September 2, 2003
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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 03/54

10:00 a.m., June 9, 2003

Contents

Executive Board Attendance

A. Krueger, Acting Chair
E. Aninat, Acting Chair

Executive Directors	Alternate Executive Directors
	A. Alazzaz
	A. Al Nassar, Temporary
I. Bennett	C. O'Loghlin
K. Bischofberger	B. Reichenstein, Temporary
M. Callaghan	M. Reddell
	G. Francis, Temporary
`	P. Gitton, Temporary
	O. Basdevant, Temporary
S. Indrawati	I. Alowi
	M. Jamaluddin, Temporary
	R. Karki, Temporary
V. Egilsson	D. Farelius, Temporary
	I. Kupca, Temporary
N. Jacklin	M. Lundsager
	N. Epstein, Temporary
	I. Ábel, Temporary
	C. Josz, Temporary
	J. Sipko, Temporary
	A. Zoccali
	C. Pereyra, Temporary
	D. Ayala, Temporary
A. Mirakhor	M. Ahmed, Temporary
	A. Lushin
	L. Palei, Temporary
	S. Vtyurina, Temporary
D. Ondo Mañe	L. Rutayisire
	K. Kpetigo, Temporary
	R. N'Sonde, Temporary
L. Martí	M. Beauregard
	P. Moreno, Temporary
	M. Mirabal, Temporary
P. Padoan	H. Vittas
	D. Lombardi, Temporary
M. Portugal	R. Steiner
	A. Tombini, Temporary
	C. De Silva, Temporary
	K. Kanagasabapathy, Temporary
	V. Bhaskar, Temporary

	R. Gauba, Temporary
	M. Brooke
	N. Joicey, Temporary
A.S. Shaalan	G. Shbikat, Temporary
	K. Nauphal, Temporary
	P. Ngumbullu
	B. Mamba, Temporary
Wei B.	X. Wang
	L. Cao, Temporary
	J. Yu, Temporary
J. Kremers	Y. Yakusha
	H. Litman, Temporary
	N. Gigineishvili, Temporary
	M.Kitahara
	T. Miyoshi, Temporary
	N. Watanabe, Temporary
F. Zurbrügg	W. Szczuka
	S. Antic, Temporary

S.J. Anjaria, Secretary
B. Esdar, Acting Secretary
A. S. Linde, Acting Secretary
Y. P. Chia, Assistant
S. Soromenho-Ramos, Assistant
O. Vongthieres, Assistant

Also Present
IBRD: C. Anstey, Country Director; A. Bassani, Lead Economist; B. Bryce, Advisor to Executive Director; B. Funck, Section Manager, S. Kathuria, Senior Country Economist. European Central Bank: J.O. Wijnholds, R. Ritter. African Department: H. Bredenkamp, A. Schwidrowski. Asia and Pacific Department: T. Feyzioglu, R. Kronenberg. European I Department: S. Schadler, Deputy Director; M. Estevao, Z. Murgasova, I. Szekely. European II Department: L. Hansen. External Relations Department: P. Loungani. Finance Department: Y. Metzgen. Legal Department: R. Leckow, I. Mouysset, N. Rendak. Monetary and Exchange Affairs Department: O. Frecaut. Middle Eastern Department: S. Beidas, A. Furtado. Office of Budget and Planning: C. Vehorn. Office of the Managing Director: A. Mazerai. Policy Development and Review Department: T. Geithner, Director; C. Aturupane, D. Desruelle, L. Ebrill, M. Fetherston, M. Fisher, M. Guerguil, J. Hicklin, I. Lukonga, A. MacArthur, Y. Sobolev, M. Walsh. Secretary's Department: L. Hubloue, M. Miller, P. Ramlogan. Statistics Department: C. Enoch, Deputy Director; L. Fernando, G. Raymond, J. Reitmaier, R. Rosales, W. Soonthornsima. Western Hemisphere Department: J. Dodsworth, Deputy Director; A. Boote, P. Gajdeczka, W. Samuel, Y. Sun, T. Turner-Jones. Advisors to Executive Directors: A. Baukol, C. Duriyaprapan, S. Farid, D. Lewis-Bynoe, J. Milton, T. Moser, P. Nijsse, S. Rouai, K. Sakr, C. Sia, F. Vermaeten. Assistants to Executive Directors: C. Faircloth, T. Komatsuzaki, J. Salleh, T. Segara, A. Segura,T. Skurzewski.

1. STRENGTHENING EFFECTIVENESS OF ARTICLE VIII, SECTION 5

Document: Strengthening the Effectiveness of Article VIII, Section 5 (SM/03/166, 5/5/03)

Staff: Geithner, PDR; Fetherston, PDR; Leckow, LEG

Length: 2 hours, 30 minutes

Mr. Egilsson submitted the following statement:

The paper on strengthening the effectiveness of Article VIII, Section 5 is well written and covers the most important issues that have been raised. We thank staff for their efforts and think that the paper provides a good basis for moving forward.

In general, we expect that all members of the Fund strive to collect and use the data on their economies that is necessary for prudent and successful policy making and economic management. In general we also expect that the economic data collected by member governments are widely accessible in appropriately aggregated forms and can be of use not only for the governments themselves but also for all other economic operators and stakeholders. Submission of economic data to the Fund should therefore be seen as a normal activity by member governments aiming at improving their credibility in international markets and contributing to increased global integration of their economies.

Article VIII, Section 5 requires members to supply specified information to the Fund. The purpose and content of the Article is both clear and unambiguous. However, the effectiveness of this Article in the Fund's work has implications for cooperation within the Fund and how transparent the Fund is perceived to be by the international community.

In recent years, important advances have been made in the area of data processing, information flow and transparency. This progress has been made possible through the hard work of the Fund and its staff, with extensive voluntary cooperation from member countries. Although the cooperation takes place within the legal framework provided by the Fund Articles, most members supply much more information than required in Article VIII, Section 5. This trend reflects the view that transparency and easy access to information benefits every member country and is fundamental to economic progress.

We support the main proposals of the staff in the present paper, namely, to expand and update the coverage of Article VIII, Section 5 to modify the application of Article VIII in the context of performance criteria and to rely upon more flexible remedies to deal with breaches of Article VIII. We, however, wish to take a more “minimalist” approach to some proposals. This is justified by our belief that the voluntary cooperation of members to ensure the provision of information needed for the Fund’s activities has served the Fund well and we should therefore continue to build on this foundation. The progress made in the SDDS, FSAP, and Article IV consultations, in addition to the relatively low incidence of misreporting, further serves to justify the need for only minor changes in the formal framework.

Following are our responses to the specific issues for discussion as listed in the nine bullet points in the staff paper:

A general decision to implement the accepted changes to all members in addition to supplementary decisions in specific cases is natural. The hybrid option combines the best elements from the available alternatives and provides the Fund with the necessary flexibility to legally require additional information when warranted.

We prefer the expanded list to include only the core statistical indicators. Data requirements, needs, and specification constantly change so only the most fundamental variables should be listed beforehand.

Consequently, we prefer a voluntary system of reporting the additional information with a two-year period of evaluation of compliance. This solution may, however, be reviewed in light of the experiences gained over some appropriate period of time.

We are in agreement with bullet point 4 suggesting that an element of judgment still should be made of the quality of information reported to the Fund in relation to best practice standards.

We agree with the proposals discussed in bullet point 5 on the proposed modifications to the application of Article VIII, Section 5 in the context of performance criteria. We are in favor of limiting the application of this Article to purchase and granting of waiver situations. We are also in favor of limiting the application to misreporting of meeting performance criteria.

The proposals regarding the Fund’s remedies for breach of the Article are logical and the path as outlined in Chart 1 appears to be an improvement. Declaration of censure will be most effective, as the internet and other means of increased information flow have amplified the responsiveness of markets to negative publicity.

A ninety-day maximum period between the issuance of MD’s report and Board decision on a breach of information is appropriate.

If only the list of core statistical indicators is expanded, a transition period of two years should be sufficient, as most of this data is already provided in the Article IV surveillance and the SDDS.

In the interest of transparency, our answer is yes, all relevant information on all Board decisions on breaches of Article VIII, Section 5 should be made public.

Mr. Portugal and Mr. Tombini submitted the following statement:

The provision of reliable and timely information by members is essential for the Fund to be able to perform its functions. As stated by the staff, the Fund relies mainly on cooperation of members who voluntarily provide the information that the institution requires. This system has served the Fund well and has reinforced its voluntary and cooperative nature.

Fortunately, members generally provide the Fund with a vast amount of information that, in the large majority of cases, is the best information available to themselves. There have been a few, isolated cases of non-cooperation and of misreporting of data. In the last 15 years, out of hundreds of programs with thousands of checkpoints, only a few tens of cases of misreporting have surfaced and even fewer resulted in non-complying purchases. To deal with these cases, the Executive Board has strengthened the policy on misreporting in 2000. The instances of non-cooperation in the case of surveillance have been equally rare.

Despite praising the voluntary approach to the provision of information, the staff seems biased against it and willing to rely more on compulsory means of achieving the objective of data provision. The Fund has a number of initiatives where the voluntary approach has been critical in ensuring broad acceptance by the membership. In the case of information provision, cooperation has been the cornerstone. The Fund should avoid moving away from the concept of voluntary provision of information, unless it is demonstrated by the staff that it has failed in adequately supporting Fund activities.

The idea of strengthening the application of Article VIII, Section 5 emerged in 2000 at a time of a few high profile misreporting cases. Before examining specific additional proposals, such as those made by the staff, we would like to have detailed information on whether the application of the revised Misreporting Guidelines has indeed been insufficient to allow the Fund to effectively discharge its responsibilities.

We are not convinced that, in the context of use of Fund resources, there is the need for a broadened definition of Article VIII, Section 5. We have the impression that the recent review of the guidelines for misreporting has already addressed most of the weaknesses in information reporting in program cases, and we fail to understand why an expansion of the list of information under the Article should be a useful complement to the misreporting guidelines. As the staff acknowledges throughout the paper, given its high leverage over program countries, the Fund has been able to enforce data requirements on users of Fund resources.

The decision to extend the list of data to be provided under Article VIII, Section 5 so as to cover the items required for surveillance does not seem appropriate or necessary either. We do not favor an enlargement of the data to be provided under Article VIII. We understand that the information required there is outdated, but in reality, member countries are already voluntarily providing the Fund with much more data than what is required under this Article. While Article VIII, Section 5(a) refers to the list presented as the minimum data to be furnished by the members, this does not mean that that Article envisages for the additional information to be obtained in a compulsory way. The Article certainly allows for the Fund to require additional information. That the Fund should do so in a mandatory manner is, in my view, an unwarranted interpretation. Indeed, the opposite could be argued from a reading of item (c) of the same Article VIII, Section 5, which states that "The Fund may arrange to obtain further information by agreement with members". We, therefore, are not prepared to support the staff's proposal to augment the list of data that members are required to furnish under Article VIII, Section 5, and prefer to continue to rely on the current voluntary approach to obtain additional information, as proposed in paragraph 34. If this approach is retained, we could support that the provision of requested information over a period of two years, as suggested by the staff, could be reviewed together with the periodic data provision review. This approach appears to strike a better balance between the cooperative nature of the Fund and the need to ensure greater reliability and coverage of data provided to the Fund for the purpose of performing its activities.

Nevertheless, if the Board decides in favor of expanding the coverage of Article VIII, Section 5, we would favor the uniform approach (as defined in paragraph 25), and would not support either a case-by-case or the staff's preferred hybrid approach. As the paper says, the Fund has never adopted any country-specific decision requiring the provision of information in the context of surveillance, and we are not prepared to depart from this important practice, unless there are very strong reasons. The flexibility sought by the staff in recommending the hybrid approach would be preserved under the uniform approach, since Article VIII, Section 5(b) takes into account the capacity of members, and Section 5(c) allows for the voluntary arrangement to obtain further information.

The staff seems to take yet other unwarranted interpretations of Article VIII, Section 5. For instance, the Article does not specify the periodicity with which the information is to be provided. From this, the staff derives the unwarranted conclusion that the obligation is continuous. Similarly, throughout the paper the staff refers to “accurate” information, which is a very stringent requirement, whereas Article VIII, Section 5(b), refers to information as accurate as practicable. We believe that the criterion for data provision both in the case of surveillance and program activities should be for information as accurate as practical.

The list of information mentioned by the staff in paragraph 31, in some respects, seems to go beyond what most members are currently able to provide. We would like the staff to indicate how many members currently provide, for instance, information concerning revenues and expenditures of states and local governments and concerning residency of public debt, and how many members would be able to provide such information with what periodicity. We prefer to stick to core indicators.

We can go along with the idea of clarifying the conditions under which the unearthing of inaccuracies in information supplied by a member would give rise to a breach of obligation. We are particularly supportive of enhancing the Fund’s ability to distinguish between misreporting and bona fide data revisions or mistakes. To that effect, the staff provides a number of useful but still insufficient suggestions in paragraphs 37–39. We concur with the proposal to limit the application of Article VIII, Section 5 in the context of use of Fund resources to avoid nuisance cases.

There are two aspects of the current misreporting policy that need amendment. First, there is a need to distinguish deliberate misreporting of information from unintended misreporting, arising from weak domestic reporting systems, genuine error, or temporary causes entirely outside the member’s control. While both willful and unintended misreporting may have similar consequences, as they may equally hinder the Fund’s ability to perform its duties, the nature and intensity of the policy responses and remedies should vary according to whether they deal with deliberate misreporting or involuntary misreporting. Second, a dimension of magnitude should be associated with the notion of misreporting. For variables usually counted in terms of millions of units, an inaccuracy of a few units should not be considered as misreporting, but as unavoidable error.

As the staff notes, Article XXVI, Section 2, establishes sanctions that are disproportionate to the breach of the obligation to provide information. Perhaps this is because the original intent of the provision might have been to deal with breaches of other types of obligations rather than the provision of inaccurate information. We are, therefore, unconvinced about the desirability of creating new sanctions for cases of misreporting, as proposed in Chart 1.

The staff proposes publication of all decisions concerning the framework. We believe, however, that intermediate Board decisions requesting further clarification should not normally be published, and that if the Board decides that no breach has occurred, publication should be at the discretion of the member concerned.

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

We fully concur that adequate data collection by members and the provision of such data to the Fund, are essential for effective Fund surveillance. The task before us today is to decide on the most effective way to build on the important strides already made in data provision, with the voluntary cooperation of members, in order to continue to fulfill the Fund's mission to assist members in policy formulation, detect emerging vulnerabilities, and reduce the probability of the emergence of financial crises. The evolution of the global economy, and accumulated Fund experience in policy design and crisis analysis, have already led to the implementation of a number of initiatives that have had a positive impact on the quality and consistency, as well as coverage, of members' data. These initiatives have been implemented in a voluntary and cooperative manner and have led to the provision of extensive information on members' economies, beyond the requirements of Article VIII, Section 5. In our view, the present framework for data provision to the Fund is working well.

It is important to acknowledge that financial and economic statistics are hardly perfect and that data revisions are the norm rather than the exception in view of the need for continual updates, methodological improvements, and institutional strengthening. This is the case for all the membership, but especially for developing countries. While agreeing that there is always scope to improve the effectiveness of our policies, we do not believe that expanding the legal obligation of members is the way to go. Our effort to improve data provision should be based on a cooperative approach and focus on extending adequate technical assistance. When inaccuracies of information provided by a member are noted, remedial actions should focus on preventing the data deficiencies from recurring. Having outlined our general position, the rest of our statement will elaborate on some of the questions raised by the staff.

We support the option of continuing to rely on the current voluntary system of reporting core indicators. A large proportion of the membership already provides the data under this system. The adequacy of data provision for surveillance purposes is carefully assessed in Article IV staff reports and is highlighted in the summings up, sending a clear message to the authorities when there is a need for improvements. In addition, the Fund has the option to refrain from concluding the Article IV consultation in the extreme cases where essential information is not provided by the country. We believe that this framework has served the membership and the institution well and see no need to expand on the legal obligation of members, including by enlarging the list of data specified in Article VIII, Section 5.

With regard to data that members are legally required to provide, we fully agree with the staff that a considerable element of judgment should continue to be involved in the assessment of members' capacity to report information, the adequacy of that information, and the implications of data revisions, and that the benefit of any doubt be given to the member. In this connection, we also believe that the definition of misreporting should be revisited. Specifically, the circumstances surrounding the particular alleged misreporting and the role of the authorities in exposing data problems should be taken into consideration, and a judgment should be formed on whether the data provided was intentionally misleading. While ill intent can be difficult to prove, it is unreasonable to solve this dilemma at the expense of the reputation of members who are making good-faith efforts to improve their statistical capacity and institutions, and who, in the process, reveal previous data inaccuracies. Furthermore, the assessment of capacity to provide data should include an assessment of organizational and other institutional weaknesses. Such weaknesses have implications on both the availability of data and the accuracy of the data provided to the Fund. Remedial actions in such cases could include improvements in the statistical systems, budget procedures and monitoring, or reserve management practices. A satisfactory implementation of such remedial actions should be the focus of our effort and countries who implement them should not be subjected to sanctions, including damaging public announcements.

While we support the staff's efforts to exclude nuisance cases, the proposal made in this regard falls short of what is necessary to ensure that we do not get bogged down with cases of relatively minor data deficiencies. First, the exclusions proposed by the staff in the context of use of Fund resources would, in practice, be extremely limited. If we understand it correctly, paragraph 5 in the paper implies that any inaccuracy in the information presented in the context of a program review, even if it does not affect the assessment, would not qualify for a "nuisance" designation. Second, the possibility of nuisance cases outside the context of use of Fund resources is not addressed altogether. We need to include some wording to the effect that the Board should pass a judgment on the "materiality" of any breach of Article VIII that is brought to its attention. Where the breach is judged to be "not material," the matter should not be pursued further, beyond bringing it to the attention of the member for possible corrective action, or technical assistance, if that is needed.

