percent of GDP, and welcome their decision to strengthen tax and customs administration. On the expenditure side, we support the authorities' efforts to contain spending while ensuring that delivery of key public services and improvement in public expenditure management.

We welcome the authorities' commitment to a prudent monetary policy, and commend their efforts to ensure an orderly functioning of the foreign exchange market and the commitment to a flexible and competitive exchange rate regime. The modest narrowing of the exchange rate differentiation is welcome. In the financial sector, while we are pleased that the banking sector remains sound, we encourage the authorities to continue their efforts to improve the capacity of the BRB to conduct banking sector supervision. Fund technical assistance in this regard is welcome.

On structural reforms, we share the view that building the conditions for peace and reconciliation are preconditions for the resumption of economic development. Therefore, we support the authorities' dual objectives of structural reforms, aimed at taking steps in line with the Arusha agreement while implementing urgent measures to provide an enabling environment for private sector development. We also support the measures under way to improve financial performance in the coffee sector and to restore its competitiveness. We welcome the gradual approach to implementation of the privatization program and share the view that, with regard to civil service reform, caution is required to preserve social stability. We emphasize that appropriate social safety nets will be required to protect vulnerable groups.

With these remarks, we wish every success to the authorities in their reform efforts.

Mr. Epstein made the following statement:

The U.S. government has strongly supported the Burundi peace process and the Arusha Peace Agreement. In particular, we have provided increasing bilateral assistance as the peace process has progressed, including support to the peace negotiations and to the South African protection force in Burundi. Installation of the transitional government in Burundi in November 2001 was a major step forward. However, the conflict continues. The cessation of hostilities is crucial if Burundi is to be able to resettle the 1.2 million displaced persons, achieve durable improvements in its precarious humanitarian situation, and return to a path of sustainable economic growth and poverty reduction.

We welcome the progress that the transitional government has made in strengthening economic policy under adverse conditions. However, under our laws, given the lack of a process for auditing Burundi's military expenditures and reporting the results of those audits to civilian authorities, we cannot support the proposed decision and request to be recorded as abstaining. We hope that the Office of the Auditor General, which is to be created in the year ahead, will give priority to establishing a process for auditing and reporting to civilian authorities on military expenditures. Furthermore, while we agree with the objectives under this facility, we are concerned about the timing, given that this Board is about to approve a 'post-conflict' facility when the conflict itself is not yet over. We have the following additional remarks for emphasis.

On performance to date, we understand from the staff that progress on quantitative targets has improved recently and that the authorities are on track to meet the end-September targets. Also encouraging is the implementation of the prior actions necessary for this facility. This is encouraging in light of the less-than-satisfactory results under the staff-monitored program. Indeed, we are troubled by the excessive military expenditure that drove the poor performance under the SMP. Given the present security situation and the lack of a cease-fire agreement, we are concerned about the potential for recurrence of this kind of slippage.

In the fiscal area, we welcome the monthly ceilings on expenditure commitments as a means to ensure attainment of the revised budget targets. We also encourage the authorities to adhere to safeguarding of social expenditures, as stipulated in the revised budget, including the relocation of refugees and the rebuilding of the health and education systems.

Regarding monetary and exchange rate policies, we welcome the initial steps taken to liberalize the exchange rate, including the recent introduction of weekly auctions, but note that the gap between the official and parallel exchange rates is still large at 20 percent (versus 30 percent prior to the initial liberalization measure). This gap is rather significant, and the distortions arising from this gap will continue to affect the economy adversely. In particular, the profitability of exports will be hampered given the high (70 percent) surrender rate for foreign exchange. We are concerned that with missed profitability in exports comes a missed opportunity for poverty reduction as the bulk of exports originate in the rural sector. We urge that all actions necessary be done so that the gap is closed as soon as possible.

The attention paid to the issue of producer prices in the coffee sector in paragraph 33 is appropriate. The profitability of the coffee sector is key, and raising the incomes of rural farmers will be essential for poverty reduction in Burundi.

Although Burundi has expressed support for the global fight against terrorist financing, we urge Burundi to take the steps necessary to deny terrorists access to the international financial system, and to implement fully all UN counter-terrorism instruments, as called for in the November 17, 2001, and April 20, 2002, IMFC Communiqués.

In closing, we would like to reiterate our support for and deep commitment to the peace process in Burundi. We wish the authorities success in implementing the measures outlined in this facility and hope that we will be in a position to support future Fund-supported arrangements in Burundi.

Mr. Siegenthaler made the following statement:

Burundi has suffered from civil war for almost a decade. Besides the humanitarian tragedy that the conflict has caused, it has also resulted in the destruction of large parts of the economic and social infrastructure, as well as in the continuous deterioration of the macroeconomic and financial situation. The authorities tried to address this very difficult situation with a series of policy measures and structural reforms under last year's Staff-Monitored Program (SMP). Unfortunately, performance remained poor and the program failed to achieve its objectives to a large extent.

For this and next year, the authorities and the staff agreed on a new program supported by post-conflict assistance, and including a number of prior actions. We commend the authorities for having implemented all prior actions by end-August, just a short time after the conclusion of program discussions. We also believe that the program is broadly adequate, even if we note that the fiscal targets are less ambitious than they were under the SMP. Based on the program design and the implemented prior actions alone, we would have little hesitation to support today's decision.

However, the success of this program will not primarily depend on its design or the implementation of prior actions. Rather, the main decisive factor will be the security situation. Without the reestablishment of peace, the chances of the program to succeed will be very limited. In our judgment, the peace process has not made significant progress over recent months. It is true that negotiations on a cease fire are ongoing, initiated by a group of regional leaders. But as commendable as these efforts are, a real breakthrough remains elusive. Fighting between government troops and several rebel groups has continued, if not increased, in the past few months. The massacre of some 170 civilians in September, allegedly by an army unit, has been a sad reminder of the persisting severity of the civil war.

Another effect of the ongoing conflict has been the overshooting of military spending under the SMP by 1.9 percentage points of GDP. While we acknowledge the commitment of the authorities to reduce defense expenditure, we doubt whether this will be possible if the security situation does not improve. Rather, as long as there is no comprehensive cease fire in place, we feel that the risks for renewed defense overruns are substantial, as are the risks of continuous political instability.

Finally, it is telling that the discussions on the proposed program took place entirely here in Washington. As I understand it, this was because Burundi was judged unsafe for a staff mission. We find it problematic to start a program in a country where we have neither a representative on the ground nor have been able to send a mission to for program discussions.

On balance, we feel that the time is not yet ripe for financial support from the Fund, and our chair will therefore abstain on today's decision. I would like to stress, however, that we did not reach this conclusion easily and that it is due to the timing of the proposed program rather than its substance. Switzerland has a sizable program of humanitarian aid in Burundi and we are thus well aware of the suffering of the country's population. We sincerely hope that a cease fire can be reached rapidly, in which case we would be very happy to support post-conflict emergency assistance for Burundi.

Mr. Fenton made the following statement:

Canada remains very supportive of the peace process in Burundi and we would like to be able to support the request for Post-conflict Emergency Assistance. The program has the right priorities and is commensurate with the capabilities of Burundi at the present time. In particular, we welcome the attention paid to increasing transparency and accountability. We also take note of the important prior actions that have been undertaken, especially with respect to liberalizing the exchange market.

It is the assessment of my authorities, however, that Burundi is not yet in a post-conflict situation, nor is there a reasonable prospect that providing this support will bring about the cease fire that is needed. I would add that we would be willing to take some risk in this regard—as we did recently in the cases of Rwanda and the DRC—but the situation is just too unsettled. In this vein, I note, like Mr. Siegenthaler, that the discussions for this report took place at headquarters. I presume this was at least in large part out of safety concerns. We fully support this and would not want the staff to be placed in jeopardy. But we do think that this speaks directly to the security situation in the country. With such a degree of insecurity, we doubt that the authorities can actually implement the program. And a failed program would be worse for the people of Burundi than no program. Consequently, we wish to be recorded as abstaining on this decision. Like other chairs, we hope that a cease fire can be reached soon, in which case we would, of course, support post-conflict assistance for Burundi.

The staff representative from the African Department (Mr. Beaugrand), in response to questions posed by Directors, made the following statement:

> Starting with the more technical issue that was raised, I agree that Table 21 in the Statistical Annex is perhaps misleading, but I do not think it could be characterized as being incorrect. It shows expenditure by ministry, so it is really an institutional breakdown of expenditure. What happened is that the Ministry of Primary Education was eliminated in 1998, which is why the numbers are shown as zero. Looking at the table in more details, for instance, in the Prime Minister's office, the expenditure in 2000 and 2001 are also zero. This is not because money was not spent in the Prime Minister's office, but because no Prime Minister's office did exist during those years. While this may appear somewhat misleading, these are the only available data in terms of the breakdown of expenditure.
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> Turning to more substantive issues, there was a question on whether the staff paid enough attention to poverty issues and social considerations in the report. I would note that this question is mentioned at the beginning of the report (paragraph 5) in the context of the deterioration of economic conditions in Burundi. Of course, the aim of Fund support in Burundi is to reverse these deteriorating economic conditions. The authorities are preparing a strategy to reduce poverty, which would be incorporated into a PRSP. The post-conflict program aims at rebuilding capacity to address, inter alia, social and poverty issues. Short run priorities include increasing the assistance to refugees and internally displaced persons—which the authorities refer to as victims. Over time, there should be an increase in humanitarian assistance and higher project aid to restore basic infrastructure, especially in the health and education sectors.
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> On the audit of fiscal accounts, as mentioned in the report, for the time being controls are the responsibilities of the internal audit of the Finance Ministry. An auditing court is due to be set up in the course of 2003. There have been delays in this area, partly due to lack of capacity. In order to speed up this process, the authorities clearly need technical assistance to draft the legislation and to submit it to parliament. I can report that the parliamentary session that started on October 7 has on its agenda this very item, but it does not have a draft law as yet, because the draft has not been finalized. As soon as the draft law has been agreed upon and finalized, it could be submitted in the coming months, which would speed up the process of approval. Of course, once the law has been approved, the auditing court will still need to be set up, and extensive resources will be needed to develop its capacity.
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> Regarding the use of indirect monetary policy instruments, the staff agreed with the authorities to go step by step, beginning with the effective use of existing instruments; the aim is to develop their financial programming capacity, and use refinance ceilings more effectively to ensure attainment of