The staff rightly notes that the sanctions for breaching Article IV, Section 5 are severe. To address this concern, however, they recommend an additional intermediate step, which is a declaration of censure. Such a declaration could have a serous impact on a member's reputation and its standing in the market, and in our view is also very severe. There is also a risk that it could be issued too frequently or prematurely. We, therefore, do not support adding this new sanction, and prefer to continue with the current graduated approach. Likewise, with regard to the proposal to automatically publish Board decisions on breaches of Article VIII, Section 5, we have concerns about the possible adverse reaction by markets, and urge for a cautious approach.

In conclusion, in view of the above concerns, we have serious problems with the proposals presented in today's paper, and urge that we continue to work within the boundaries of current procedures.

Mr. Reddy submitted the following statement:

We thank the staff for its well-documented paper on provision of information by members to the Fund needed for its activities. The important functions of the Fund requiring it to collect extensive data and information from member countries stem from its obligations to undertake periodical bilateral and multilateral surveillance particularly governed by Article IV consultations and its need to closely monitor program implementation in conjunction with qualitative and quantitative performance criteria. The staff paper has brought out relevant issues and makes certain proposals in the right perspective clearly highlighting the role of conventions and practices in this vital area of multilateral cooperation.

General Observations

We would like to make certain general observations before addressing the specific proposals/issues raised for discussion in the paper:

First, as rightly argued by the staff, based on the existing healthy conventions and practices, the Fund within its legal framework has relied primarily on the cooperation of members, to obtain the relevant information/data. Over the period, it is well known that the nature, quality, scope, and volume of data and information sets collected by the Fund have expanded considerably. In addition to surveillance and program monitoring, the Fund evidently is using this data base for its extensive cross-country research on a variety of issues.

Second, the Fund, on the strength of its unique role, has built up an extensive data base on a variety of qualitative and quantitative indicators, as reflected in country information system provided through external and also internal websites. The Fund's country wide data base could be considered unique and enviable in that respect and this has come about out of its unique surveillance role and special relationship with the member countries. Given the narrow coverage of listed items under Article VIII, Section 5, this listing in practice should be considered more symbolic and illustrative rather than mandatory and complete listing of all Fund's data and information requirements. The data/information collection by the Fund, therefore, in practice has gone substantially beyond this formal listing. In this backdrop, any attempt to strengthen the mandatory nature of listing, may give rise to apprehensions and diminution of the value and spirit of cooperation and mutual trust built successfully over the years. Therefore, in our view, there is a need for the Fund to persevere with this spirit of cooperation in information and data collection from member countries.

Third, with the increasing emphasis on transparency both at the Fund level and individual country level and with recent thrusts of FSAP and standards initiatives, countries on their own have been considerably strengthening their quality of information provided to the Fund as well as to the market and data dissemination standards and most of the vital economic and market data are available to the public released by member countries on a voluntary basis.

Fourth, a reading of the paper on the experience thus far indicates that both in respect of program and non-program countries, barring some cases, even where the data delinquencies appear to be more inadvertent and not deliberate, there is no strong evidence to conclude that there was any significant loss of vital information undermining effectiveness of Fund's monitoring or any damage caused to the safeguarding of Fund's resource use. In this circumstance, any substantive actions taken on the basis of this paper may lead to an exaggerated impression that there are widespread and serious gaps in data reporting and serious problems of misreporting.

Comments/Observations on Specific Proposals/Issues

While we are in general agreement with the need for an improvement in the mechanisms of data reporting by members as well as strengthening the system of data checks by the Fund, enhancing the scope of Article VIII, Section 5 for provision of an expanded set of information does not seem to be the appropriate route. The members have varying ability to furnish the information/data required by the Fund reflecting, in part, the level of development of member countries. Hence, there cannot be a uniform approach that will be applicable to all members as regarding broadening the requisite information set in respect of Article VIII, Section 5. The voluntary adoption of the SDDS along with the Codes of Transparency in Fiscal, Monetary and Financial Policies are appropriate mechanisms to complement the information requirements of the Fund. The FSAP review is other mechanism for obtaining information on the financial sector. During Article IV consultations also, member countries provide wide ranging data to the Fund staff. As indicated in the Fund document, most additional information sought by the Fund staff is in any case being already provided by the authorities on a voluntary basis. Hence, in our view, there is no need for an amendment to Article VIII to provide for additional information/data sets for the purpose of surveillance/program reviews.

We would, therefore, urge continued reliance upon a voluntary system of reporting any additional information, backed by offer of technical assistance from the Fund in respect of those countries who are at present unable to furnish the requisite information. In specific cases, rather than having a fixed two-year period for judging compliance, the periodicity of compliance could be determined taking into account the existing gaps in the technical and administrative capacity of members to build their statistical reporting system. We hasten to add that an element of judgment would always need to be present while assessing members' capacity to report required information, the adequacy of the information provided, and the implications of data revisions, on the basis of best statistical practices and experience, with the benefit of any doubt being given to the member.

The application of Article VIII, Section 5 should, as rightly proposed by the staff, be limited to exceptional situations where safeguarding Fund's resources are involved. We need at the same time to recognize that mistaken data reporting quite often is inadvertent and could be the result of weak statistical systems in program countries and sometimes due to the rigidity often shown in Fund programs while setting the performance targets. Hence, certain degree of acceptable deviation from the set performance targets must be taken and viewed as an integral element of review of Fund programs and the strict application of Article VIII, Section 5 should be limited only to those cases where misreporting in case of major variables is of a very large magnitude and clearly established to be deliberate. In such cases, the misreporting may be published. Such an approach will minimize the potential dangers of moral hazard in the use of Fund resources.

As regards remedial measures against misreporting, we suggest that if misreporting related to information required under Article VIII, Section 5 is deliberate and deviates by a large margin (and not resulting from statistical incapacity), the member ought to be required to quickly correct the errors. In case where misreporting arises from deficiencies in the member's statistical system, remedial measures by the member country supported by the Fund's technical assistance would be appropriate. However, if within a reasonable time frame, the member fails to take remedial measures, the Fund instead of immediately imposing sanctions could take an intermediate step of declaration of a censure, which could be made public. This would bring peer pressure into operation. The Fund would need to give appropriate opportunity to the member country to rectify the situation.

As regards the fixation of maximum period between the issuance of MD's report on a possible breach of obligation and a Board decision, while the general guiding principle would be 'earlier the better', the urgency of the situation and the need to safeguard Fund resources may differ from case to case. As the experience shows, there may be need for several rounds of communication with the concerned authorities. Hence, any maximum limit could be specified in respect of only such cases where misreporting is closely linked with provision of Fund's financial assistance. Incidentally, the basis for fixing a 90-day limit has not been indicated in the paper. We invite staff comments on how they arrived at the proposed 90-day maximum limit.

In cases where the misreporting is of a very large dimension in major variables, such as net international reserves or current account/fiscal deficit (say more than 1 percent of GDP), or where the member is found to deliberately involved in misreporting in more than one occasion, the relevant information on those Board decisions regarding breaches of Article VIII, Section 5 could be made public on the basis of a Board decision. However, member countries would need to be given the benefit of doubt where the Fund staff may not be absolutely sure that the misreporting had been deliberate.

Conclusion

In general, we feel that the proposal for making more active use of legal remedies available to the Fund in problem cases need to be viewed with great caution for a number of reasons. First, identifying a problem case, which demands the application of extreme punitive measures, may prove to be difficult for the Board, particularly if non-technical considerations are brought to bear. Past experience of the Fund in this regard tends to reinforce this proposition. Second, we understand that this paper arises from a request made by the Executive Board in March 2000 during a discussion on misreporting policies. Since then a number of positive developments have occurred in the dissemination of data by member countries as well as their increasing participation in data ROSCs. Strengthening legal provisions at this stage may serve to dampen the enthusiasm of member countries who have engaged in these initiatives voluntarily. Third, the Articles of Agreement govern several other obligations of members besides those being considered now, for which extreme remedies are provided for but in practice very difficult to apply. Formulating enhanced legal procedures for enforcing Article VIII, Section 5 by itself may not prove to be an appropriate and consistent solution in a specified and narrow area of data provision. Fourth, legal remedies are in our view inappropriate solutions in the context of the fundamental multilateral and cooperative character of the Fund. We recognize that extreme cases do need to be appropriately addressed, but adequate provision for dealing with such cases already exists in the Article and hence we need to persevere with processes to persuade and increase pressure to comply.

We would suggest, illustratively, that the effectiveness of application of Article VIII, Section 5 may be considered as part of strengthening systems and procedures by incorporating the basic proposals of staff in informal guidance notes. Bringing peer pressure into operation may be a better way than finding solutions through legal means which are enabling, but difficult to implement in practice.

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

We thank the staff for a well written paper, and welcome the opportunity to discuss ways to enhance the relevance of Article VIII, Section 5 of the Articles of Agreement. At the outset, we broadly agree with main thrust of the staff report, i.e., that the minimum list of data that member countries must submit to the Fund for the discharge of its duties must be updated to reflect current economic developments and concerns. In particular, the list does not include critical information on the monetary and fiscal sectors. Also, we agree that a decision requesting information in addition to the one stated in Article VIII, Section 5 would apply to all the membership, with the purpose of underpinning the Fund's surveillance work, as explained in paragraph 22. The staff points out that similar decisions have been adopted in the past, but only for members using Fund resources.

We concur that expanding the list in this way would enhance the relevance of Article VIII, Section 5, and would strengthen the Fund's call for transparency among the membership. However, regarding the specific ways to implement the proposal, we favor the notion that the Articles of Agreement should lay out general principles empowering the Fund with enough flexibility to fulfill its information requirements and remain consistent with changing conditions. In this regard, even though we see merit in the "hybrid" approach suggested by the staff in paragraph 27—in which the general decision would be supplemented with decisions for specific cases, for example a history of misreporting or increased crisis risks—the original phrasing of Article VIII, Section 5 states in general that "the Fund may require members to furnish it with such information as it deems necessary for its activities". Therefore, its mandate already encompasses any requirements in excess of the minimum list for special cases. In consequence, we can support the uniform approach in paragraph 25, with the qualifications explained below.

Specifically, concerning the appropriate scope of an expanded list of data which members are required to report under Article VIII, Section 5, and consistent with the need for flexibility, we would not lean towards establishing detailed data requirements, and therefore the new minimum list does not need to be expanded as described in paragraph 31. In this regard, we agree that the core list mentioned in paragraph 29 is appropriate. Its adoption would formalize and give more strength to a list that is already used in surveillance missions. Furthermore, adoption of such list would be practical because, as highlighted by the staff, it is currently available for a majority of countries.

In sum, both the level of detail of the requested information, as well as individual decisions like the ones proposed under the "hybrid" approach, should be established in the course of the Fund's surveillance work on a case-by-case basis. Notably, the most suitable way to enforce the requirement of adequate statistics is in the context of Article IV exercises, in which data weaknesses must be clearly pointed out and reported to the Board. At the same time, members would not be considered to be in breach of Article VIII, Section 5 for the information that they unable to provide, following current practice. Assessing these cases should continue to involve an element of judgment on the basis of experience, and the member should be given the benefit of any doubt.

We agree with the proposal to limit the application of Article VIII, Section 5 to the provision of inaccurate information leading to the belief that a performance criterion was met, or to the granting of a waiver for noncompliance based on a breach that is subsequently discovered to be greater than reported. In both cases, a country would be found in breach of Article VIII, Section 5, even if they do not originate purchases, given the potential damage to the Fund's reputation. This is consistent with current practice, and, therefore, only the case explained in paragraph 43 would not represent a breach of obligation, in light of the perverse incentive it would entail.

We concur that the sanctions under Article XXVI could turn out to be disproportionate to the breach of obligation—especially in minor misreporting cases—and that voluntary remedial measures can be more effective to correct these kinds of situations. In this regard, we have the following comments on the enhanced framework for remedial action described in Chart 1:

In principle, a 90-day period would be appropriate for the Executive Board to decide on the Managing Director's report regarding a breach of obligation. However, we would like to ask the staff to elaborate further on the considerations leading to this proposal.

We support the standardization of remedial measures to be taken voluntarily by a country, and in particular a timeframe established by the Executive Board's decision finding it to be in breach of obligation. At this stage, proper consideration should be given to the complexity of the problem, the size of the detected breach, and other characteristics of each specific case.

In case of failure to undertake remedial action, a declaration of censure can be considered as an intermediate step before the imposition of sanctions under Article XXVI, as well as an additional chance for the authorities to clarify the situation. Publication of the declaration could be effective in further exerting moral suasion. At the same time, before taking this action, and in general at all instances of the process, the authorities should be given the opportunity to rectify any data reporting problems or clear themselves.

We agree that, since data requirements under the proposed decisions would acquire legal force, a transition period would be in order to allow the membership as a whole to come into compliance. In this regard, a period of two years would be suitable. Finally, concerning publication of all Board decisions under the proposed framework, we share other Director's call for caution. In our view, Board documents dealing with these cases should not automatically be published, and should rather be regarded as a final instance when all means to correct a data reporting problem have been exhausted.

Mr. Zurbrügg and Mr. Moser submitted the following statement:

We welcome today's discussion and support the objective of strengthening the effectiveness of Article VIII, Section 5. First and foremost, this means that its coverage should be expanded to bring it more closely into line with the Fund's data needs. We do see some possibility, however, in discussing the scope of this expansion. The staff's proposal is quite ambitious. We would prefer achieving a broad-based support for a less ambitious expansion, than reverting to the status quo. As regards the proposed modifications of the application of Article VIII, Section 5 in the context of use of Fund resources and the proposed framework for remedial action, we support the staff proposal.

Reporting Obligation

We fully agree with the staff that the range of information that members are required to report under Article VIII, Section 5 should be expanded, but that the member's capacity constraints should be taken into account. Capacity limitations can be a legitimate reason for not delivering full data, given that reasonable steps are taken to improve capacity. We also agree with the staff that assessments of a member's capacity, the adequacy of information provided, and the implications of data revisions must involve an element of judgment, and that the benefit of the doubt should be given to the member.

Given that we support the idea to establish the expanded list as an obligation, the main issue is its appropriate range. Generally speaking, two extremes are possible: (1) a broad uniform mandatory requirement with many exemptions, or (2) a narrow uniform mandatory requirement with many country-specific decisions setting out additional information requirements. The task is to find the right balance between the two extremes.

While the current framework clearly tilts too much towards the second extreme, we wonder whether the list proposed in Box 4 does not overshoot in the other direction. We fully agree with the staff that all the indicators listed in Box 4 are desirable for the purpose of surveillance, and we should aim at a general provision of these data. However, we wonder whether it would not be better, at this stage, to limit the obligation to the core statistical indicators (paragraph 29). We would prefer a narrower obligation with broader compliance rather than a broader obligation with narrower compliance. Of course, the list would be periodically reviewed.

Application in the Context of Use of Fund Resources

We fully agree with the proposed modifications in the application of Article VIII, Section 5 in the context of use of Fund resources. The proposed limitations seem reasonable.

Framework for Remedial Action

The proposed procedural framework to address a breach of Article VIII, Section 5 would provide clearer guidance and facilitate uniformity of treatment among members. We welcome that the proposed framework still allows that cases where members fail to provide information can be solved informally and that it would be activated only after having followed the graduated voluntary approach put in place by the Board in 1995.

The framework newly prescribes that the Board would either confirm that a member has breached its obligation or require factual clarification after the issuance of the Managing Director's report on a possible breach of obligation. We support the idea of establishing a timeframe of 90 days within which the Board would have to reach its decision. This would ensure that the matter is treated within a reasonable period, while still giving the Board enough time to study the case. We also agree that the Board should specify a deadline for the clarification, if it requests such a clarification.

The proposed framework recognizes that asking for remedial measures is often more appropriate than imposing sanctions. A standard set of possible remedial measures and a timeframe for the implementation of such measures would probably be helpful. Technical Assistance could be useful to support the member in its efforts. An important and welcome new feature of the proposed framework is that it offers a declaration of censure as an appropriate intermediate step before imposing sanctions. To be effective, however, both the statement of concern and the declaration of censure would have to be made public.

More generally, we strongly support the publication of all Board decisions under this framework, as well as the publication of management's decisions to delay the completion of an Article IV consultation because of a member's failure to provide requested data. Making the relevant information on Board decisions public gives the importance of data provision the appropriate weight and sets the right incentives to comply with this obligation. We also continue to believe in the merits of transparency as an important instrument to increase the effectiveness of Fund surveillance and crisis prevention.

Regarding the question of a transition period, we could go along with the suggested one-year period. However, we do not think that a longer transition period would be appropriate.

Mr. Kremers submitted the following statement:

Key Points

I welcome and endorse the proposed update of the information requirement under Article VIII, Section 5 of the Fund's Articles of Agreement.

I would, however, restrict the information requirement to a general one, applicable to the entire membership. Specific country related information requirements should be limited to data related to program conditionality or to exceptional cases of failure to deliver the necessary information by a country under surveillance.

When requiring data from member countries, their administrative capacity to provide those data and the cost associated with the collection of the data should be weighed against its relevance.

If we were to include a timeframe in the remedial action framework, the deadlines should be considered as the latest acceptable in specific cases, which could be accelerated in clear cases of intentional failure to meet the reporting requirement.

I agree with the staff report that the current listing of data required under Article VIII, Section 5 is no longer reflecting current realities. Also, the recent IEO report on the role of the IMF in capital account crises identified weaknesses in the assessment of vulnerabilities related to the financial and corporate sector. Information on the balance sheet of the financial sector could, therefore, particularly enhance the impact and effectiveness of surveillance. Nevertheless, I also see some merit in using one of the existing data sets which we already work with as the standard (the 'core indicators' or the SDDS) instead of again creating a slightly different new data requirement. If those standards do not cover all the data required for adequate surveillance, we might want to consider the comprehensiveness of those standards.

I would want to caution against being overly ambitious in demanding data from countries with limited administrative capacity. I noted that the staff report takes this into account and suggests that “the benefit of any doubt should be given to the member”. Still, I would like to stress that we should prevent requiring more from countries than they can reasonably provide. Furthermore, for very small economies, it might be excessively expensive to collect data on a detail level which we would ideally like to see and we should always weigh the costs of demanding data against the potential benefits. Furthermore, before entering into any remedial action framework, Fund staff should be able to show that an adequate effort has been made through technical assistance to provide the country with the technical capacity to reach the desired level of data provision.