the program's objectives. Over time, the authorities will certainly need technical assistance. There are plans to send an MAE staff mission to Burundi, possibly as early as next month, which would lay the groundwork to develop monetary policy instruments. It will take some time before sophisticated techniques in monetary management can be put in place.

Also related to monetary management was the issue of exchange rate management and the differential on the parallel market. It is true that the narrowing of the differential was limited and the current differential of 20 percent remains large. In the staff's view, it mainly reflects a lack of confidence in the system. We did not want to have a chase of the two rates—the parallel and official exchange rates—which could be a source of high inflation. So, we agreed to adopt a gradual approach, with the expectation that, once the central bank resumes and steps up regular sales on the market, confidence will be restored. With the elimination of restrictions, the differential should narrow, maybe not to zero, but certainly to a lower range. If this strategy is not sufficiently effective, the authorities will need to take additional measures to address the problem.

Finally, there was a question about the contingency plans. The program does include an explicit contingency, but only for external assistance. As indicated in the report, we agreed with the authorities that there was very little scope to raise revenue further, as the level of government revenue is already high considering the low per capita income, and that there is very little room to maneuver on the expenditure side, partly because of the size of military expenditure. In case of a shortfall in available resources, the only possibility for the government would be to slow down or reduce the repayment of arrears, and that would delay the restoration of normal relations with external creditors, such as the African Development Bank, and certainly complicate the process of finalizing a request for PRGF resources, possibly in the course of 2003.

Mr. Komatsuzaki made the following statement:

This is a case that requires hard judgment. On the one hand, there are some encouraging developments such as improvement in economic policies, indicated by the timely completion of all the prior actions. On the other hand, the security situation remains fluid. This chair's position is very close to that of Mr. von Kleist's, and we concur with his analysis on risks and opportunities, and weighing them against one another. We can support the provision of post-conflict assistance, as we agree that therein lies a window of opportunity. There are significant risks, however. There is still uneasiness on our part. The performance under the staff-monitored program last year was less than satisfactory in addition to the security concerns. Looking ahead, much will depend on the progress made on the security situation and the work of the transition government. We feel Burundi still has not reached the stage of formulating a medium-term framework, and we therefore will not comment in detail. Now is the time to concentrate on returning to normalcy. Without peace, a comprehensive strategy for growth and poverty reduction cannot be formulated.

In the fiscal area, a cautious fiscal stance will be needed to maintain macroeconomic stability while liberalizing the foreign exchange regime. Revenue mobilization cannot be obtained easily in the current situation and in light of already high tax revenue, expenditure containment is key to fiscal consolidation. As pointed out by many Directors, military spending accounts for a large portion of expenditures, and we hope that the security situation improves enough to allow for a reduction in this spending.

On monetary policy, we agree with the overall objective of achieving low inflation. However, central bank refinancing, the main tool for monetary management, is also a tool used to finance private sector activities. The rise in interest rates might affect private sector activities. While I do not disagree with the most recent interest rate hike, if these rates increase too much, it could hurt recovery of production. In any event, retrenchment of credit to the government through fiscal consolidation would be helpful, since it would allow monetary tightening with less of an increase in interest rates. Regarding the foreign exchange, the recent liberalization is a step in the right direction.

The coffee sector is undoubtedly the most important sector for exports and I do not deny that it should be a priority in the program, but the other sectors are as important for improving lives. In fact, export crops account for only a small amount of the economy, according to Table 2 of the Statistical Appendix. The list of public and mixed enterprises in Table 26 of the Statistical appendix shows that the public sector covers a broad part of the economy, and it appears that the improvement of management/privatization of these enterprises is important to growth of private sector activities. We hope there will be adequate attention given to non-coffee sectors.