In this context, the staff could have provided somewhat more information on the extent of the capacity problems which could arise, including estimates of the technical assistance effort that would be necessary to bring countries in line with the proposed requirements.

With regard to the proposed ‘hybrid approach’, I was somewhat concerned by the presentation in the staff report which left the impression that we can expect in the near future a series of proposed Board decisions on data requirements for individual countries. Bearing in mind the comparability of treatment of member countries, the basic proposition should be that we have only one uniform set of data that have to be provided by all member countries of the Fund. I could agree with the so-called ‘hybrid approach’ if that were to be interpreted as a continuation of our current policy, which means that the option to require ‘non-standard’ data from individual member countries under Article VIII, Section 5(a) will only be used in cases where the surveillance of a member is severely hampered by its unwillingness to provide the necessary data. Any other specific data demands should only be considered if the information is required to assess the compliance with the conditionality of Fund-supported programs.

I endorse the proposal to consider misinformation in the context of performance criteria established under Fund-supported programs only as an explicit breach of Article VIII, Section 5 in cases where it formed the basis of an unjustified, positive Board decision on reviews or waivers for non-observance of a performance criterion. This would protect the credibility and reputation of the Fund in the surveillance of members that have received financial assistance and/or endorsement of their policies.

I also agree to the proposed changes in the framework for remedial action. I would, however, like to add that if we were to attach a timeframe to the subsequent steps, those should also be considered as the maximum acceptable deadlines. In cases where there has been a clear and intentional failure to report the necessary data or where there is a lack of cooperation by the authorities in solving the problems, an accelerated procedure should remain possible.

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

General Remarks

The timely provision of accurate information is essential for the Fund to conduct its activities, including surveillance and the provision of financial assistance under appropriate conditionality. Misreporting fundamentally threatens the effectiveness of the Fund's core activities.

The staff paper for today's Board discussion focuses on ways to strengthen the effectiveness of Article VIII, Section 5, following the previous discussion in 2000. This chair broadly agrees with the thrust of the paper and thanks the staff for making concrete proposals. Here, however, we would like to stress the importance of the Fund's making the utmost effort to prevent and detect at an early stage the occurrence of misreporting, and we would emphasize that strengthening the effectiveness of Article VIII, Section 5 is part of a comprehensive strategy in this regard. In addition to strengthening the effectiveness of remedial actions and sanctions and expecting them to be a deterrent against misreporting, the Fund staff should strive to establish a good relationship of mutual trust with authorities, and to make the methodologies for data collection and other statistical practices as clear as possible. Providing adequate technical assistance to members with limited institutional capacity in the area of statistics and data collection is also important. Since the provision of accurate information by members is a prerequisite for enhancing the effectiveness of the Fund's activities, priority should be given to this area within the whole technical assistance exercise. While we believe that this view is shared by management and the staff, as well as other chairs, we wish to reiterate this view for emphasis.

Issues for Discussion

We support the staff's proposal that, in strengthening the effectiveness of Article VIII, Section 5, a general decision applicable to all members should be adopted, which could be supplemented by specific decisions applicable to individual countries as necessary. While it is important to ensure uniformity of treatment across the membership in the application of this section, which is accompanied by legal sanctions, countries' specific circumstances should be taken into consideration at the same time. We therefore think that a hybrid approach, as recommended by the staff, is appropriate.

We have the impression that the proposed expanded list of data which members are required to report (Box 4) is a little too ambitious. As the staff argues, the existing list of data stipulated in Article VIII, Section 5 certainly lacks the information necessary for the Fund's surveillance and other activities today, and this chair is of the view that the Fund should require members to report such information by stipulating it clearly in a Board decision. That said, we should also be careful in making a judgment about the appropriate scope of additional information because the breach of this obligation would have legal consequences in the form of sanctions. From this standpoint, the list proposed by the staff includes information that is not required to be collected and disseminated even in the SDDS, and is therefore excessive in our view. This chair prefers the expanded list, which would be applicable to all members, to include only the core statistical indicators mentioned in paragraph 29. This list could of course be supplemented by decisions applicable to individual countries in particular cases as necessary.

Concerning the third bullet of paragraph 65, we do not favor continued reliance upon a voluntary system of reporting additional information. As mentioned above, the existing list of data in Article VIII, Section 5 has remained unchanged since 1944 and lacks the information necessary for the effective discharge of the Fund's current duties. This chair is of the view that the Fund should, and is entitled to, legally require members to report at least the minimum of such information.

This chair agrees with the staff that assessments of members' capacity to report required information, the adequacy of the information provided, and the implications of data revisions must continue to involve an element of judgment, and that the member concerned should be given the benefit of any doubt. Since not every member has perfect statistical systems and statistical practices vary among members, and in order to avoid discouraging members from providing revised information voluntarily, the application of Article VIII, Section 5 should continue to be limited to exceptional cases.

We support the proposed modifications in the application of Article VIII, Section 5 in the context of performance criteria established under Fund arrangements in the General Resources Account. In cases where a performance criterion has been judged to have been met with misreported information, we agree with the staff that it would be counterproductive to apply Article VIII, Section 5 to a member when it later provides revised information on the basis of which it meets the performance criterion, even though we recognize some inconsistency with the application of this Section in the context of surveillance, where there is no question of whether a performance criterion is met. As the staff points out, the application of this Section in such cases would only become an incentive for not correcting the information provided, while the results of the program review would be unaffected. We think that the staff's proposal is realistic.

We support the proposed remedial actions for breach of Article VIII, Section 5 and the procedures for these actions and sanctions. The staff's approach is appropriate to ensure greater clarity in the procedures and uniformity of treatment across the membership, as well as to make clear the measures that can be implemented before imposition of legal sanctions stipulated in Article XXVI, the severity of which is disproportionate to that of the breach of Article VIII, Section 5 if directly applied.

We can support the proposed 90-day maximum period between the issuance of the Managing Director's report and a Board decision. Although we cannot see a strong reason for the proposed length of the period, we think that it is broadly appropriate in that it will enable members to take corrective actions voluntarily.

On the issue of whether to establish a transition period before the proposed expansion of the list of required information would take effect, it can be argued that such a period is not needed, particularly if the list of additional information is limited to the core statistical indicators, because such information is already provided in the context of surveillance. We prefer, however, having a transitional period of one year because the failure to provide newly required information could ultimately lead to legal sanctions under Article XXVI.

We support the staff's proposal that relevant information on all Board decisions regarding breaches of Article VIII, Section 5 should be made public, but only if the member concerned is given the benefit of any doubt, and the application of this Section is limited to exceptional cases. On a more detailed point, while the staff proposes that management make public any decision to delay the completion of an Article IV consultation when the failure of a member to provide information required under this Section impeded the effective conduct of surveillance, we believe that approval by the Board should be required, even on a lapse of time basis. As footnote 50 suggests, the Executive Director representing the member concerned should be entitled to present the authorities' views, and it should therefore be for the Board to decide whether the consultation should be delayed.

Mr. Bennett submitted the following statement:

Key Points

I endorse the staff's proposals to strengthen the effectiveness of Article VIII, Section 5, as the collection of macroeconomic data is essential for the Fund to carry out its mandate of promoting economic growth and international financial stability.

If approved, these revisions would constitute a clear reaffirmation by the membership to this overarching objective.

On the set of additional information to be required under the provision, I support the items listed in Box 4. This constitutes an appropriate data set that is commensurate with the ambitious objectives of Fund surveillance in preventing crises.

As regards the framework for remedial action:

I welcome the emphasis put on the voluntary adoption of remedial measures. Requests for technical assistance in this context should be accorded high priority in the application of the Fund's new terchnical assistance prioritization process.

I strongly support the public dissemination of Board decisions on breaches of Article VIII, Section 5, as an essential component of the framework.

It would be helpful to give further consideration to the timetable that might accompany the process.

My preference is for a relatively short transition period of one year.

I welcome this opportunity to review Article VIII, Section 5, and broadly endorse the staff's proposals to strengthen its effectiveness. This chair's clear preference for establishing a revised reporting requirement as mandatory, rather than voluntary, is rooted in the essential character of the information at issue. The basic financial and economic data required for Fund surveillance speaks to the very essence—the heart—of the IMF's raison d'être. Without this information, the effectiveness of our organization would be severely constrained and, therefore, a collective decision to make its provision mandatory seems, to us, a reasonable one. It does not, as some might argue, detract from the cooperative nature of the Fund's operations or its tradition of consensual decision-making; rather, it simply reflects the fact that in this, as in any organization, there are essential, basic responsibilities of membership.

With these general remarks, I would like to comment specifically on issues relating to the proposed set of additional information to be required under the provision, as well as the revised process for remedial action if Article VIII, Section 5 is breached.

Required Information under Article VIII, Section 5

The list of data Fund members are required to report on under Article VIII, Section 5 is specified as the "minimum necessary for the effective discharge of the Fund's duties". As a general principle, therefore, it makes perfect sense for the Fund to review the adequacy of this list, reflecting on the capacity of members to compile data and, more fundamentally, its ability to inform the IMF membership of underlying economic and financial risks that evolve in tandem with developments in the global economy. In this latter respect, the current required set of information listed in the provision is seriously dated; it reflects economic priorities and concerns germane to the global economy at the time of the IMF's inception.

In my view, Box 4 represents a contemporary list of essential macroeconomic information. This proposed set draws heavily on the core statistical indicators, on which there is broad agreement, and specifies additional details on government revenues, expenditures, debt, and financial assets, which experience has shown is critical for detecting emerging vulnerabilities that may give rise to international financial crises. Some Directors have expressed a preference to include only core indicators in the expanded list. In my view, however, the set of information proposed by the staff is appropriately ambitious and commensurate with the important surveillance objective of crisis prevention. I would be reluctant to endorse a subset of the proposed list, particularly if many Fund members are currently providing this data voluntarily. It would be helpful if the staff could clarify the degree of voluntary provision of this information across the membership, as well as give an indication as to the number of Fund members that would face practical difficulties conforming to this full set as compared to the core set.

In any event, in keeping with the principle noted above, there should be a presumption to review periodically this list of additional information required under the provision—say, every two to three years—to ensure consistency with evolving core data priorities. Finally, the potential need for additional data (depending on countries' unique circumstances) should be assessed on a case-by-case basis, consistent with the staff's preferred hybrid option.

The Framework for Remedial Action

The remedial framework that presently exists has proven impracticable, in part because the proposed sanctions are not entirely reflective of the magnitude of the breach. As a result, and despite the fact that the provision applies to all instances of IMF surveillance, a breach in obligation under Article VIII, Section 5 has on only one occasion been pursued outside the context of Fund financial assistance.

The phased approach advanced by the staff, in our view, provides a logical basis by which to evaluate and correct any breach in obligations. In doing so, it will help assure a more equitable application of the provision across the membership, which, in our view, is an overriding objective of the exercise.

I welcome, in particular, the inclusion of the graduated approach approved in 1995. Indeed, providing the country with the initial option to undertake remedial measures on a voluntary basis once the Board has determined a breach has occurred reinforces the institution's strong commitment to cooperative principles. Remedial measures will need to be tailored to country-specific circumstances, and realistic timelines set for coming into compliance. In situations where capacity constraints are relevant, it will be imperative that the IMF provide adequate technical assistance support on a timely basis.

I agree that a statement of concern and declaration of censure would help keep incentives for compliance aligned, particularly for members who do not intend to use Fund resources in the near future and for which a declaration of ineligibility would have little practical impact. This depends critically, however, on the public nature of these statements. As such, I strongly endorse the public dissemination of all relevant information on Board decisions regarding breaches of Article VIII, Section 5.

Going forward, it would be useful to better articulate the timeframe associated with the framework for remedial action beyond the 90-day maximum period for the Board taking a decision on breach of obligations. I recognize that this will be difficult to clarify as it relates to the voluntary remedial stage; timing is likely to differ in each case depending on circumstances that contributed to the breach and some flexibility will likely be required in this context. However, the process that follows, beginning with issuing a formal statement of concern, is relatively routine, and its timing could be defined with greater precision. It would be useful if the staff could come back to the Board with proposals on this issue.

Finally, as regards the transition period, my general preference is for a relatively short transition. As noted in the report, the transition is not intended to give countries time to address institutional weaknesses (consideration of administrative capacity is already embedded in Article VIII, Section 5). With this in mind, the staff's original proposal of a one-year transition period seems adequate for members to take any necessary internal decisions, although I am willing to go along with the Board consensus on this matter.

Mr. Mozhin and Ms. Vtyurina submitted the following statement:

We thank the staff for bringing forward the proposals on how to improve the provision of data under the Fund's Article VIII.5 and strengthen the framework for dealing with misreporting of data. The issue of limitations of present data available for surveillance has been discussed on various past occasions, which makes this Board meeting a right occasion to make changes to the existing rules. We found the paper and the staff proposals to be clear, and, therefore, we will only address the specific issues for discussion presented by the staff.

We are in favor of adopting a general decision to implement the approach proposed by the staff to strengthen the provision of information under Article VIII, Section 5m and to make a more active use of the legal procedures available to the Fund in problem cases. Thus, we see the proposed uniform option to be the most adequate one among the three presented options. As Mr. Portugal and Mr. Tombini put it, the flexibility would still be preserved under this approach, as the Articles allow the staff to request additional country specific information if deemed necessary, while members' capacity to furnish information is also taken into account.

We find appropriate the expanded list of data to be provided by all members. The list of data that is required to be provided at present has become outdated, as it was established in 1944 to address the surveillance issues facing the countries at that time. It is essential for the Fund to move in tandem with the economic developments and supplement the current set of required data with additional items that better reflect the realities of the present day. We support the inclusion of both core statistical indicators and other fiscal and financial information as presented in paragraph 31 and agree with the layout in Box 4. These are fairly basic data that we deem necessary for effective surveillance. In the spirit of consistency, we would not, however, object to this list to be slightly modified so that to make it consistent with the SDDS approach, in particular regarding items iv, x, and xii.

We would favor the expanded list of information becoming a reporting obligation. Looking at the proposed list, we believe that all members will be able to furnish the Fund with this information, and this is already being done by most members. At the same time, this would give a legal basis for the staff to request such necessary information for proper surveillance from those members who are hesitant to provide such without presenting adequate explanation.

We are fully confident that the staff will be able to distinguish appropriately between cases where some of the data are not available due to a lack of technical capacity and where the authorities are just reluctant to provide such data due to their own reasons. Overall, an element of judgment should be an essential component of this exercise and a practice of giving the member a benefit of the doubt, which has always been a part of the Fund's engagement with a member, should be preserved.

We fully agree with the staff on the proposed modifications in the application of Article VIII, Section 5 in the context of performance criteria. This is, indeed, a very timely proposal, and the Thailand's case demonstrated well the rigidities and limitations of the current framework.

The proposed remedies to deal with the breaches of obligations under Article VIII, Section 5 seem reasonable and well balanced. A declaration of censure will send an appropriate signal to the authorities and the outside observers while giving the member in breach an adequate time and opportunity to rectify the situation.

We agree with the proposed 90-day maximum period for the Executive Board to consider the Managing Director's report on a breach of obligation.

We see a transition period of one year as appropriate. However, we would be prepared to join a consensus on this issue.

All information on Board decisions regarding breaches of Article VIII, Section 5 should be made public. At the same time, we are not convinced that the information about the initiation of the inquiry into the breach of an Article should be disclosed to the public, as this could lead to premature conclusions and would go against the principle of giving a member a benefit of the doubt.

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

Key Points

Strengthening data requirements is a critical element of crisis prevention. Members need to collect high quality and timely data of sufficient scope for the development and maintenance of sound and sustainable economic policies, and the Fund needs access to a robust set of data to conduct effective surveillance and perform its program functions.

We therefore welcome the staff's proposal to require an expanded set of data. At this stage, we would suggest that the Board require a slightly smaller list of data than the staff proposal. In particular, we propose that the list in Box 4 include only those data that are included in SDDS. The Board should review this list periodically, to include as soon as practical 'encouraged' items in SDDS.

We welcome the staff's proposal to set up a framework for remedial action in the case of noncompliance with Article VIII. We propose that the

Board approve a timeline to accompany this framework in order to enhance the effectiveness of the process.

We welcome this long-awaited discussion on Article VIII, Section 5. The Board had asked for this effort three years ago when the Fund took steps to strengthen safeguards on the use of Fund resources and bolster the misreporting guidelines. Those decisions have proven their worth over the last two years, as evidenced by the strong support to make permanent the policy on safeguards assessment.

Today's overdue action to strengthen Article VIII, Section 5 represents another step forward, particularly for the purposes of Fund surveillance. The Fund should be at the forefront in requiring key economic data from the membership in order to bolster our crisis prevention efforts. As emphasized in the recent IEO report on capital account crises, Fund staff and the Board are unable to conduct effective surveillance if adequate data are not provided by the member. In our view, it is also important that key economic data be available to the public.

Member's Obligations under Article VIII, Section 5

As noted in the paper, the manner in which the IMF is implementing Article VIII, Section 5 needs to be strengthened to reflect the economic realities of today rather than 1944. There are several ways in which the Fund could do this, and we support the staff's approach to require a broader set of data from all members, rather than only in program cases. Of course, the Board routinely seeks additional information from members in the context of a specific request for Fund resources. We also note the staff's intention to apply the data requirements flexibly in view of a member's capacity to provide the information. It is important that the relationship between the Fund and member continue to be based on cooperation and dialogue. As the staff notes, assessments of compliance will involve a measure of judgment.