Good performance under the post-conflict program is crucial to formulating a medium-term strategy to achieve growth and mitigate poverty that can induce a deeper involvement of donors and international institutions. Unless sufficient progress is made, the window of opportunity will be closed again. We hope that the authorities recognize this and act accordingly. In this regard, a quick conclusion of cease-fire negotiations is very important.

With these remarks, I wish the authorities every success.

Mr. Macia made the following statement:

Economic performance improved as good weather fostered a rebound in agricultural production, while reconstruction activities also progressed.

Unfortunately, the strong performance of fiscal revenue was offset by increased military expenditures and health and education outlays, which affected the quantitative targets under the 2001 SMP. In addition, the external sector was hampered by low international commodity prices affecting export revenues, which, coupled with delays in external assistance, had a negative impact on the overall balance of payments. Finally, we note that inflation was significantly subdued.

The 2002-03 program starts from a firm basis, as prior actions were all complied with at end-August 2002. We look forward to a strong resolution on the forthcoming structural indicators detailed in Table 3. The commitment to attain macroeconomic stability has to be supported by fiscal consolidation. Revenues should remain strong based on improved customs and tax administration efforts, the review on tariffs exemptions, and the setting of the large TPU under donors' and Fund support. We welcome the monthly ceiling on expenditures, the constraint on wages, the envisaged phase-out of coffee subsidies next year, and the safeguarding of social outlays coupled with containment of unproductive expenditures as has been mentioned by other Directors.

We commend the central bank's prudent monetary policies. We support efforts to limit financing of the central government, enhance private sector credit, and control subsidies. If needed, inflationary pressures could be subdued by increasing the level of unremunerated deposits. We welcome the liberalization of the foreign exchange market, as well as the technical assistance requested from the Fund.

This chair is aware of the structural challenges that lie ahead. We look forward to the restructuring of the coffee sector and we support the efforts at enhancing export competitiveness and helping marginal farmers in their diversification efforts. We expect further progress in reconstruction activities, continued efforts in labor-intensive public projects based on donor support, and continued humanitarian assistance to victims of the war. An equitable distribution of positions in the civil service among ethnic groups is important to support the peace efforts.

The authorities have made significant progress to set the stage to consolidate economic growth and pursue fiscal consolidation. As noted in Mr. Rustomjee's detailed statement, the strengthening of public finances and the pursuit of fiscal transparency become vital to attain the 2002-03 program objectives. The endurance of the peace and the cease-fire arrangements are today more crucial than ever before. With these words, we support the staff request to allow Burundi to draw funds under the post-conflict emergency assistance policy. We wish the authorities well.

Mr. Vogel made the following statement:

The staff should be commended for a well-focused report. Even though some sporadic rebel activity remains, the Peace and Reconciliation Agreement provides Burundi with a precious chance, which should not be wasted, for exiting one of the most severe poverty conditions in the world. Burundi's position is still fragile and the authorities will need to make strong and sustained efforts to allow the country to attain a stable macroeconomic situation and continuous growth. Obviously, as clearly stated in Mr. Rustomjee and Mr. Campos's helpful statement, Burundi could not be expected to succeed alone in these efforts, and the internationally-concerted effort to support Burundi's recovery process is very welcome.

In order to attain stability and sustainable development, progress toward better governance and more transparent policies is critical, in order to discourage rent-seeking activities and adequately discover and punish corruption. In this regard, we are encouraged by the awareness of the authorities on the need to modify the foreign exchange system so as to avoid distortions and manipulations by moving toward a more flexible and less regulated foreign exchange market. The authorities' concerns about the consequences of a rapid liberalization on the exchange rates are well placed, considering the restrictions under which the foreign exchange system has been operating. A gradual but decisive approach may be needed, and at the same time, as staff point out, appropriate demand management policies should be part of a comprehensive package to complete the reform.

Fiscal policy will play a critical role to attain macroeconomic stability. As Mr. Rustomjee and Mr. Campos point out, the precarious security situation resulted in an increase in military spending. It is expected that improvements in the peace process will lead to lower defense spending and encourage donor support. Thus, the authorities could give priority to social and capital expenditures, keeping in mind the extremely weak indicators that Burundi shows in terms of education and health. In this regard, establishing an independent auditing court is a welcome step, which could improve budgetary control. Nevertheless, the staff report underscores delays in the implementation of this agency, which was expected for 2001. While we welcome the authorities' intention to reform civil service, we agree with Mr. Daïri about the need to be cautious in order to preserve social stability.

Another important element for the fiscal situation refers to the budget subsidies in the coffee sector that have caused large losses. On the one hand, it is a fact that coffee provided a significant part of Burundi's export. On the other hand, subsidies, while tending to discourage other crops that could benefit Burundi through greater diversification, may be unsustainable to the extent that low international prices persist as pointed out in the staff report. We welcome the authorities' announcement on the reduction of coffee subsidies in 2003 and urge them to take decisive action on this front, redirecting the resources from subsidizing producers to compensating those affected by the transition to other economic activities.

With these comments, we support the proposed decision and wish the authorities every success in their future endeavors.

Mr. Kelmanson made the following statement:

We are grateful to the staff for the paper and, in particular, we welcome the flexibility that has been shown in reaching understandings with the authorities on a program that could be supported with the Fund's resources. Overall, we agree with the analysis and proposals set out by the staff, and strongly support the request for emergency post-conflict assistance, which is coming at a critical time for Burundi. We particularly welcome the fact that, as a result of the actions of some donors, such resources can be made available on concessional terms.

We welcome the authorities' implementation of the prior actions, as noted by others, and agree that this provides the basis for a Fund-supported program. In supporting post-conflict assistance at this time, we would highlight a number of factors: (1) the need for balance of payments support; (2) the need to consolidate the recent economic gains and commitment to poverty reduction; (3) the need to help provide a tangible peace dividend to a fragile transitional national government; and (4) to help provide a catalyst to broader international support, aimed at raising the level of assistance to Burundi overall.

However, as in all conflict cases, and certainly reflected by some of the comments made in today's discussion, there are risks that cannot be ignored. Having said this, we agree with the staff that the risks to the program must be viewed against the commitments of the authorities to the program, and the importance of the program in supporting stabilization and peace. There are also risks associated with not proceeding at this time and, on balance, we support proceeding forward.

On the main elements of the program, we would stress a number of points that have already been touched on by other chairs, in particular, the importance of the commitment to fiscal reform, improvements in tax administration, the importance of the monthly ceilings on expenditure commitments, commitments to safeguard social sector spending, commitments to reduce military spending, as well as the importance of reforming the exchange rate system to moderate the differential with the parallel market, and to prevent large exchange rate fluctuations. We would also highlight the importance of making progress on a good quality I–PRSP, building a solid track record, and ultimately moving toward a PRGF-supported arrangement in due course.

In this regard, it will certainly be important, given the weak capacity and fragile situation in Burundi, for donor assistance to be provided. We certainly note the comments made by colleagues of the assistance that they currently are putting in place and have in plan. More generally on donor support, we would highlight the need to provide debt relief through the Multilateral Debt Trust Fund and to provide additional capacity-building assistance in support of key government functions, such as public expenditure and financial management, enhancing transparency, and implementing the auditor's court, once the legislation is in the books.

Mr. Bossone made the following statement:

As the staff and Mr. Rustomjee and Mr. Campos indicate, there are significant signs of a successful peace process taking root in Burundi at this time. Hence, there is a window of opportunity to be exploited.

In light of this, we can support Burundi's request for Fund assistance and the international community can now send a signal to the people of Burundi that there is a peace dividend to be reaped by them if cooperation takes the place of hostilities and conflicts. In particular, large benefits for society can quickly derive from the expected decline in military spending. This is an area where continuous and close monitoring will be essential.

We support the program for 2002 and 2003, although the risks facing it are significant, as the staff recognizes, especially in light of the fragility of Burundi's overall situation. The prior actions in place are a good basis to start economic reforms and to address imbalances. Aside from setting correct macroeconomic incentives, as key help in the resumption of normal economic activities, the importance of institution building cannot be overemphasized.

As Burundi emerges from conflict and embraces a program of reconstruction and development, an area that will deserve great attention is the development of the financial sector. This area will certainly require a much deeper analysis from the staff in the future. Broadening the access to financial services, if necessary through micro-financial institutions, establishing intermediaries to support small enterprises, and setting up the needed financial infrastructures should be placed high on the list of the country's developmental priorities. This would help Burundi reduce poverty more rapidly through private sector growth, and support faster product diversification and better management of output volatility.

Here, we believe the Bank has an important role to play, in cooperation with the Fund, especially in consideration of its increasing focus on policies for small financial systems. It is important that the Fund and the Bank cooperate closely on this aspect as the country's development strategy takes shape under the support of the international community.

With these remarks, we reiterate our support for the proposed decision and wish the authorities full success.

The staff representative from the Policy Development and Review Department (Mr. Fetherston), in response to comments made by Directors, made the following statement:

I could say a few words about the post-conflict policy in light of the comments made by some Directors. Mr. Josz helped me in this by beginning his intervention by quoting from the 1995 summing up, laying out the conditions for post-conflict assistance. As is detailed in the report, the staff evaluated those four conditions and considers that Burundi has met them. What is noticeable in those conditions is the fact that there is no specific definition in the policy of what constitutes being post-conflict. Rather, this is left to be a matter of judgment for the Board on a case-by-case basis. It is clearly a difficult area and, as is evident from today's discussion, there is scope for coming to different judgments on the issue.