Coverage of New Requirements

The staff proposes a specific set of additional information to be required of all members. Most of the data are already provided routinely by most of the membership. Nonetheless, in our view, the list of new data requirements in Box 4 should be adjusted to be consistent with the SDDS as several items in Box 4 are not included under SDDS and relatively few countries currently provide these data. The SDDS was created to guide members in the provision to the public of comprehensive, timely, and reliable economic and financial statistics. Currently, 53 member countries subscribe to SDDS, and it would be beneficial to move the full membership toward a common standard as quickly as possible. We understand from the staff (and welcome the staff's correction if mistaken) that the following three items in Box 4 are not required in the SDDS:

Item iv: the non-central government portion of 'public and guaranteed debt' (external debt of the public sector will be required in SDDS this fall);

Item x: 'external debt service' is only 'encouraged' in SDDS; and

Item xii: 'domestic and external public financial assets' (only external public financial assets are required under IIP).

We propose that the list of items in Box 4 be limited to those items included under SDDS. This would leave a list that is more expansive than the 'core indictors', but less expansive than Box 4. We support the proposal to phase in this approach over the next year and to periodically review the list of data to be required, including consideration of 'encouraged' items under SDDS.

Application in Context of UFR

The staff proposes various clarifications for the application of Article VIII in the context of GRA programs. While rather complicated, the staff proposals are acceptable, given that they aim to avoid nuisance cases while protecting the Fund from misuse of resources and reputational damage. We note that the guidelines for misreporting are still fully applicable.

The Framework for Remedial Action

The staff proposes an expanded framework for remedial action for cases of a breach of Article VIII, Section 5 as summarized in Chart 1. We consider the staff's proposal as a practical approach to obtaining corrective actions, noting that a declaration of censure may be more meaningful to the member than a declaration of ineligibility. We expect that this framework would be used primarily for rare cases in which a member is clearly failing to cooperate with Fund staff in providing data, which is currently the case with one member. We welcome the proposal that a public statement would be made for all Board decisions, and that the Managing Director can also make public statements during the process.

We propose that the Board approve a timeline for the actions in Chart 1 so as to generate incentives for compliance. While we would expect to rarely, if ever, reach the final stage, clarifying the timeframe could help focus the authorities' attention on the need for corrective action. Specifically, this timeline could be:

Board consideration 90 days after the MD's report, with likely Statement of Concern to Member issued at that time;

Consideration of Declaration of Censure 90 days later;

Consideration of Declaration of Ineligibility 180 days later (12 months after initial MD notification to Board);

Consideration of Suspension of Voting Rights 180 days later (18 months after MD notification); and

Consideration of Expulsion 180 days later (24 months after MD notification).

Mr. Brooke submitted the following statement:

As we have seen in the past, the provision of inadequate information to staff can significantly impede the Fund's ability to undertake its surveillance and crisis prevention responsibilities. Recognizing this possibility, the Fund's Articles of Agreement quite rightly require members to furnish the Fund with such information as the Board deems necessary. Unfortunately, however, the specific list of data mentioned in the Articles of Agreement is incomplete when viewed from the perspective of recent financial crises. Consequently, we fully support staff's proposal to expand the coverage of Article VIII, Section 5 to bring it more closely into line with the Fund's current data needs. We also welcome the intention to clarify the circumstances in which the discovery of inaccuracies in information supplied by a member would give rise to a breach of obligation.

Like Mr. Bennett, we support the inclusion of all the proposed additional information outlined in Box 4 and would be reluctant to drop any of these data series given their importance for the Fund's surveillance responsibilities. Once the new framework is approved, we very much agree with the staff's proposal that the required list of data should be reviewed periodically to ensure that it satisfies the Fund's needs.

We favor the proposed hybrid approach towards framing the new information obligations, as outlined in paragraph 27. We would, however, be willing to accept the uniform approach.

We agree with the staff's proposals for the application of Article VIII, Section 5 in the context of use of Fund resources. In these cases, the guiding principles should be to try to help prevent the misuse of IMF resources and to limit damage to the Fund's reputation.

In addressing problems of misreporting, delayed reporting and non-reporting of information, we fully agree that the Fund should rely mainly on cooperation and dialogue with members. In addition, it is entirely appropriate that Article VIII, Section 5 should continue to require the Fund take into consideration the varying abilities of members to furnish data. The Fund should of course continue to help countries to expand their statistical capabilities through the provision of IMF Technical Assistance. That being said, we see merit in strengthening the effectiveness of data reporting requirements through the adoption of the proposed framework for remedial actions.

We fully recognize that assessing whether a country has breached its obligations under Article VIII, Section 5 will involve an element of judgment. In this regard, we accept that the benefit of any doubt should be given to the member country concerned.

The proposed 90-day maximum period between the issuance of the Managing Director's report on a possible breach of obligation and a Board decision seems reasonable. We look forward to the staff working up a more precise timetable for activation of the steps outlined in Chart 1 of the staff paper. And, we agree that that relevant information on all Board decisions regarding breaches of Article VIII, Section 5 should be made public.

Given that most members are already voluntarily providing nearly all of the additional information that they would be required to provide under the proposed new framework, we do not see a need for a lengthy transition period for the introduction of the proposed obligations. This argument is reinforced by the fact that allowance will continue to be made for countries that do not have the capacity to provide some of the information. Consequently, if there is a transition period it should be kept as short as possible.

Mr. Mirakhor submitted the following statement:

We thank the staff for their useful paper. There is growing recognition by member countries of the importance of adequate data for the formulation and conduct of effective economic policy, as reflected in their increased willingness to subscribe to the SDDS or the GDDS to improve data systems, dissemination, and transparency. The membership continues also to provide the Fund with timely and wide-ranging information for surveillance purposes beyond the scope of Article VIII, Section 5, including more detailed data on international reserves and external debt, the financial sector under the FSAP, and the compilation of financial soundness indicators. It is worth noting that some member countries are even willing to provide the Fund with detailed data on individual banks and corporations within the FSAP exercise, whereas Article VIII, Section 5 states that "members shall be under no obligation to furnish information in such detail that the affairs of individuals or corporations are disclosed."

The progress in provision of extensive information by the members has been achieved because of the cooperative and collaborative approach followed by the Fund and the technical assistance provided to the membership. The Board, on the occasion of the 2002 review of data provision for surveillance, "welcomed the recent improvements in members' data provision to the Fund for surveillance purpose." While recent cases of misreporting are regrettable, we would like to emphasize the Board's strong policy reaction through the strengthening of the Misreporting Guidelines and the introduction of Safeguards Assessments. Overall, we are confident that more progress will be achieved under the cooperative, voluntary, and collaborative approach and are not convinced of the necessity of relying on more compulsory reporting of data by member countries.

Turning to the issues for discussions, our position is as follows:

We do not favor an active use of the legal provision under Article VIII, Section 5 to expand the compulsory list of information to be provided to the Fund. Instead, we continue to support the voluntary approach referred to by the staff in Paragraph 34. The Board will always have the opportunity to assess data provision by each country in the context of the Article IV surveillance exercise and during periodic reviews of data provision to the Fund. In this connection, we agree with the staff's proposal to continue to apply an element of judgment in the assessment of members' capacity to provide the required information and associated revision with the benefit of the doubt given to the member.

We support the staff's intention to avoid possible "nuisance" cases of breach of Article VIII, Section 5 in the context of use of Fund resources. However, like Mr. Shaalan and Mr. Sakr, we are not sure that the proposed framework is clear enough to avoid the application of Article VIII, Section 5 in the context of minor data deficiencies, in particular in cases listed in paragraphs 44 to 46, where no purchase was requested.

Finally, and since we are satisfied with the collaborative approach to the provision of data for surveillance purposes, we cannot support introducing a declaration of censure. The staff considers this proposal as "an appropriate remedy before imposing the sanctions envisaged under Article XXVI;" a censure would be tantamount to an additional sanction. We agree, however, that, if a member is found to be in breach of its obligations under Article VIII, Section 5, as it stands now, the relevant Board decisions should be made public.

Ms. Indrawati submitted the following statement:

We welcome the opportunity to discuss the effectiveness of data provision to the Fund under the Article VIII, Section 5 and thank the staff for preparing a well-written paper for our discussion and consideration.

We would like to highlight at the very outset that, as the staff has indicated in their report in paragraph 1 and Box 1, cases of misreporting—plus delayed reporting and non-reporting of information—are not pervasive. However, a review of Article VIII, Section 5 is useful to ensure that the Fund is not hampered by the lack of information in the discharge of its responsibilities. In this regard, we conclude that there is indeed ample evidence to show that the current voluntary framework in data provision, based on cooperation and trust, is working very well in terms of allowing Fund access to key information that it needs to carry out effectively its mandate. Member countries have in fact provided information beyond what is prescribed by the Article VIII, Section 5, including those listed in Box 4. Consequently, since the current framework has served the Fund and member countries' interests well, like Mr. Shaalan and Mr. Portugal, we do not see compelling reasons for strengthening the legal channel on data provision requirements through Article VIII, Section 5.

For the purpose of updating the Board, we would appreciate it if the staff could provide broad statistics on the compliance of member countries to the list of data under the Article presently. It would also be useful if the staff could provide some aggregated statistics on the membership's voluntary provision of data as listed in Box 4.

In determining the capacity to report, Article VIII, Section 5 is explicit in highlighting the need to spare member countries the burden of providing the information if these countries do not have the capacity to do so, i.e., that compliance to this Article is subject to "the varying ability of members to furnish the data requested". Such recognition is important not only on issues of data provision, but in many other areas that we continue to discuss in the Board, and it reflects the varying levels of development across the Fund's membership. We remain strongly supportive of the spirit of this Article which defines members' responsibilities as not an absolute obligation, but rather a conditional obligation. Hence, we continue to believe that assessments of member countries' capacity should be based on a combination of judgment and reference to best statistical practice and experience, with the benefit of doubt given to member countries. Nevertheless, we recognize that countries should also display clear intentions of continuing to improve their capacity in data provision. Where appropriate, member countries can undertake remedial measures to overcome their statistical capacity constraints.

It is worth recalling the previous Board discussion on misreporting in 2000 that, inter alia, underscored the importance of having adequate technical assistance to help improve the ability of member countries to provide reliable and timely data. We should be aware that, while statistical capacity can be improved at any point in time, it is still subject to the need for continuous improvement as data systems improve and methodologies evolve over time. Given that efforts on improving data provision have been actively pursued through numerous initiatives including the GDDS, SDDS, ROSCs, FSAP reviews, and the recently-discussed FSIs, we wonder if the Fund has made commensurate efforts to strengthen its resources in response to increasing demands for technical assistance. Paragraph 63 seems to imply that this is not the case.

With regard to remedies and sanctions, we believe that the current mechanisms are sufficient and appropriate in dealing with cases of non-compliance on data provision, as past cases have shown. Consistent with the cooperative spirit of this institution, we strongly believe that efforts in dealing with non-reporting or misreporting of data under Article VIII, Section 5 should be dealt through informal staff/management consultations and moral suasion, and ample time should be given before sanctions under Article XXVI are activated. Further, like Mr. Shaalan, we feel the Board should exercise judgment on the application of Article VIII, Section 5 in the context of UFR to avoid negligible cases being unnecessarily subjected to severe corrective procedures.

We see no merit in making public cases of non-compliance of Article VIII, Section 5 during the intermediate stages of consultation with authorities, as it would cause harm to the countries concerned even before they have an opportunity to remedy the problem fully. The credibility of the Fund would not be affected since countries would be expected to take remedial action based on advice and technical assistance from the Fund.

In summary, we favor the maintenance of the existing voluntary framework in meeting the Fund's data requirements. The cooperative nature of this institution, based on mutual trust, has proven effective in serving the needs and objectives of this institution and member countries.

Mr. Ondo Mañe submitted the following statement:

Introduction

We thank the staff for the well-written paper and management for having brought the important issue of strengthening the effectiveness of Article VIII, Section 5 to the Board. We agree that the information listed in the original Article may not respond completely to today's needs for adequate surveillance, or to monitor performance under program. However, we note also that, in practice and over the years, the Fund has implemented a number of initiatives that have led to an expansion in the coverage and scope of the data collected by the Fund, and that, the membership has cooperated voluntarily to the collection and provision of the requested data.

It is also very important that we keep in mind the varying ability of the membership to furnish the data requested, which is well recognized in the Article. Misreporting has in most cases been due to weak capacity, and not deliberate. Therefore, instead of emphasizing a strengthening of the legal requirements, we would have preferred to see more emphasis on a cooperative approach which includes the provision of technical assistance to help those countries reach the needed level. We also agree that the sanctions specified under Article XXVI for a breach of obligation are quite severe, and should be reviewed.

Specific Observations

As we noted above, the membership already provides the Fund with the data it needs to conduct its Surveillance exercise. Moreover, when data are inadequate, these are well highlighted in staff reports and are mentioned in summing-ups. Therefore, we do not see the need for the uniform approach, which also does not adequately take into consideration the specific circumstances of the individual country. We agree with Directors who are of the view that the present system has served the membership well and should be maintained. Also, we do not see the need to enlarge the list of data specified in Article VIII, Section 5, or to increase the legal obligations of the membership in the provision of these data.

As regards the data that members are legally required to provide to the Fund, the staff has rightly noted the need for an element of judgment. We agree with the staff on this, because of the varying capacity of each country. Full consideration should also be given to the efforts of each country to improve its data through revision, where necessary, and before a judgment of misreporting is arrived at, staff should make an adequate assessment of institutional capacity. Where remedial actions are seen to be required these should be given priority over the issuance of a misreporting report which will have damaging consequences for the country. Clearly, any misreporting in these cases should constitute, and be treated as, shared responsibilities.

It is also important to distinguish intentional misreporting from revision of data compiling policy. Misreporting may stem from data revisions that could occur, either as a member develops statistical capacity it may contemplate to improve its dissemination practices by compiling and releasing preliminary as well as final data, or when data are revised following a switch from one acceptable statistical methodology to another, following Fund staff recommendations. Both of these practices are quite normal and should not give rise to a breach of Article VIII, Section 5, particularly with regard to developing countries. We acknowledge however that there are limits for such specification of methodology and for revisions policy to remain practicable. To make sure that a country has breached its obligations under Article VIII, Section 5 involves an element of judgment with the benefit of any doubt given to the member. In the same context, we do not favor the publication of decisions where remedial actions have been recommended. A public announcement should be reserved only for cases when the country does not take remedial actions or where there is clear evidence of a deliberate misreporting.

We would like to put emphasis on the importance of technical assistance to help members where needed to build up statistical capacity, and that members in this situation would not be in breach of the Article for failure to report information that they are unable to provide. Strengthening the provision of information under Article VIII, Section 5 in this context is more likely to preserve the Fund's cooperative strategy for data-reporting problems. It is essential that developing country members develop their ownership.

Regarding the modifications in the use of Articles in the context of performance criteria, the current application of Article VIII, Section 5 seems to be too constraining to a member as it may be found in breach of obligation if it provides revised information. On the other hand, it seems to make sense and to be more productive by limiting the application of the Article to the situation in which information given by a member has a real impact on decision making of the Board as regards purchase in the GRA. We support the limitation of application of the Article where a member reports wrongly that a performance criterion was met or where a member intentionally makes a false report.

A sanction may be imposed on a member found in a breach of obligation. However, before going to this step, the Board has the responsibility to call on the member to address or remedy the situation that gave rise to the misreporting. We support the proposed framework for remedial action under Article VIII, Section 5 on page 28.

A time frame for implementation of the sanction as proposed by the staff will be appropriate. While we endorse the sequential steps of escalating severity, it is essential that these steps be triggered only after the new proposals of Statement of concern to member, and the Declaration of Censure are already made.

We agree with the proposed 90-day maximum period between the issuance of the Managing Director's report on a possible breach of obligation and a Board decision.

Mr. Duquesne submitted the following statement:

We thank the staff for a balanced report, which responds in a comprehensive way to a specific request made by the Executive Board several years ago. We fully support the objective of strengthening the effectiveness of Article VIII, Section 5.

We agree with the objective to include the additional list presented in paragraph 31 of the staff report in the list of data that members are required to report under Article VIII, Section 5. These data are presented as necessary for the Fund to fulfill adequately its mission of bilateral surveillance (the issue of shortcomings in data provision has again been highlighted in the recent IEO report on capital account crises). We also support the staff's proposed modifications of the application of Article VIII, Section 5 in the context of the use of Fund resources, and the proposed framework for remedial action.

As a general remark, we also emphasize that, while upgrading the reporting requirement framework, the provision of sufficient technical assistance by the Fund will be imperative.

Our responses to the specific issues listed in the nine bullet points in the staff report are the following:

We would prefer the core statistical indicators as well as other fiscal and financial information as detailed in paragraph 31 being included in the list of data which members are required to report under Article VIII, section 5. Indeed, these data are already presented on a regular basis in Article IV staff reports and, in that sense, the staff's proposal is guided by pragmatism and the realities of the Fund's activities. However, as a second best, we would be ready to consider the option raised by some Directors to limit the list in Box 4 to the data required in the SDDS.

We agree with the staff that a general decision to implement the proposed approach that will be applicable to all members is preferable. We also accept that this decision be supplemented by decisions applicable to individual members, on a case-by-case basis. In this context, we support Staff's hybrid option as it seems to strike a fair balance between flexibility and uniformity of treatment.

We support the proposal that the expanded list of information be made a reporting obligation under Article VIII, Section 5.

We recognize that the member country's capacity constraints should be duly taken into account. We therefore agree with staff that assessments of a member's capacity, the adequacy of information provided, and the implications of data revisions must involve an element of judgment, and that the benefit of the doubt should be given to the member.

We fully agree with the proposed modifications in the application of Article VIII, Section 5 in the context of the use of Fund resources. The proposed limitations to situations in which the assessment of the Board is effectively affected seem reasonable.

We support the staff's proposals regarding the Fund's remedies for breaches of Article VIII, Section 5, as it would establish a clearer framework for dealing with these cases. We also believe that a declaration of censure would be an appropriate remedy before imposing the sanctions envisaged in the Articles of Agreement. It is however important that, before issuing the declaration, the Fund issue a statement to the member setting out its concerns and giving the concerned member the opportunity either to rectify the situation or to express its position. For remedial measures to be effective, both the statement of concern and the declaration of censure would have to be made public.

We agree with the idea of establishing a timeframe of 90 days after the issuance of the Managing Director's Report within which the Board would have either to confirm that a member has breached its obligation or to require factual clarification.