Of course, the staff view was that sufficient progress had indeed been made to justify proceeding. There was reference by one speaker to risks taken in other cases. I would not comment on those particular cases, but to the extent that we can make these judgments, which are not easy, the staff view is that the security situation currently in Burundi is more favorable than it was, for example, in Sierra Leone at the time of its request for post-conflict assistance.

Mr. Epstein considered that, going forward, it would be helpful for the Fund to revisit and better define the concept of post-conflict.

Mr. Rustomjee made the following concluding statement:

First, let me thank the staff for comprehensively answering the questions that my colleagues have asked, and also for the quality of the interaction that they have had with the authorities. It has been a long haul, and everyone will take satisfaction from the outcome of this discussion. It seems that, notwithstanding the expressions of abstention, which have been reasonably put by a few colleagues, that the decision will probably carry. That is a great development for the authorities and grounds the efforts of staff to help a set of authorities that are serious about their economic development.

I thank my colleagues for the valuable comments that they have made, and welcome the recognition by many of the six out of nine structural measures that have been accomplished, as well as the prior actions. For the authorities, receiving the endorsement of the Board for actions well done, where they have been struggling for a number of years now, is valuable and encouraging, and they will take heart from that.

I want to express my profound thanks to the Belgian and French authorities particularly, and to the European Commission and to all bilateral donors, including the United States, who have provided all forms of assistance to the Burundi authorities. We could not have reached today's discussion without that wide and significant level of support that has already flowed. I would like to also thank the Belgian authorities for indicating their willingness to provide the subvention on the post-conflict emergency facility. This is something that our chair raised not in the context of Burundi, but more generically some time ago, and it has been gratifying to see that various chairs have been willing to support that subvention.

I have noted the opinion of some colleagues that the SMP had a mixed level of success, and I will take that back to the authorities. I did understand the basis on which some of my colleagues rendered themselves unable at this time to support the proposed decision, particularly the issue of timing and the concern that perhaps the conflict may not be over and the risk of a potential recurrence. Of course, the authorities are seized with the challenge of peace, and I do want to reiterate to the Board that they are serious about putting conflict completely behind them.

On fiscal issues, I noted the comments on the performance to date. I welcome Mr. Josz and Mr. Liu's remarks on the relative success of tax collection, and that this aspect of fiscal policy will be key to attaining stability in Burundi. I have also understood the need to reduce military expenditure, give greater priority to social and capital expenditures, and maintain a cautious fiscal stance. I welcome the support given to the efforts to contain expenditure while delivering public services. I have noted the need for an independent civilian audit of military expenditure, which was the reason for one chair's abstention. I will take that certainly back to the authorities as it will be key information for them for the future. I am grateful for the recognition of the efforts to preserve and strengthen social safety nets, as well as the advice to strengthen the process of rebuilding the health and education sectors.

On the exchange rate, I welcome the comments on the commitment of the authorities to a flexible exchange rate regime, but also noted the need to further narrow and finally close out the parallel exchange rate framework. This does represent a diversion of resources, and ultimately it translates into reduced resources for poverty reduction. There was recognition of the initiation of weekly auctions, and want to reiterate the authorities' ongoing request for TA in this area and it was valuable that it came out in the discussion.

On the external sector, many useful comments were made, initially by Mr. Duquesne, on the issue of the need for diversification of the export base, the need for raising incomes of rural farmers as a method of trying to raise output and productivity in the rural sector as a base for promoting exports from the agricultural sector, and the critical need to restructure the coffee sector. There were many interventions on the issue of coffee subsidies—to what extent they are sustainable, and whether they should be directed to coffee farmers or rather shifted over to those who are transiting to other forms of activity.

In terms of program content, I noted the comments that the risks of failure of the program are perceived to be high, and that it will need stricter budget implementation, a tighter monetary stance, and stronger structural measures—all necessary ingredients to ensure that the program succeeds. I did, nevertheless, also note the comments of colleagues on what they felt were an appropriate structure in the phasing of program measures. There were a number of issues, including focusing more strongly on public expenditure management, better distribution of civil service personnel along ethnic lines, strengthening public finances, fiscal reform, improving tax administration, safeguarding the social safety net framework, progressing toward a quality I–PRSP, improved attention to small, micro, and medium enterprise development, and infrastructure development. Here, I valued particularly the comment on the need for the Bank and the Fund to collaborate, and for the Bank's role to play itself out strongly in these areas.

I did note the comment on anti–money laundering and combating the financing of terrorism and the need for the authorities to implement UN and other resolutions.

Mr. Josz's point on the structuring of expenditure in the education sector is certainly something I will mention to the authorities. I am sure this will be a matter for further discussion with the authorities through the staff. In terms of final comments, chair, I think clearly today's step is vital for the authorities. They have waited a long time, and certainly we will go back and do a little bit of celebrating from our chair's perspective on this one.

Burundi has waited a long time for an endorsement of flow of resources from the Fund, stepping out of a staff–monitored framework to disbursement of resources. It will certainly accomplish what Mr. Josz suggested in his opening remarks—unlock long–awaited resources. It will also contribute to helping restore peace and creating the conditions for growth in this economy. There is no crystal ball, and one can never predict what may lie around the corner. If there is stability on the peace front, this step will surely contribute to that process.

I do want to appeal, on behalf of the authorities, for maximum coordinated assistance from external partners following this decision. This step alone will not suffice, but if it does serve as the catalyst, it will assist the authorities in achieving many of the program objectives, and will further strengthen the peace process, which will further strengthen the process of bringing about durable growth in the Burundi economy. I do appeal for extensive Fund technical assistance to continue to be provided. The authorities are taking this very seriously, and they have a good track record on implementation, given the lack of administrative capacity and given the severe challenges that they have had, and they deserve ongoing strong technical assistance in many areas, as listed in the staff report.

I am grateful to the one or two colleagues who were looking even further ahead than today's decision and expressed the hope that the authorities will go on to a PRGF-supported program. I express my hope in concluding that the authorities will do everything in their power to enable my colleagues to make that determination at a later date.

I would like just finally to comment on points raised by Mr. Josz in his opening statement. I am grateful to him for clarifying the policy on post-conflict assistance. It is clear, in my view, that Burundi is eligible, as he stated at the beginning of the discussion. At the same time, it has certainly always been clear to me, particularly as I came out of a country that experienced conflict itself, that unless every firearm is laid down and every soldier is demobilized, and the process of reintegration has been well set on its way, there is always a risk. As Mr. von Kleist described, moving forward requires an act of faith in one degree or another.

The judgment of colleagues in describing post-conflict assistance as an act of faith that they can come on board with is the right judgment. I feel confident that when the time comes for the discussion of the next disbursement, that those colleagues that have been, for understandable reasons, unable to join support for the program at this stage will probably come on board at that stage.

Finally, I wanted to thank Mr. Duquesne and Mr. von Kleist, in a personal context, for their kind remarks. It has always been a great pleasure sitting at this particular chair at the Board, and I would not want to sit at any other chair, in preference to this one. It has been a great pleasure working with my colleagues on very challenging cases.

The Acting Chair made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They noted that Burundi had faced unusually difficult circumstances since the mid-1990s, as the severe impact on the economy of the drawn-out conflict had been compounded by a sharp fall in the terms of trade. Against this background, Directors welcomed the progress made toward normalizing the situation since the signing of the Arusha Peace and Reconciliation Agreement in August 2000. These developments provided a basis for cautious optimism that a broad-based settlement would be reached soon, allowing for a full recovery of the economy.

Directors commended the Burundi authorities for having introduced measures designed to restore economic and financial stability and mobilize the support of the international community. They agreed that improved economic management and the launch of the much-needed rehabilitation and reconstruction of basic infrastructure, with substantial external assistance, would help consolidate the progress made under the Arusha agreement. Measures to achieve macroeconomic stability were clearly essential in this respect, especially to strengthen the fiscal position, reform the foreign exchange auction market, and restore the competitiveness of coffee exports. However, Directors noted that progress toward high sustainable growth and poverty reduction would require the elaboration of a comprehensive medium-term macroeconomic program and structural policy framework.

Directors considered that the authorities' fiscal consolidation objectives for 2002–03 struck an appropriate balance between the requirements of emergency needs and reconstruction, on the one hand, and the objective of reducing internal and external imbalances, on the other. They welcomed the authorities' decision to strengthen tax and customs administration, as well as their efforts at containing the growth of current expenditure, and called for further improvements in public expenditure management. Directors emphasized the importance of reducing military outlays as soon as circumstances permit, thereby facilitating an increase in spending on high priority sectors.

Directors welcomed the adoption of a more flexible approach to monetary and exchange rate management. They noted that the holding of more regular auctions would help improve the allocation of foreign exchange, and urged the authorities to phase out exchange restrictions as soon as possible. This, together with sufficiently tight liquidity conditions, should allow a convergence between the official and parallel market exchange rates. Directors also stressed the importance of improving monetary control to ensure a pace of broad money growth that is consistent with price stability and the economic recovery needs.

Directors agreed on the priority assigned to ensuring the profitability of coffee and tea exports, which continue to account for the bulk of Burundi's foreign exchange earnings. The measures taken by the coffee marketing board to reduce processing margins were steps in the right direction, but Directors took the view that these steps would need to be followed by reforms of the entire subsector, including through deregulation and privatization. Directors noted the importance of proceeding with other structural reforms, especially the setting up of the auditing court, which would improve accountability in the management of public finances. They also encouraged the authorities to take measures to foster private sector development and economic diversification once normal conditions and business confidence have been restored.