Regarding the question of a transition period, we could go along with the suggested one-year period.

We strongly support the publication of all Board decisions regarding breaches of Article VIII, Section 5 as well as the publication of management's decisions to delay the completion of an Article IV consultation because of a member's failure to provide requested data. In our view, increased transparency, on this issue among others, is crucial in improving the effectiveness of Fund surveillance and its ability to prevent financial crises from occurring.

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

We welcome the opportunity to discuss the issue of how to strengthen the effectiveness of Article VIII, Section 5. The discussion is clearly overdue, considering that the request for it was made by the Board as long ago as in March 2000.

Before commenting on the issues for discussion, we would like to express our appreciation to the staff for producing a concise and candid paper for today's meeting and make a few preliminary observations.

First, we would like to note that in a cooperative institution, such as the Fund, members are required to display cooperative behavior. This should be understood as a fundamental obligation of membership and not just as a question of good will. Failure to share with the Fund information that the Fund needs in order to perform its functions, let alone the provision of information that is known to be inaccurate at the time when it is provided, does not constitute cooperative behavior. In that sense, it could be seen as entailing a breach of a member's obligations under the Articles, regardless of whether the information that the Fund had requested was explicitly mentioned in the Articles of Agreement.

Second, we recognize that the aforementioned interpretation of a member's obligations under the Articles may not be generally acceptable and that, in any case, it may be too broad to be of much use in practice. We also are aware that it has not been an interpretation that has been used in the past in making judgments on the applicability of Article VIII, Section 5. Thus, we welcome the proposals in the staff paper as they can contribute to greater clarity as regards members' obligations to provide data to the Fund and can also help establish a reasonable system of remedial actions, if such obligations are not met.

Third, we note that the staff paper mainly focuses on strengthening Article VIII, Section 5 from the point of view of safeguarding the Fund against cases of misreporting that may arise in conjunction with the use of Fund resources. We believe that strengthening Article VIII, Section 5 provides the appropriate legal framework to cover data requirements in the context of surveillance. All in all, the strengthening of Article VIII, Section 5 would reinforce the cooperative nature of this institution, since member countries would provide the Fund with the necessary legal tools to enable it to discharge more effectively its functions.

Issues for Discussion

We are in favor of the proposal to adopt a general decision identifying the information categories to be provided by the membership. We agree that this could be supplemented occasionally by specific decisions applicable to individual members. However, we would be concerned if the Board had to consider such specific decisions very often and we would hope that their use will be limited to a few cases in which past cooperation has been especially unsatisfactory.

We are somewhat flexible as regards the scope of an expanded list of data that members are required to report under Article VIII, Section 5. In principle, we would see merit in a list that defines the general categories broadly enough so as to encompass all the information the Fund needed to effectively carry out its surveillance function. This would argue for a list along the lines spelled out in paragraph 31 of the staff paper. However, we recognize that some members may have difficulty providing information on all the indicators in that list. For this reason, but also for the sake of avoiding a proliferation of lists of statistical indicators, we would be prepared to accept a somewhat shorter list consisting of all indicators in Box 4 that are included in the SDDS.

We agree that assessments of members' compliance with the enhanced data reporting requirements should continue to involve an element of judgment, to take into account especially a member's capacity to collect data, and that in all cases the benefit of any doubt should be given to the member.

For cases involving data provision in the context of use of Fund resources, we are willing to accept the staff's proposals.

Similarly, we are pleased to endorse the new framework for remedial actions proposed in the staff paper.

It is essential, in our view, to establish a transition period before the proposed expansion of the list of required information would take effect. In fact, such a transition period—that could be quantified at a later stage—would be needed to enable all member countries to carry out the necessary improvements in their statistical systems so as to confidently meet the new legal obligations arising in the provision of data to the Fund from the modification of Article VIII, Section 5. This seems to us an appropriate way to address the issue—mentioned in the same Article VII—of varying ability of member countries to provide the Fund with the data requested.

Finally, in the interest of transparency, we agree that relevant information on all Board decisions regarding breaches of Article VIII, Section 5 should be made public.

Mr. Usman submitted the following statement:

To perform its functions, the Fund relies on the cooperation of members on the provision of information and data. As rightly stated by the staff, inappropriate or incomplete information can affect the quality of Fund advice to members and, as such, it tends to undermine efforts towards a timely response to a potential crisis situation. We are therefore in agreement with the staff that the Fund continues to rely especially on the cooperation and dialogue with its members towards alleviating any unforeseen problems and to find ways of addressing them.

Although Directors have recognized the need to strengthen the reporting of information under Article VIII, Section 5 in the context of all Fund activities that are subject to the Articles, due cognizance should be given to the various disparities in the capacities of all its members. The provision of data under Article VIII, Section 5 should therefore be dependent upon the member's capacity to provide the needed information. The Article also permits the Fund to require members to provide it with other information that it considers necessary for its activities, including surveillance and Fund financial assistance. While we agree that this is relevant, we are of the view that such information could be obtained in other surveillance exercises.

On the other main issues for discussion, we would like to comment as follows:

While we would support the decision for the implementation of a general approach applicable to all members, we hasten to caution against the one size fits all approach which fails to take cognizance of the different levels of development of the member countries and their differing abilities to furnish required data.

The proposal to extend the list of data requirements is not considered necessary, given that the Fund could obtain data from members by other means. As earlier mentioned, information can be obtained from members through Article IV consultations, the FSAP reviews, SDDS, and GDDS mechanisms already undertaken by members on a voluntary basis.

In this connection, we would prefer to see a completely voluntary system of reporting. Considering the level of technical assistance needs of most of our members, the two-year period of evaluation of compliance would only be appropriate if massive technical assistance support would be provided to members identified to have such needs.

We agree that assessments of members' capacity to report relevant information, the adequacy of what has been provided, and the implications of data revision must continue and remain to be an element of judgment. This should be based on the best statistical practice and experience, with the benefit of the doubt given to the member.

As rightly stated by the staff, it is essential to recognize that there is a tradeoff between the timeliness and accuracy of data, and that improvements in methodology often have "teething problems," which could lead to temporary inaccuracies.

We support limiting the application of Article VIII, Section 5 to situations in which a purchase was made on the basis of the information provided by the member and the granting of a waiver for non-observance of a performance criterion. Caution should, however, be exercised with regard to program countries and those currently emerging from conflict, whose statistical databases would still need to be improved. The application of the Article should be limited to misreporting and unmet performance criteria, and more importantly, limited to situations where the need to safeguard Funds resources become apparent.

The proposals with regard to remedies for breach of the Article in order, considering the period involved for corrective action to be taken by a member prior to embarking on a "declaration of censure." However, it is very vital for a distinction to be made between what is considered an error in relation to what is to be considered as misreporting.

> We cannot find in the document under discussion how the proposal for a 90 day maximum period between the issuance of the MD's report on a possible breach of obligation and a Board decision arose, neither to the breaches nor to the remedies. However, if we are to consider it, we would prefer to have a 180 days period between a breach of obligation and a Board decision.
>
> A transition period of three years would be appropriate, considering the issue of need for technical assistance requirements of our members mentioned earlier. This would help develop capacity for most program countries and those emerging from conflicts.
>
> We do not support the publication of all information on Board decisions regarding breaches of the Article. We are of the view that it is the prerogative of the member country to decide on whether to publish or not.

Extending her remarks, Ms. Jacklin said that she wished to apologize for the late addition to her preliminary statement, in which she had proposed a timeline for the framework for remedial action. The proposal should give a proper balance that would permit the country to take corrective actions before further remedial actions would take place. It would be interesting to hear Directors' views on that proposed timeline, as well as on the proposal to include only the categories of data that were currently required under the SDDS.

Mr. Zurbrügg commented that, while he was flexible as to what the expanded list should contain, the aim should be to expand the coverage of data provision under the Article rather than maintaining the status quo. He had proposed that the expanded list include the core statistical indicators, not the SDDS required list, because, given the fact that the present system of data dissemination was two-tiered—the Special Data Dissemination Standard (SDDS) and the General Data Dissemination System (GDDS)—it would appear unreasonable to impose the SDDS as a general standard on the whole membership.

Mr. Martí made the following statement:

> This is an excellent report by the staff and I certainly appreciate its quality. I will just make five or six comments on what I believe are the main points that we should consider.
>
> First, the staff provides reasonable arguments on the benefits of its proposal to expand the list of required information under Article VIII, Section 5. The current list is clearly outdated and expanding it would adapt it to the realities of the Fund's activities or the realities of the current world. We are, however, not persuaded that it is necessary to make this a legal obligation of member countries. The Fund has been able to establish over time a satisfactory working relationship with a large majority of its members, and the authorities are, as a matter of fact, only too willing to provide most or all of

the information required for the purposes of a comprehensive Article IV consultation or for a specialized report.

The staff says as much in paragraph 35, and the Fund can be proud of the level of cooperative support lent by its members. Why, then, should we modify a status that has proved its worth, especially when the status quo has not been frozen, but is evolving over time to embrace additional or more detailed information? Given the multilateral and cooperative nature of the institution, we tend to favor this formula. We prefer to see the Fund in its tasks of advisor and provider of technical assistance rather than as an institution claiming rights on the basis of legal powers. We think that this agrees more with the spirit of the words in paragraph C of Article VIII, Section 5, which states that the Fund may arrange to obtain further information by agreement with members. This is how the Fund has been able to move flexibly from the tight framework of Article VIII, Section 5 to the current list of indicators that most countries are providing. The staff has done a great job in achieving this, and member countries have consistently shown their commitment to the cooperative nature of the institution. This voluntary system of reporting additional information would come as the staff suggests, with a two-year period of evaluation. The issue could be brought to the Board again after that period.

Second, the staff states that we may be confronted at times with egregious cases. Like Mr. Reddy, we think that having a legal framework is no better for dealing with such cases than operating a provision based on effective peer pressure. The Fund is not going to take a member country to court over the provision of data, but at the end of the day, the staff will not be able to perform its tasks if it does not receive the relevant information from the member country. This may entail serious consequences for the member concerned.

Third, as in our discussion on financial soundness indicators, we admit that an expanded set of data is an improvement of the set of core indicators currently provided. We suggest, however, that the distinction between "core" and "expanded" should not be seen in rigid terms nor fixed in time. The process of adding to and improving on existing requirements is dynamic if macro analysis broadens over time and scope, thus requiring new analytical tools. Member countries have gone well beyond the requirements of Article VIII, Section 5 and can no doubt move further yet to embrace the concepts of an expanded set at a speed that takes into account the ability to furnish the data in the terms of Article VIII, Section 5, that is, the amount and quality of the resources that countries can effectively engage to enhance their statistical capacity. In this context, we tend to emphasize the need for continuing technical support from the staff, and the updated guidance note announced in the report is certainly welcome.

Fourth, there is merit in the provisional framework proposed in the report and we do not object to the introduction of a declaration of censure even if we tend to dislike this particular word "censure." We do not object to making it public either. Given the disproportionate nature of the formal sanctions as envisaged in Article XXVI, an additional intermediate step involving renewed direct contact with the member country is welcome as a way to ensure that all possible avenues have been tried to persuade the member country to cooperate.

Fifth, at the same time, we are aware that the Board will want to make sure that noncooperation by a member country can be attributed to reasons other than difficulties with the complexity of the statistical requirements of modern policy making. Conclusive evidence will have to be put forward that the problem did not arise from deficiencies in the country's statistical capacity. Let us bear in mind that not every country has the resources needed to systematically review the actual implementation of the methodologies and criteria applied by the compilers of primary data and then later on in the process. The actual quality of data depends on how often and how efficiently this exercise is carried through. We would like to emphasize again that the Fund could play a crucial role in assisting the authorities through the surveillance of their statistical procedures from the primary sources all the way to the final output.

Finally, we agree with the staff that delaying the completion of Article IV consultations cannot be used to punish a member, but we draw a different conclusion from the mere fact that the consultation could not take place in due course. We believe that market perception is a factor that adds pressure on countries whose regular consultation with the Fund appears to be overdue without any good reason. Financial institutions, rating firms, and export credit agencies update at intervals their country risk files by referring to the Article IV staff report as a basis for their review. Delays in the publication of the report tend to be read that not all is well in relations between the Fund and that particular country, and many creditors would prefer to wait and see before they make proposals to renew credit lines or country ceilings. That factor, the noncooperative attitude of the authorities, brings about serious consequences for the country, irrespective of whether sanctioning procedures have been activated by the Fund.

Mr. Wei made the following statement:

Today's discussion provides a good opportunity for us to discuss how member countries could improve in providing data to the Fund. We thank the staff for a concise and clear paper laying out the topic for today's debate. To begin with, let me make a few general observations.

First, I agree with Mr. Shaalan and Mr. Sakr, Ms. Indrawati, and others that the existing framework for meeting the Fund's data requirements is working well. As pointed out in Mr. Shaalan's and Mr. Sakr's statement, while there is always scope to improve the effectiveness of the Fund's policies, we do not believe that expanding the legal obligation of members is the way to go. The best way to go is for us to continue to pursue with enthusiasm the cooperative, voluntary, and collaborative approach.

Second, it is important to describe the voluntary nature of data provision to the Fund as reflecting the cooperative culture between the Fund and its member countries. Based on this principle, many countries have provided comprehensive data to the Fund even beyond the scope of Article VIII, Section 5. No one doubts that improved domestic statistical systems and enhanced data provision to the Fund is in the interest of member countries, as these data will more accurately and promptly reflect the economic situations and policy analysis at both the country and global levels.

We also agree with others that the GDDS, SDDS, FSAP reviews, and recently discussed financial soundness indicators have served the data provision purpose as additional channels.

Third, we should have full trust in the authorities of member countries with respect to data provision to the Fund. What impedes some countries, developing countries in particular, from doing this is, to a large extent, their underdeveloped statistical systems and lack of competent human resources. In this connection, the Fund should cooperate more closely with member countries to help them address data deficiencies. Increasing the data provision threshold and tightening sanctions for failure to provide adequate information may harm the cooperative culture and not do much good.

In this regard, more technical assistance aimed at enhancing member countries' statistical capacity is essential. Mr. Martí has just made comprehensive remarks on the issue of countries' reality and statistical capacity, as well as the importance of Fund technical assistance. I fully share his comments. With these general observations, I would like to comment on some of the key issues raised by the staff.

First, we agree that member countries should be encouraged to provide core macroeconomic data to the Fund to enhance the effectiveness of Fund surveillance. However, given the considerable disparities across member countries in the development status and statistical levels, the Fund should avoid setting a high data provision threshold for member countries without taking account of the realities in developing countries and difficulties they face. In this vein, further study is needed on the revised list of core statistical indicators and other fiscal and financial information proposed by the staff to see whether every member country can meet the requirements, including the information criteria and reporting frequency.

Second, as further study is required on the proposed list, we favor a voluntary system of reporting this additional information. We support the staff's suggestion to review the provision of these data in two years' time to assess to what extent and how frequently member countries can report to the Fund. Experience in capacity building and in strengthening statistical systems can also be shared at the next meeting.

Third, the benefit of the doubt should be given to a member when the Fund assesses its capacity to report required information along with the adequacy of data and any data revision.

Fourth, we thank the staff for clarifying the circumstances in which Article VIII, Section 5 will apply in the context of performance criteria under Fund arrangements. What we should bear in mind is that there should be a distinction between deliberate and unintentional misreporting, and between normal and abnormal data revisions. As a matter of fact, even the most advanced economies sometimes revise their published data by a large margin. We, therefore, are of the view that the application of Article VIII, Section 5 should only be considered when a serious loss occurs to Fund resources owing to deliberate misreporting.

We take note of the staff's efforts to formulate a procedural framework for the Fund's remedies and sanctions for breaches of Article VIII, Section 5. Several remedial measures before finally invoking Article XXVI have been suggested by the staff. We share the view that remedial action should first focus on preventing a reoccurrence of the data deficiency. At the same time, for the sake of a member country's reputation, which is a serious issue, it is more appropriate that we try to deal with the breach internally rather than disclosing the decision to the outside world. What we hope is that the country can make a swift correction. We need to provide an appropriate interval of time between issuing a declaration of sanction and its final release, thus giving the country concerned a final chance to safeguard its reputation.

In conclusion, we reiterate the voluntary principle for member countries to provide as much data as possible to the Fund. In the meantime, the adequacy of data provision for surveillance purposes is carefully assessed in Article IV staff reports. At the current stage, it is premature to add the revised data list to the information list required under Article VIII, Section 5. The Fund can help member countries to provide comprehensive data through capacity building technical assistance.

Mr. Josz made the following statement:

Let me begin by saying that we still disagree on the staff's interpretation of Article VIII, Section 5(a) on which they base their proposals. They contend that a country's legal obligation to furnish information to the Fund is limited to the items explicitly named there as the minimum needed for the Fund to discharge its duties effectively.

We believe that a country's obligation to furnish information to the Fund goes far beyond the contents of this list, and that the misreporting of data that are essential for the Fund's surveillance but that are not included in this list (e.g., the fiscal deficit), is a breach of a country's obligation under Article VIII, Section 5. All data provided to the Fund are presumed to be accurate, and the provision of information beyond the list in Article VIII, Section 5 is not based on a country's free choice to cooperate with the Fund, but on its obligation under the Article.

Based on this interpretation, it follows that there is no need for a decision to make providing the information on the items listed in Box 4 a legal obligation under the Fund's Articles. That is already an obligation, with which members, to the best of their various abilities to provide data, have already been complying for years, as shown by Article IV consultation staff reports that we consider almost daily. But, this being said, I can support a gratuitous decision confirming the obvious, namely, that members are obliged to provide correct data concerning the core items listed in Box 4.

Under our interpretation, it would also be unnecessary, and a waste of the Board's time, to adopt an individual decision every time a new item is to be added to a country's list of obligatory data reports, as suggested by the staff in paragraph 27. The staff, under the direction of the Managing Director, has received, from the Board, the authority to require information that it deems necessary for the fulfillment of the Fund's duties. Making that delegation of power explicit is a much more simple, flexible, and effective way to strengthen the effectiveness of Article VIII, Section 5 than the current set of proposals to expand the list of items that countries must report to the Fund. The Executive Director concerned has the right to ask for a ruling by the Board if his authorities believe that the staff is seeking information beyond what is needed to carry out the Fund's duties. That the Fund's information needs should have changed over time with the enormous changes in the world economy since 1945, should surprise no one. The history of requests from the staff for new kinds of information, implicitly ratified by the Board as belonging to a country's obligation to provide the Fund with accurate information, reflects the continuing evolution of the kinds of information that the Fund needs and countries must provide.

It also follows from our interpretation of Article VIII, Section 5 that there is no need for a transition period before entry into force of the proposed expansion of the list of the minimum necessary information that countries must provide to the Fund. According to our interpretation, the expanded list already belongs to the data that countries, to the best of their various abilities, must provide to the Fund.

Finally, I agree with the proposed framework for remedial action, subject to the following caveat with respect to publication: in order to avoid confusion, Board decisions annulling a confidential conclusion by the Managing Director that a breach of obligation has occurred, should not be published.

Mr. Callaghan made the following statement:

Like many others, we agree that the effort to improve data should be based on a cooperative approach. We think that it is more relevant to convince countries that it is in their own interest to improve their data than essentially threaten them with a legal stick. As far as possible, a voluntary, cooperative approach should be the hallmark of this institution's activities. The more we rely on legally specifying what members must do, the more we will get into debates of legal technicalities and legal niceties. Maybe I am missing something for I do not think that what is being proposed in the paper represents a radical departure from a voluntary, cooperative approach to data provision. We would not support anything that did.

Also, I think that what is being proposed fails to give due recognition to the need to take into account the capacity limitations that members face. A voluntary, cooperative approach to doing business should be the mainstay of our operations, and as others have noted, this approach is working well in allowing Fund access to the key information it needs to carry out its mandate. But, there will be rare, egregious cases when cooperation is not working, and we should be able to deal with such cases. Hence, we broadly support the thrust of the measures being proposed. But, undermining this endorsement is the assumption—if not the recognition—that the application of the measures being proposed will always have to be sensible, pragmatic, and not dominated by legal technicalities. The benefit of the doubt should be given to the member.

Many of the concerns that Directors have raised about the staff's proposals seem to stem from the fear that we are going down a path of a strict, black letter application of legal provisions where members will be held in breach of matters that are beyond their control and capacity, or for honest mistakes. I hope that is never the case.

As regards the specific proposals, the hybrid approach to expanding the information provided by members under Article VIII, Section 5 seems sensible. Even if the uniform approach was adopted, the Board would presumably always have the capacity to adopt an individual decision for a member if warranted by specific circumstances. It has to be very specific circumstances. Uniformity of treatment is a fundamental principle and there should be a substantial justification if country specific action is required.

We are broadly comfortable with the expanded list of information outlined in Box 4. Nevertheless, I have some sympathy with the view that has been expressed that one of the existing data sets, like the SDDS, should be the basis for data provision, and we should not introduce a slightly different set of data requirements. But most importantly, the general capacity-based limitations on members' obligations must apply such that no member would be in breach of Article VIII, Section 5 for the failure to report information that they are unable to provide. The concept of reasonableness has to come into judgment. It has to be reasonable to expect a member to provide the data. This should handle concerns that have been raised over a member's administrative capacity to compile the data. As noted previously, the benefit of the doubt should be given to the member.

We agree to the proposed application of Article VIII, Section 5 in the context of performance criteria under Fund arrangements. Some Directors have said that a judgment should be made as to whether there was ill intent when it comes to misreporting cases. It has also been raised that any breach should be material. These are reasonable concerns. However, we think that the arrangements address these concerns. There is allowance for data revision and, as the paper notes, well understood and documented revisions regardless of the motivation and magnitude is a welcome element of data dissemination. I would think that errors are a normal source of data revisions.

In addition, the graduated remedial action provides the opportunity for the members to address data errors once detected. If there was no ill intent behind the misreporting, the member will presumably be willing to take the necessary remedial action. The remedial measures have to be carefully and sensitively handled. The current sanctions provided under Article XXVI are like using a sledge hammer to crack a nut. The proposal for a declaration of censure as an intermediate remedy for cases of breach of obligation is appropriate. However, the declaration of censure can have significant reputational harm on a member. This reinforces again that, in assessing the application of Article VIII, the benefit of the doubt should be given to the member.

As regards the timetable for actions, Ms. Jacklin's proposal seems reasonable in terms of the appropriate transition period for the new arrangements. Given the extent of the concerns that have been expressed over what is being proposed, we would urge a longer period rather than a shorter one.

Mr. Alazzaz made the following statement:

In addressing the important issues raised in the staff report, a number of considerations should be taken into account.

First, there is no doubt that countries do their utmost to collect economic and financial data not for the sake of collecting them but because it is essential for monitoring economic developments and formulating appropriate policies. Needless to say, it is also clear that such data should be provided to the Fund in order to allow the institution to discharge its duties. Here, I take comfort in the fact that countries provide all available data to the Fund in a cooperative manner and not because it is an obligation under Article VIII, Section 5.

Second, misreporting or non-provision of data to the Fund that is necessary for surveillance is a very serious concern and additional efforts to minimize such cases should be considered. At the same time, it is essential that the cost of the effort does not exceed the benefits. Therefore, the Fund should not overburden members by using an approach to address a problem relating to very few countries. It is also worth noting that evenhandedness and equity of treatment of members are characteristics that this institution should strive to maintain.

Third, the main strength of the Fund, as has been stressed by many in the Board, is its cooperative nature and its consensus decision-making approach. It would be most unfortunate to shift from this proven and successful approach to a legalistic one that relies on additional obligations for all the membership to resolve the very few cases of noncooperation on data issues. Here, it is critical to differentiate between cases where misreporting or nonprovision of data is inadvertent or due to capacity constraints and those that are deliberate.

Taking all the above considerations into account, my strong preference is to continue with the current system of reporting. After two years we can evaluate compliance and assess the extent of the problem, if any. In any event, if there are any egregious cases of nonprovision of information or misreporting, the staff, after exhausting all available avenues to reach agreement with the concerned country, could come to the Board for a decision under Article VIII, Section 5 on that specific case. Of course, a country's capacity to produce the needed data, the cost of collecting this data, as well as the priorities and budgetary constraints of the country need to be fully taken into account. Here, I agree with the staff that an element of judgment will always be required and that the benefit of any doubt should be given to the member.

On the modifications of the application of Article VIII, Section 5 in the context of use of Fund resources, I can endorse the staff's proposal.

Turning to the proposals for the Fund's remedies for breach of Article VIII, Section 5, I do not see much value in changing the current system. Indeed, the application of the graduated voluntary approach, the publication of the Board's decisions regarding the breaches of Article VIII, Section 5, and the sanctions outlined in Article XXVI are more than adequate to address the problem. In this connection, whether or not to make public Article VIII, Section 5 decisions should be decided on a case-by-case basis. Let me reiterate here my strong belief that it will not be in the interest of anyone for the Fund to be perceived as moving away from a cooperative to a coercive mode.

Finally, if there is a broad majority in the Board to expand the list of required information, the focus should be on a few core statistical data. Moreover, it is important to give countries a transitional period of at least two years and provide the needed technical assistance to help them compile the required data.

Mr. von Kleist made the following statement:

The staff should be commended for a well-focused paper. With the objective of strengthening the effectiveness of Article VIII, Section 5, the staff's proposals overall strike a fair balance between measures that may imply additional efforts by part of the membership and others that relieve the burden of conforming to Article VIII, Section 5 in its current version. We agree with the thrust of the staff paper.

Overall, the staff has made a convincing case for aligning the information members have to provide to the Fund under Article VIII, Section 5 with what is currently necessary in order for the Fund to efficiently fulfil its surveillance function. Such an alignment is timely, if not overdue, for several reasons: First, the current data coverage of Article VIII, Section 5 still reflects the situation of more than 50 years ago. Second, updating the coverage is first and foremost in the interest of the members themselves, since it improves their capabilities to pursue sound economic policies. Third, expanding the coverage would guard against situations in which members could decide to discontinue the provision of important data to the Fund that they provided voluntarily before. This may unduly restrain the Fund's ability to act appropriately, particularly in times when a member experiences economic stress. Finally, an expansion of the coverage would increase the incentive of those members that have not yet done so to subscribe to the SDDS.

At the same time, the so called "hybrid approach", which we support, represents a good compromise between the necessary uniformity of treatment among the membership, limiting the burden on members as well as on the staff and giving the Fund the necessary, legally secured flexibility to require additional information.

That being said, regarding the appropriate range for the expansion of the obligations under Article VIII, Section 5, we very much sympathize with Mr. Zurbrügg's and Mr. Moser's view that the proposal contained in Box 4 of the staff report might be somewhat overambitious in terms of keeping an appropriate cost-benefit balance and given the finite and differing statistical capacities of members. In this vein and for the sake of reaching a broad-based consensus in the board, we see merits in limiting the mandatory data reporting requirements to the prescribed SDDS data categories. I would welcome staff comments on this question of the consistency of the SDDS prescribed reporting requirements, the GDDS, and today's discussion. The new approach can be phased in over one year. Apart from aiming at a single unified set of data information for Fund purposes, as a further benefit, this would—as also noted by Ms. Jacklin and Mr. Baukol—increase the incentive to subscribe to the SDDS for those members that have not already done so. The application of the above mentioned flexibility seems particularly warranted with regard to information on the external debt service called for under the staff's proposal in Box 4. Taking into account the economic rationale behind this data category, it seems reasonable to limit the collection of such data to net debtor countries, which, due to their status, face increased vulnerability to external shocks. Moreover, we agree with the staff that, in assessing the adequacy of a member's information provision, due regard should be given to its statistical capacity. However, the proposed benefit of the doubt should not be given indefinitely, and we understand that members, with the support of the Fund, are urged to increase their efforts to swiftly address existing deficiencies in their statistical systems.

Regarding the application of Article VIII, Section 5 in the context of use of Fund resources, we support the introduction of limitations as proposed by the staff, which will efficiently avoid nuisance cases.

For the well-founded reasons noted in the staff report, we are also in favor of the proposed procedural framework for the application of sanctions and remedies in case of a breach of obligation under Article VIII, Section 5, including the introduction of a maximum 90 day timeframe for the Board to reach a decision on a possible breach. The proposed expansion of the sanctions toolkit by a declaration of censure will ensure the proportionality between the gravity of the breach in the one hand and the severity of the respective sanction on the other. Furthermore, such a declaration would give the member concerned an additional opportunity to initiate remedial actions and, thus, underlines the cooperative character of the framework. We see the benefits in terms of enhanced effectiveness of Ms. Jacklin's and Mr. Baukol's proposal to assign a pre-specified timeline to the framework for remedial action. We would, however, regard such a timeline as a general guidance for the timing of board action rather than as a strict rule.

The following is essentially a moot point, but we would have preferred a discussion of today's issue closer to the May 2002 discussion on "Data Provision to the Fund for Surveillance Purposes."

Finally, we strongly support the publication of all Board decisions under this framework.

Mr. Bennett remarked that it was important for the Fund, with its diverse membership and international character, to have a clear understanding on what was voluntary and what was mandatory. The debate, in his view, was being waged on the wrong grounds. It was not over the question of changing from a consultative, cooperative organization to a coercive one. Rather, the debate should be on what was considered important for the essential functioning of the organization, which should then be made mandatory for its members. The provision of data went to the heart of the Fund's mandate. Making the provision of data a mandatory obligation of members did not necessarily change the cooperative nature of the organization. It signaled to its members the importance of providing a specific set of data for the Fund to discharge its mandate and for the countries themselves to enhance their credibility. As stressed by Mr. Wei and a number of other Directors, the Fund should provide technical assistance to countries. If the Fund attached great importance to data provision and made it mandatory, it would enhance the credibility of those who would devote more resources to helping other members that had difficulty in providing the required data.

On the expanded set of required information, while he preferred the list contained in Box 4 to the SDDS list, he could go along with a consensus on SDDS, Mr. Bennett stated. Progress would likely be made over time toward expanding the data coverage to those items listed in Box 4.

As regards the timeline, Ms. Jacklin had made a useful proposal, which he could support, Mr. Bennett continued. The application of that timeline, however, should be based on the understanding that, before issuing a statement of concern, every effort had been made and sufficient time had been given to the country to address the problem.

Mr. Portugal disagreed with Mr. Bennett's interpretation of the purpose of the staff's proposal to expand the coverage of data required under Article VIII, Section 5. He recalled that a number of Directors had argued that the staff's proposals were acceptable on the grounds that the list of data specified in Article VIII, Section 5 was outdated, that the data contained in Box 4 were information that countries already provided to the Fund, and that the importance of data for surveillance purposes had also been emphasized by the IEO.

Mr. Bennett's argument that the staff's proposal was intended to indicate what data were important was a misunderstanding of the staff's proposal. The objective of the proposal was not to obtain more data, as the Fund already received most of the data needed and well beyond the requirement under Article VIII, Section 5. The objective of the staff's proposal was to make it easier to punish member countries that provided inaccurate data to the Fund. That was the substance of the current discussion.

The staff's proposal for punishment could make sense if the policy on misreporting were more reasonable, which unfortunately was not the case, Mr. Portugal continued. He fully agreed with Mr. Vittas and Mr. Lombardi that the provision of information that was known to be inaccurate at the time of the provision was not reflective of a cooperative behavior and should be considered a breach of obligation of the Article. However, that was not the definition of misreporting under the existing policy on misreporting; it was a definition of "deliberate" misreporting. The Fund's policy on misreporting was one of objective retribution, of punishing countries whenever inaccurate data had been provided for whatever reason, and without regard to intent, negligence, or materiality of the inaccuracy itself. Such a policy was not sensible, as it did not create the right incentives for countries to provide data and improve the quality of data, on the one hand. On the other hand, it did not create sufficiently strong disincentives for countries to eliminate the undesirable behavior, namely, the intention of misreporting, with the objective of deceiving the Fund or of getting some advantage. The staff's proposal would give more teeth to a policy that had been wrongly conceived. For this reason, he was not in favor of it.

Mr. Josz agreed with Mr. Portugal that one of the key objectives of the current discussion was to strengthen the remedial framework. Another key decision that the Board had to make was on the scope of the legal obligations of members under Article VIII, Section 5. The current wording of the Article covered far beyond the legal obligations and beyond the items listed in the Article. As it stood, the Fund might require members to furnish it with such information as it deemed necessary for its activities, including the minimum necessary for the effective discharge of the Fund's duties. The proposed decision would limit members' obligations to only the minimum specified in the Article plus additional items as proposed. The question was whether that would be the only legal obligation, or whether a broader interpretation would be more appropriate. The Board's interpretation of the legal obligations of members under Article VIII, Section 5 would have important implications.

Mr. Brooke said that, on Mr. Portugal's comment that most countries already provided more data than those outlined in Box 4, the staff paper issued for the Board discussion on statistics in July 2002 showed that the number of countries that complied with the core data, not even the SDDS requirements and not even those contained in Box 4, was only about 130 countries. A considerable number of countries were still not meeting the core standards. All Directors recognized the need to make allowances for countries' varying capacity and to support the provision of technical assistance to build up statistical capacity. He fully endorsed Mr. Bennett's comment that the purpose of the proposal to expand the data coverage under Article VIII, Section 5 was to highlight to members the importance attached to those issues and where more effort should be put to make progress. He did not agree with Mr. Portugal's suggestion that there was no need to address the issue of data provision on grounds that it had already been dealt with by the Fund. In fact, it continued to be a serious issue, and the staff's proposals seemed to receive considerable support.

On the appropriate list of information that should be required—the items in Box 4, the SDDS required list, or the core statistical indicators—the aim should be to secure the largest body of support for a single list, Mr. Brooke commented. He could support the SDDS list if that were the option to receive most support, which appeared to be the case.

Ms. Jacklin's suggested timeline for the remedial actions seemed reasonable, but he wished to hear the staff's reactions, particularly with regard to the downsides, Mr. Brooke said. The staff should consider what would be the most appropriate timeline when presenting more detailed proposals to the Board.

Mr. Shaalan said that, after reading most of the preliminary statements and hearing Directors' interventions, he was even more convinced that the voluntary, cooperative approach was really in the best interest of the Fund and the membership. The negative impacts of legal threats and technicalities on the institution and the cooperative approach should not be underestimated. He fully agreed with Mr. Portugal's comment that the focus of the paper was on punitive measures for providing inaccurate data regardless of the reasons, which he found unacceptable. Corrective action should be taken only when the Fund determined that the country in question had, indeed, provided inaccurate information with the intention of misleading the Fund.

Mr. Portugal said that he agreed with Mr. Josz's point that the expansion of the list of required information constituted a legal obligation for member countries, but the purpose of doing so, in his view, was not to obtain more data but to make it easier to punish countries. The staff did not propose methods for improving the flow of data to the Fund because members currently provided adequate and reliable information far beyond their obligations. That should be dealt with as an issue of trust, shared objectives, and shared values. No legal framework or mechanism of enforcement could adequately deal with the provision of data in cases of noncooperation. If the aim were to obtain more data, the staff's proposal was simply the wrong tool. The most effective tool to ensure timely and reliable data was to maintain the current system of mutual trust between the Fund and each member, which had been operating properly while providing incentives for members to correct genuine reporting mistakes arising from weak domestic reporting systems, from data revisions, or from normal errors, which, unfortunately, were quite common. A system that treated genuine mistakes in reporting—which were not even material for the purpose for which the data were being provided—as a punishable event created adverse incentives for the correction of genuine mistakes. That view seemed to be a minority position in the Board.