Directors commended the authorities for maintaining core statistics that are deemed adequate for Fund surveillance. However, they noted the need for improving the quality and timeliness of data, and supported the provision of technical assistance in this area. The authorities were also encouraged to mobilize technical assistance in the areas of tax administration, expenditure control, monetary and exchange rate management, and bank supervision.

While welcoming Burundi's support for the global fight against terrorist financing, Directors encouraged the authorities to take steps to combat money laundering and to implement all relevant UN regulations.

Directors expressed the view that Burundi's political and economic situation remained fragile, despite the progress made during the last two years. They hoped the authorities would seize the opportunity, with the help from external assistance, to consolidate the prospects for lasting peace and economic development in Burundi.

It is expected that the next Article IV consultation with Burundi will take place on the 24month cycle, subject to the provisions of the decision on consultation cycles approved by the Board on July 15, 2002.

Request for Post–Conflict Emergency Assistance

Directors commended the authorities for having achieved all prior actions. They noted, however, that despite progress, the authorities still faced major challenges to reduce domestic and external imbalances and improve financial management.

Directors stressed the importance of adhering to tighter fiscal policy, a more active monetary policy, a liberalization of the foreign exchange auction market, and lower processing charges in the coffee sector. The mobilization of donors' assistance in the context of the authorities' program was expected to facilitate economic and financial reforms, and thus to help consolidate the prospects for lasting peace and economic development in Burundi.

Directors noted that further liberalization of the foreign exchange market, together with regular auctions of foreign exchange and a more active use of monetary policy instruments, should narrow the differential between the official and parallel market exchange rates. They urged the Bank of the

Republic of Burundi to improve its capacity to monitor and control bank liquidity, and develop more flexible monetary policy instruments.

Directors expressed the view that rapid progress in the implementation of the program would speed up the delivery of external assistance and lay the groundwork for a medium-term program that could be supported by the Fund under the Poverty Reduction and Growth Facility and a decision point under the Initiative for Heavily Indebted Poor Countries. They stressed that the authorities should take utmost care to ensure that external financial assistance is not used to finance military spending.

The Executive Board took the following decision, with 3 abstentions from Mr. Epstein (UA), Mr. Siegenthaler (SZ), and Mr. Fenton (CO):

1. The government of the Republic of Burundi has requested a purchase in an amount equivalent to SDR 9.625 million (12.5 percent of quota) under the Fund's policy on post-conflict emergency assistance.

2. The Fund notes the intentions of the government of the Republic of Burundi as stated in its letter dated September 19, 2002 (attached to EBS/02/174, 9/2/4/02) from the Minister of Finance and the Governor, Bank of the Republic of Burundi, with attached memorandum of economic and financial policies (MEFP), and approves the purchase in accordance with the request on the condition that the information provided by the Republic of Burundi on the implementation of the prior actions specified in Table 3 attached to the MEFP is accurate.

Decision No. 12868-(02/104), adopted
October 9, 2002

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/02/103 (10/4/02) and EBM/02/104 (10/9/02).

4. LIBERIA—OVERDUE FINANCIAL OBLIGATIONS—CONSIDERATION OF COMPLAINT WITH RESPECT TO SUSPENSION OF VOTING RIGHTS AND RELATED RIGHTS IN FUND

1. On April 8, 2002, the Managing Director issued a complaint to the Executive Board pursuant to Article XXVI, Section 2(b), setting out the facts on the basis of which it appeared to him that Liberia had persisted in its failure to fulfill its obligations under the Articles of Agreement of the Fund after the expiration of a reasonable time period following the declaration of ineligibility under Article XXVI, Section 2(a) on January 24, 1986 (EBS/02/63, 4/8/02). The complaint was communicated to the authorities of Liberia on April 18, 2002.

2. The Executive Board regretted the further accumulation of arrears to the Fund by Liberia and limited actions taken by the authorities to improve economic policy implementation. It urged Liberia to adopt and implement quickly an economic adjustment program that would improve economic performance and that could form the basis for a resolution of its overdue obligations to the Fund.

3. The Fund will again consider the Managing Director's complaint before March 4, 2003 or at the time of the Board's consideration of the next Article IV consultation with Liberia, whichever is earlier, so as to provide a further opportunity for the authorities of Liberia to strengthen their economic policies and increase payments to the Fund. If the Executive Board determines at the time of the next review that Liberia has not strengthened its cooperation with the Fund in the areas of policy implementation and payments to the Fund, it could at that time decide to suspend Liberia's voting and related rights in the Fund. (EBS/02/171, Sup. 1, 10/4/02)

Decision No. 12869-(02/104), adopted
October 7, 2002

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/02/124 (10/3/02) and EBAM/02/125 (10/7/02) is approved.

APPROVAL: January 29, 2003

SHAILENDRA J. ANJARIA
Secretary