Ms. Jacklin said that she shared Mr. Callaghan's and Mr. Bennett's comments. Timely and quality data provision was at the heart of the future success of the Fund. A number of past crises might have been prevented or mitigated at an earlier stage if the authorities had made clear, accurate, and timely data available to the Fund staff. It was important that members strive to meet their obligation under Article IV consultations in terms of sound economic policies that contributed to the stability of the system, and that the

Fund successfully perform its surveillance activity by keeping apace with the evolving economic and financial systems. The staff's intention should not be misinterpreted as strengthening the penalty mechanism. Rather, its purpose was to raise the standards of the institution and, as pointed out by Mr. Bennett, to provide members with additional persuasive arguments within their own capitals for allocating resources to the development of data, which was essential to the development and maintenance of sound policies. Embedded in the proposed sanctions on pages 21–23 of the staff paper were references to judgment and the need to give the benefit of the doubt to members, which were consistent with the voluntary, cooperative nature of the institution.

Mr. Mirakhor asked that the staff from the Legal Department clarify whether there was any legal obstacle under the present provisions that prevented the Board from imposing remedial action in the most egregious misreporting cases. He wondered if any aspect of the existing remedial framework needed to be fixed and, if so, what would be the most appropriate approach.

Mr. Lombardi clarified that, on Mr. Portugal's remarks, the third paragraph of his preliminary statement had referred to an instance in which a member provided information that was known to be inaccurate at the time when that information was provided. That was only one of the possible cases of uncooperative behavior to which he was referring.

As regards the proposal put forward by Ms. Jacklin and Mr. Baukol, the idea of specifying ex ante a time frame for remedial actions was worth pursuing, although it might seem too tight, Mr. Lombardi noted. It would be interesting to hear the views of other Directors and the staff.

Mr. Miyoshi said that he agreed with Mr. von Kleist, Mr. Callaghan, and in particular Mr. Bennett that the staff's proposals would not change the Fund's approach from a cooperative to coercive nature. As stated in his preliminary statement, the Fund should, as part of the comprehensive strategy, intensify efforts in other related areas, such as building good relationships with the authorities and providing technical assistance in the area of data provision. Although the staff paper focused on strengthening the effectiveness of the legal framework, it was part of that comprehensive strategy.

On the time frame proposed by Ms. Jacklin and Mr. Baukol, he shared Mr. Callaghan's view that, while it appeared sensible, the Fund should err on the longer period rather than the shorter period, Mr. Miyoshi said.

While some Directors argued that the proposal to expand the categories of information under Article VIII, Section 5 did not provide a good incentive for the purpose of data provision to the Fund, he viewed it more in terms of Fund governance, as the existing list of data required under the provision had not been changed since 1945, Mr. Miyoshi continued. It was important that the Fund adapt to the current circumstances, and hence to re-specify what types of data were necessary for its activities. He thanked Mr. Brooke for pointing out that only 130 of the total 184 member countries were currently able to meet the core statistical indicators. Based on that information, it was not reasonable to support the proposal to use the prescribed SDDS data list as the basis for expanding the data coverage under the Article. The staff did not provide sufficient analysis of the cost and benefit implications of requiring additional information, and did not provide any information about the number of countries that could not meet the SDDS requirements, or how long it would take those countries to provide such information. Japan had subscribed to the SDDS and did not expect to have any difficulty in complying with the expanded list to include the data required in the SDDS. At the present time, he would hesitate to support the proposal to expand the list to include the SDDS required data or those proposed in Box 4 until the cost and benefit analysis was conducted.

Ms. Indrawati said that the importance of data provision for the Fund to perform its functions was indisputable. The question was how to determine remedial action for rare cases of misreporting or noncooperation. She supported Mr. Mirakhor's call for further elaboration on the effectiveness of the current mechanism for dealing with the cases involving problems with the reporting of information in Box 1 of the staff paper. The staff noted in paragraph 49 that no sanctions had been imposed in any of the misreporting cases listed there, and yet the authorities had adopted remedial measures. That supported the views that the current graduated approach was already effective, and that there was no need for adopting a new remedial framework, whose value added was not clear.

Mr. Martí said that, in his past experience working on insurance cases, he had frequently used Fund reports and thus was well aware of the importance of accurate and timely data. For many countries, the non-availability of recent Article IV staff reports meant that their credit lines would not be renewed or would be cancelled altogether. To answer Mr. Bennett's question, what was considered important was, indeed, the provision of data to the Fund because markets would make decisions based on the information that was processed through the Fund. The idea of sanctions and penalties was not desirable, and the experience with its application had proved to be unsatisfactory in some parts of the European Union. If the Fund staff had not received adequate information to complete its Article IV consultation with a member country such that a staff report could not be made available, markets would consider that omission a serious matter and would exert pressure on that country to improve its relationship with the Fund.

There was no such thing as "cooperative" in an absolute sense; it had to be viewed along the legal/cooperative continuum, Mr. Martí observed. Emphasis on the legal aspect tended to tilt the organization more or less slightly in the direction of relying on its legal aspect as opposed to the voluntary, cooperative aspect. It would be much more appropriate for the Fund to stand on the cooperative side than on the legal side.

Mr. Egilsson noted that there was not substantial disagreement among Directors on the current procedures and the way forward. Directors agreed that statistics were most important for economic management and decision-making by governments. That was the overriding purpose of collecting economic data. The obligations under Article VIII, Section 5 were pertinent to the realities 50 years ago. It was justifiable to modify the list of core data every 50 years. In so doing, due consideration should be given to the relevance of those data over the next 50 years. The provision of data to the Fund was, in a sense, a moving target, as it was expected to change over time along with changes in the requirements in any given country and in response to government needs for specific types of data.

Sanctions were not practical, except in cases of deliberate misreporting linked to the use of Fund resources, which was the focus of the current staff paper, Mr. Egilsson considered. Nobody disputed that the Fund should have a framework for remedial measures and sanctions to deal with those undesirable cases of misreporting in the context of the use of Fund resources. Any disagreement on this issue should be played down. The main question was what should be the minimum data required from member countries over the next 50 years.

Mr. Mirakhor noted that, in addition to Mr. Egilsson's comment, two sets of comments deserved consideration by the Board—one by Mr. Josz and the other by Mr. Martí. Mr. Josz had pointed out that the staff's proposal to expand the data coverage could undermine the strength of the present Article VIII, Section 5. Under the existing provisions, the Board could, at any time, make a decision to impose remedial actions. It might choose not to do so because it had felt that flexibility was called for in some cases. One of the remedies, as Mr. Martí had suggested, was for the staff to recommend that the Board not complete the Article IV consultation on grounds of insufficient information, in the same way as in a program review where a recommendation was made not to complete a review. Such a decision was indeed a serious remedy—a decision that the Board was empowered to make without having to resort to a series of new decisions that would move the institution away from the generally accepted cooperative framework. The proposed remedial framework would give a misleading sense that the Fund was moving toward coercion.

Mr. Ondo Mañe, supporting Mr. Mirakhor's proposal, said that the importance of data was well recognized. The main problem facing developing countries was a lack of clarity of economic policy. The issue at hand should be discussed after the Board discussion of the paper on the role of technical assistance, which was particularly important for the countries in his constituency. It was difficult to bring all technical assistance experts in the field together in order to compile the data that would present a complete picture of the country's economic situation. Countries were expected to be more transparent by providing more data. However, the imposition of a punitive measure for not providing the requested data would send a wrong signal and might lead to resistance. The role of technical assistance experts in the field was still not clear at some levels of decision-making. In some countries, a Director of a Statistics Department could face strong censure or be removed from office if the advice of technical assistance experts were not to be followed. What was more important than punishment was to strengthen the cooperative nature and to raise the authorities' awareness of the importance of data provision at all levels of decision-making. As a global institution, the Fund had to take account of the different levels of development and technicality of its members. Care should be exercised when making decisions on the issue of data provision to the Fund, especially since the current system was working well.

Mr. Zurbrügg said that he had suggested a more modest proposal to include only the core statistical indicators with the expectation that it would force countries that did not comply yet with these core standards to upgrade their statistical data standard. The staff made it clear in the paper that a member that demonstrated its incapacity to furnish the required information would not be found in breach of obligation. As of the present time, 130 countries already reported the core statistical indicators to the Fund. The question was whether the staff intended to assess the capacity and progress of the remaining 54 countries on an annual basis. It was his understanding that the Fund would push those countries to make progress toward the new minimum standard for surveillance purposes.

The Director of the Policy Development and Review Department (Mr. Geithner), responding to questions and comments from Executive Directors, made the following statement:

> I was going to make some general comments and then, with your permission, suggest that Legal Department and Mr. Fetherston respond to some of the more detailed questions.
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> Let me make a few general points. Are these proposals merely important for the Fund or are they necessary for the Fund? Our view, of course, is that they are both important and necessary; otherwise, we would not have proposed them. They are important because the provision of appropriate data to the Fund is the foundation for effective surveillance, and because the Fund is a financial institution whose members have the contingent right to draw resources from the institution. In that context, it is sensible to define a set of minimal obligations that accompany membership, and provision of data to the Fund with an appropriate scope is a reasonable place to begin to define those obligations.
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> Are they necessary for the institution? Although the memory of the cases that motivated this paper may have faded, those cases were quite awkward for the institution. It is our view that the measures that we have taken since then and the progress we have seen in the voluntary provision of data do not themselves provide an adequate basis for the reduction of the risk of future cases of that character. While institutions are often accused of being excessively preoccupied with fighting the last war, it is reasonable to say, as a minimum, that we should address the weaknesses in the current framework that left us vulnerable to those cases, and at least try to narrow the scope for a recurrence of those cases.
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> Is the regime too harsh? Does it create the risk of gratuitous legal issues around innocent offenses in data reporting? Again, our view is that we offer a sensible, pragmatic balance. The overwhelming emphasis remains on the voluntary, cooperative approach. We emphasize repeatedly the importance of giving the benefit of the doubt to the member. We make it clear that we cannot establish an obligation to provide data that the member does not have the capacity to provide. We propose a rather generous transition period to help reduce some of the concerns associated with excessive ambition. And, the

> proposed regime gives substantial capacity for discretion in judgment not just by management, but by the Board itself.
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> Is the proposed standard for data unreasonably high? It is our view that we have made a reasonable proposal. Let me say something about the principal distinctions between our proposal and the core statistical indicators we define for the purposes of surveillance. There really are two types of gaps in that context. One is reporting on the aggregate balance sheet of the banking sector, which we think is reasonable to include in that minimum set of requirements for members as an obligation of membership in the Fund, simply because of the overwhelming importance of those indicators. The other is information on the balance sheet of the public sector where our proposals go beyond the core set of indicators, so as to ensure that we have a picture of the liabilities of the public sector. For reasons I do not fully understand, the existing core indicators do not actually prescribe a picture of the liabilities of the public sector as part of those core data necessary for the conduct of surveillance. I can understand the reservations expressed about the scope of the definition of the public sector. But, some picture of the liabilities of the public sector themselves seem to be reasonable for us to define as necessary for the ability of the Fund to conduct its business.
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> I would like to address one specific question and then turn it over to my colleagues. We have not had a chance to look in detail at the procedural time frame, proposed by some Directors, that would follow the initiation of the regime we have laid out here. We have looked at them quickly, but have not had a chance to evaluate them fully. At first glance, they look reasonable, but we would want to have a chance to look at them more carefully before we committed to a view on whether they strike the right balance.

Mr. Mirakhor thanked the Director of the Policy Development and Review Department for his comments. The case had already been made many times both inside and outside of the institution that if the Fund had had the kind of information that it should have had, probably the crises could have been avoided. There had been no clear idea in the Board as to what kind of information could have helped prevent those crises, which should have been requested from members. Although there was no counterfactual information, he was convinced that such information would have made little difference irrespective of the data provision system or the remedial regime. He agreed with Mr. Josz that the current provision was far stronger than the one proposed by the staff. Crises were not predictable; neither were the causes. One could not foresee what kind of information would be required for the next crisis and amend the current system accordingly. An important question remains whether the Article VIII, Section 5, in its current form—with the general language that every member had an obligation to provide the kind of information that the Fund needed in order to carry out its duty, not that the member thought they should provide—had any weakness that should be corrected. Whether or not the proposed regime was in place, a crisis would still occur because no one knew ex ante what kind of information would be necessary to have that might be able to help prevent the crisis. The balance sheet of the banking system, for example, had not been considered relevant before the recent crises had occurred. Otherwise, the staff would have required such information from the members concerned.

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

> I would just like to address a couple of specific questions raised in Directors' preliminary statements and interventions. First of all, on the basis for the 90-day time frame that is part of the staff proposals on the remedial framework, one of the statements answered this question quite effectively by suggesting that this would ensure that the matter is treated within a reasonable period while still giving the Board enough time to study the case.
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> On the extent to which countries already provide data according to the various lists, I would like to clarify that the extent to which countries provide information on the core indicators list is considerably higher than this morning's discussion may have suggested. The last paper on data provision for surveillance contains the results of a survey of 133 countries for which staff reports were issued during a specified 12-month period. Thus, it does not cover the entire membership. The actual rate of data provision from that group of 133 countries on average across the core indicators is about 97 percent. As regards the consolidated banking system balance sheet, the latest issue of *International Financial Statistics* has information on this for around 170 member countries.
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> Moving to the other areas where we are proposing to go beyond the core list, it is somewhat more difficult to come up with quick concrete indicators. We have some statistics for two areas—lower levels of government and the SDDS. On the former, about two-thirds of the membership published information on lower levels of government in the recent issue of the *Government Finance Statistics Yearbook*. Of that, about half provided information on the flow operations of lower levels of government, and about one-fifth showed some information on the debt stock of those lower levels of government.
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> Regarding the questions on the SDDS and the time taken for countries to come into compliance with it, there are currently 53 countries that comply with the SDDS, and the average transition period for new data categories introduced into the SDDS is typically three years. It is important to keep in mind that the SDDS is not just about providing a certain set of data; it is also about meeting standards for timeliness and periodicity of those data. In many cases, countries may also be producing data on a certain category, but they need time to be compliant with the SDDS, not on that score, but because they do not produce it with sufficient frequency or sufficient timeliness. So, there is a bit of an apples-and-oranges issue in comparing the requirements for coming

into compliance with the SDDS with the staff's proposal in this paper, which only addresses coverage issues.

The staff representative from the Legal Department (Mr. Leckow), responding to legal questions and comments from Executive Directors, made the following statement:

Let me begin by responding to the points made by Mr. Josz in his intervention before turning to some of the questions raised in the various statements, including that raised by Mr. Mirakhor.

With respect to the position that Mr. Josz indicates—that no Board decision is required to get additional information from members and members are already under a legal obligation to report information additional to what is specifically listed in Article VIII, Section 5(a)—we do not share that view. The reason is that Article VIII, Section 5 gives the Fund the power to require additional information from members. In this context, the Fund means the Executive Board, not staff or management. It can only be said that the Board has required particular information if there is some Board decision setting out that information and giving members notice that they have to provide it. The Fund has never taken the position that other information provided by members in the context of a consultation is required for the purposes of Article VIII, Section 5. In this regard, it is important to remember that, in dealing with cases of information misreporting, the Executive Board is in a rather unique position. It is, on one level, an agreed party, a party to the proceedings. It is the prosecuting attorney. It is the judge and ultimately the jury. This places the very high standard on the manner in which the case should be dealt with. Basic principles of due process demand that great care be taken by the Board to ensure that, in determining whether a member was under a particular legal obligation or not, that obligation has a firm legal basis rooted in the Articles or in a decision of the Board. For these reasons, we take the position that for the Board to require additional information under Article VIII, Section 5, there has to be a Board decision requiring it.

Mr. Portugal, in his statement, questioned whether Article VIII, Section 5(c) precludes the Fund from requiring additional information under Article VIII, Section 5(a). Again, we simply do not share the interpretation that he adopted in his statement. Article VIII, Section 5(c) simply recognizes the Fund's practice of obtaining additional information with the agreement of the member; it does not preclude the Fund from requiring additional information under Article VIII, Section 5(a). Article VIII, Section 5(a) expressly empowers the Fund to require additional information, that is, additional information from that specifically listed in the provision for the effective discharge of the Fund's duties. Article VIII, Section 5(c) refers to the Fund obtaining by agreement information further to what is required under Article VIII, Section 5(a).

> Mr. Portugal also questioned whether the obligation to report the information that is specifically listed in Article VIII, Section 5(a) is a continuous obligation or not. Before examining this, it is important to ask what a continuous obligation really means. It means that a member is under an obligation to report the information that is specifically listed in Article VIII, Section 5(a) without the Fund having to ask for it; and within the capacity limitations of the particular member to keep the information as up to date as possible.
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> The reason for this approach is that Article VIII does not specify any particular periodicity for the information that is required, as specifically listed in Article VIII, Section 5(a). It must be interpreted for this reason as being continuous. This is particularly important when one remembers the purposes for which the information will be used, in particular, surveillance. Surveillance is itself a continuous process, and the information that the Fund needs in order to carry on this process needs to be updated on a continuous basis.

Mr. Josz remarked that Article VIII, Section 5(a) stated, "The Fund may require members to furnish it with such information as it deems necessary for its activities, including, as the minimum necessary for the effective discharge of Fund duties, national data on the following matters." That meant that the legal obligation to furnish information to the Fund went beyond the twelve items listed under the provision. The staff's interpretation of Article VIII, Section 5(a) that members' obligation for the purpose of surveillance was limited to those twelve items was not correct. It was of concern that such an interpretation could limit the legal obligation of members to a certain set of data and thus weaken Article VIII, Section 5(a).

Mr. Mirakhor asked what had been the enabling decision from the Board that had allowed the staff to request additional information as had been practiced so far. To achieve the objectives of the proposed modifications, including the remedial framework, could the Board instead adopt a simple decision requiring members to provide the additional information under Article VIII, Section 5?

The staff representative from the Legal Department (Mr. Leckow), responding to Mr. Mirakhor's question, explained that, effectively, the staff was proposing that the Fund adopt a decision requiring additional information in the form of a simple Board decision. It would be possible for the Board to adopt that decision while refraining from establishing a formal legal framework for remedies and sanctions.

With respect to Mr. Josz's intervention, the focus was on the first three words, namely, "the Fund may require," with the most important word being the Fund, Mr. Leckow continued. Some positive action must be taken on the part of the Executive Board to require members to provide additional information, which would establish a legal obligation. However, the Board had never taken such action. Information other than that specifically listed in the provision had been provided voluntarily by members.

Mr. Josz said that he recognized that point. For that reason, he had proposed an alternative whereby the Board would empower the staff to seek the information that it deemed necessary, and allow the respective Executive Director to seek a Board ruling if he or she considered that the staff had gone beyond the scope of that Article. By maintaining some ambiguity about the scope of Article VIII, Section 5, such an approach would strengthen, rather than weaken, the Article.

The staff representative from the Legal Department (Mr. Leckow) replied that it was not clear if the Board would have the authority to do so, the reason being that the power to require information from members under Article VIII, Section 5 was the power that had been delegated to the Board by the Board of Governors. The Articles of Agreement gave the Board of Governors the express authority to delegate certain powers to the Executive Board. There was, however, no comparable mandate that gave the Executive Board the authority to delegate such types of power to management. There was a basic legal principle that the delegatee—the person to whom a power has been delegated—could only delegate that power to someone else with the express permission to do so.

Mr. Shaalan did not agree with the legal interpretation, which he considered too restrictive. The Board had power to carry out surveillance and, for that purpose, it could request additional information.

The staff representative from the Legal Department (Mr. Leckow), responding to other comments from Executive Directors, made the following further statement:

> Mr. Portugal and Mr. Shaalan in their statements questioned whether the application of Article VIII, Section 5 should be limited to cases in which the failure to report or the reporting of inaccurate information was intentional on the part of the member. This is an issue that has been raised in previous discussions on misreporting. For a number of reasons, the staff believes that it would not be possible to limit the application of Article VIII, Section 5 in this manner.
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> First of all, Article VIII, Section 5 says nothing about intention. It requires members to report information in an accurate manner. It does not limit cases of breach to intentional ones.
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> Second, as a practical matter, it is often very difficult to establish whether a particular nonreporting or inaccurate reporting was intentional. One can really distinguish between cases of failure to report versus cases of inaccurate reporting. With respect to the first group of cases—cases where the member has openly refused to provide particular information, or where it is clear that the member either has the information or is capable of providing it, and is failing to provide it—presumably, it would be possible to determine some level of intention. With respect to cases of inaccurate reporting, it becomes much more difficult. It places the Fund in the position of having to engage in what is really a forensic investigation, which it is ill suited to

conduct. It also raises the question as to whose intention is relevant. Do we have to determine that the cabinet of the government of the country intended to mislead the Fund, or is it enough that a relatively junior official in the government or in the central bank openly falsified data? Is there enough reason for that junior official to mislead the cabinet or mislead the Fund? These are all very difficult questions and are very difficult to resolve in practice.

Finally, in some case, it can be argued that intention is factored indirectly in the assessment of a member's capacity. Clearly, if a member lacks the capacity to produce particular information, it cannot be said that the member somehow intended to breach its obligation under the Article. Perhaps one can consider intention as part of the analysis.

Mr. Portugal also asked whether it would be possible under Article VIII, Section 5 to establish some sort of margin of error before determining whether a member was in breach of obligation. Again, a margin of error is indirectly taken into account in the sense that, in assessing whether a member has the capacity to produce particular information, the Fund will look at how close that member, given its circumstances, could reasonably expect to come to the correct number. Obviously, a member that misses a target by a small amount as opposed to a large amount will be more likely to be able to argue that it lacked the capacity to do better than it did.

Finally, Mr. Shaalan, in his statement, raised a question as to whether it would be possible to limit cases of breach of obligation under Article VIII, Section 5 to cases in which the particular nonreporting or misreporting was somehow material to a decision taken by the Executive Board. What I believe he was asking is whether, having determined that a member misreported and that the member possessed the capacity to do better, the Board could decide whether the particular nonreporting or inaccuracy was somehow material in reaching a decision of the Board. While it is possible to take such an approach, it requires the Fund to adopt one of two mechanisms.

The first is for the Executive Board, on a case-by-case basis, to specify ex ante what particular factors are relevant for the adoption of a particular decision that it takes. An example of this would be the specification of prior actions in a Board decision under the guidelines on misreporting. What the Board is saying up front is that these are the particular prior actions that are relevant for the purposes of this decision.

Alternatively, the Board can again ex ante, as a general matter, say that certain types of categories of information will always be deemed to be material for a particular purpose, such as Article VIII, Section 5. This essentially is what I think the Board would be doing today in the sense that, with respect to the specification of the data listed in the expanded list for the purposes of surveillance, and also with respect to the circumstances in which misreporting of performance criteria in the context of the use of Fund resources would give rise to the application of Article VIII, Section 5, the Board is saying upfront that these types of categories of information will always be material for the purposes of Article VIII, Section 5. What the Board cannot do—and this is something we have said in previous discussions of misreporting—is to ex post, after the fact, enter into a determination as to what factors were relevant and what factors were irrelevant for a particular decision. This, again, comes back to the unique position of the Board in dealing with these cases. It is often the case in domestic legal systems that a third-party tribunal, a court, will be asked to determine the intention of the parties in particular situations. And, as a disinterested and impartial third party, a court can enter into that analysis. The Board is in a different position. It is not really a disinterested third party; it is on one level a party to the proceedings. And it is for that reason that the Fund has always taken the position that, in determining what is material, it has to be done before the decision is taken rather than afterwards.

Finally, on the question raised by Mr. Mirakhor as to whether it would be possible for the Fund, on a case-by-case basis, to call upon members to take remedial action, as an alternative to the imposition of sanctions under the Articles, the answer is yes, it would be possible, and this is the approach that has been taken in previous cases involving a breach of Article VIII, Section 5. Ukraine, in particular, comes to mind. It would be somewhat more difficult with respect to some of the more formalized measures we have referred to in the paper, such as declaration of censure. Given the more formal nature of that action, it would be preferable if the Board were to provide for its imposition pursuant to a general Board decision adopted up front.

Mr. Portugal said that the staff's explanation that 97 percent of the membership already provided the core information lent further support to his argument that the purpose of the current discussion was not to obtain information but to strengthen the punitive framework. In his interpretation, paragraph 10 of the staff paper, which stated that the aim of strengthening the provision of information under Article VIII, Section 5 was to provide the Fund more effective tools to address cases of misreporting, confirmed that the aim of the discussion was to provide tools to punish countries.

The staff's interpretation of his point regarding the ability of the Fund to obtain additional information was not correct, Mr. Portugal pointed out. He had not maintained the position that the Fund could not require additional information under Article VIII, Section 5. Rather, he had noted that the Fund should do so by agreement with members, which was the current practice, as provided for in Article VIII, Section 5(c).

On the question of whether the obligation under the Article was continuous or not, it would be useful if the staff could provide the definition of "continuous," Mr. Portugal added. He could not accept the staff's position that because the periodicity for reporting the required information was not specified under the Article, therefore, the obligation was continuous in nature. It was not a logical interpretation of the Article.

As regards the question of intent, while it was difficult to judge intent as noted by the staff, it was not impossible to do so, Mr. Portugal argued. The courts had to routinely make that judgment. Information was being provided, and should be provided by members as was currently practiced under the cooperative approach. Cases of noncooperation should be dealt with severely. There were two types of uncooperative behavior, both of which deserved punishment. One was the refusal to provide information that was available and other members regularly provided. The other was the provision of inaccurate information deliberately, in bad faith, or as a result of gross negligence, a negligence that could be avoided by average or modal diligence. The problem was that, contrary to the argument put forth by the Director of the Policy Development and Review Department, the current policy on misreporting did not provide ample scope for discretion, as they did not look into intent or materiality. While it was not possible to specify in detail upfront what was material and what was not, at least the policy should contain some quantity element. For variables reported in millions of units, for example, misreporting by one unit should not be judged to be in breach of obligation. None of the staff reports on these issues had ever discussed either the materiality or the intent of misreporting.

Mr. Nijsse requested that the staff elaborate on the procedural aspect of the hybrid approach, in particular how it would depart from the current practice. Under the proposed hybrid approach, it was not clear whether the staff would come to the Board for a specific decision in each individual case where a member refused to provide the required information, or the Board would adopt ex ante a set of decisions on the specific types of information required from particular countries. If the former were to be the case, his chair could agree to either the hybrid or the uniform approach. In the case of the latter, the uniform approach would be preferable to the hybrid approach.

On the issue of data standards, the existing SDDS or the core data should be used instead of inventing a slightly different standard, Mr. Nijsse continued. If the existing standards were not adequate for surveillance purposes, perhaps consideration should be given to modifying them rather than adding a new standard.

The staff representative from the Policy Development and Review Department (Mr. Fetherston) replied that the first scenario outlined by Mr. Nijsse was envisaged for the hybrid approach, namely, that the staff would seek a Board decision only when there was a need to address the specific situation of a member. The staff did not have an ex ante list of country-specific decisions.

Ms. Jacklin explained her position that she could accept the hybrid approach as further clarified by staff. When presenting the Board with specific proposals, she asked that the staff also offer its views on the timeline for remedial action.

Mr. Miyoshi thanked the staff for its helpful comments and statistics and shared Mr. Egilsson's comment that exerting too much pressure on national authorities could be counterproductive. The comment by the Director of the Policy Development and Review Department that the staff's proposed framework would give substantial scope for discretion in the application of Article VIII, Section 5 was a cause for concern. Discretion, while desirable and necessary, came attached with legal implications for members. The Fund should bear in mind that a breach of obligation to provide information had legal consequences in the form of sanctions. Therefore, the degree of discretion in this context was of particular importance. Although the staff had argued that members would not be in breach of obligation under Article VIII, Section 5 for their failure to report information that they were unable to provide, a large number of those having difficulty complying with the obligation would likely request technical assistance in this area. Requests for technical assistance could be expected to rise substantially. While the provision of sufficient data was desirable, excessive pressure could create uncertainty among a substantial number of members. Requiring data beyond the core indicators could have considerable implications, particularly for technical assistance.

The Acting Chair (Ms. Krueger) made the following summing up:

Executive Directors emphasized the importance of accurate, timely, and comprehensive information for every aspect of the Fund's activities, including surveillance and financial assistance. The Articles of Agreement and decisions of the Executive Board establish a legal framework for the reporting of information by members. Article VIII, Section 5, a central pillar of this legal framework, requires members to report certain types of information for the purposes of the Fund's activities. More specifically, it lists several categories of information as the minimum necessary for the Fund's activities and empowers the Fund to require additional information from members. The Fund's Articles also specify sanctions that can be applied in those relatively rare cases involving breaches of obligation that are not amenable to cooperative approaches. All Directors expressed strong support for the voluntary and cooperative approaches underlying the Fund's relations with members and underscored the importance of preserving it even as the legal framework for data reporting is clarified and strengthened.

Directors discussed the manner in which the effectiveness of Article VIII, Section 5 could be strengthened. They agreed that the coverage of categories of information in the provision is now relatively narrow, given changes in the international economy, and excludes key categories of monetary and fiscal information. Directors also reviewed the application of Article VIII, Section 5 to avoid a possible proliferation of nuisance cases. They acknowledged that the sanctions specified under Article XXVI for a breach of obligation have rarely been applied, perhaps in part because they are relatively severe.

Directors noted that the voluntary cooperation of members in providing the information the Fund needs to conduct its operations is working well. In recent years, several initiatives based on such a voluntary approach—

notably the Special Data Dissemination Standard (SDDS) and the General Data Dissemination System (GDDS), as well as Reports on the Observance of Standards and Codes (ROSCs)—have resulted in an increase in the quantity and quality of data provided to the Fund and to the public. In addition, nearly all member country authorities have promoted the development and dissemination of economic and financial data to improve the national policymaking process and national ownership of sound policy reforms. As a result, members now provide extensive information to the Fund that far exceeds the requirements of Article VIII, Section 5, which was crafted to reflect the realities of 1944.

Against this background, Directors considered how best to update the provisions of Article VIII, Section 5, in particular by expanding the scope of the minimum data requirements. A majority of the Board agreed that it would be useful to adopt a decision of general applicability expanding the coverage of Article VIII, Section 5 to bring it more closely into line with the Fund's data needs. This would help ensure that the Fund has the information needed for effective operations, including surveillance, and strengthen incentives to provide accurate information by aligning members' reporting obligations more closely to the actual practice in most cases. Directors favoring this approach felt that it is fully consistent with, and supportive of, the voluntary and cooperative nature of the Fund. Many Directors, however, favored retaining the present coverage of Article VIII, Section 5 and the Fund's continued reliance on the voluntary provision of additional information, which they felt are more consistent with the voluntary and cooperative nature of the Fund and avoids an overly formalistic approach. It was noted that the Fund's Guidelines on Misreporting do not distinguish between intentional and unintentional misreporting and do not give consideration to the materiality of instances of misreporting. Some Directors suggested that these aspects of the Guidelines on Misreporting should be reconsidered.

Directors discussed the data set members would be required to provide to the Fund under Article VIII, Section 5. Many Directors favored modifying the staff proposal to exclude elements that go beyond the requirements of the SDDS, while a number of Directors supported requiring the core set of data for Fund surveillance. They noted the need to ensure that the information required includes the minimum needed for effective surveillance, while avoiding an undue proliferation of data requirements, or requirements that are over-ambitious, in light of capacity constraints and institutional limitations in many countries.

A majority of the Board agreed that those data requirements that would be applicable to all members could be supplemented by specific data requirements for individual members if warranted by the specific circumstances of the member, while cautioning that the Board should refrain from excessive case-by-case specification to ensure uniformity of treatment of members. Directors also agreed that, to allow members time to ensure their compliance, the additional information reporting requirements would come into effect one year after the relevant Board decision.

Directors also agreed to limit the circumstances under which Article VIII, Section 5 would be applied in the context of performance criteria associated with the use of the Fund's general resources. The Article will apply only in situations in which (i) a purchase was made on the basis of the information provided by the member, or (ii) the information was reported to the Board in the context of a review which was subsequently completed or of a decision of the Board to grant a waiver for non-observance of a performance criterion; moreover, Article VIII, Section 5 will only apply where a member reports that a performance criterion was met when in fact it was not, or where the member reports that a performance criterion was breached by a particular margin and it is subsequently discovered that the margin of non-observance was greater than originally reported. This approach would not affect the application of Article VIII, Section 5 outside the context of performance criteria in the General Resources Account.

The vast majority of the members provide the Fund with the core statistical indicators for Article IV surveillance, while 53 members currently subscribe to the SDDS. Nevertheless, Directors acknowledged that technical capacity varies across the membership. It is therefore appropriate that Article VIII, Section 5 establishes obligations for members to report information to the Fund only to the extent that they have the capacity to do so. Directors noted that assessments of members' capacity to report required information, and the implications of data revisions, must continue to involve an element of judgment on the basis of best statistical practice and experience, with the member being given the benefit of any doubt. They also stressed the importance of the Fund's technical assistance in strengthening members' capacity to provide the needed information, and considered that the provision of technical assistance to help members meet their obligations under Article VIII, Section 5 should be given high priority. Directors underscored the need to preserve the voluntary nature of existing data dissemination standards, and to continue efforts to pursue cooperative approaches to resolving data reporting problems.

Directors also agreed to adopt a new framework of procedures to be followed and remedies to be applied in cases in which a member is in breach of Article VIII, Section 5. Specifically, in cases in which a member reported required information inaccurately, or failed to report it, despite having the capacity to do so, the Fund would act in accordance with a framework of procedures that takes account of remedies and corrective actions voluntarily taken by the member and, where such measures proved insufficient, sanctions imposed by the Fund. As one element of this framework, Directors agreed to establish the practice that, within 90 days of issuance of the Managing

Director's report on a possible breach of obligation under Article VIII, Section 5, the Board will take a decision on the potential breach. Some Directors favored developing an indicative timeline for subsequent actions by the Board. Most Directors supported the proposal for a declaration of censure as an intermediate step before the imposition of sanctions under Article XXVI.

Directors considered the issue of publication of relevant documents under the proposed remedial framework. A majority of the Board agreed that actions taken by the Board regarding breaches of Article VIII, Section 5 should be published, as should decisions by management to delay the completion of an Article IV consultation due to a member's failure to provide adequate data for effective surveillance. It was agreed that actions other than those respecting the delay of an Article IV consultation should be made public only after the Board has decided that a breach of obligation has occurred. Therefore, the Managing Director's initial reports on possible breaches of obligation and intermediate Board requests for further clarification would not be published. Directors acknowledged that publication of misreporting and delays in Article IV consultations could unduly stigmatize countries that had difficulty reporting accurate information but were taking steps to overcome them, and could also undermine the authorities' credibility and lead to adverse reactions by financial markets and credit-rating agencies. It was therefore agreed that, consistent with the policy on misreporting adopted in 2000, the information will be released in a way that clarifies the circumstances of the particular case, and that the Board will be given the opportunity to review the text of the public announcement.

Directors asked staff to return to the Board with proposed decisions reflecting the conclusions of this meeting, including a revised proposal for the data set that members would be required to provide to the Fund.

2. REPUBLIC OF POLAND—2003 ARTICLE IV CONSULTATION

Documents: Staff Report for the 2003 Article IV Consultation (SM/03/181, 5/19/03; and Sup. 1, 6/3/03); Selected Issues (SM/03/187, 5/22/03); and Report on the Observance of Standards and Codes—Fiscal Transparency Module—Update (SM/03/196, 6/3/03)

Staff: Schadler, EU1; Ebrill, PDR

Length: 1 hour, 10 minutes

Mr. Szczuka submitted the following statement:

The documents prepared by the staff for today's discussion present a comprehensive picture of recent developments and trends in the Polish economy, and of the numerous challenges still facing the policy makers in my country. In line with the already well-established tradition, the Polish authorities consent to the publication of all these documents. My authorities broadly share most of the staff's conclusions and are very grateful for the staff's effort to provide sound policy advice. The challenge, as always, is to find a way of implementing such recommendations in a given political and social environment.

This Board's discussion on Poland takes place at a very important moment for my country, just one day after the referendum on accepting the EU Accession Treaty. While the outcome of this referendum is not yet known at the time of submitting this statement, my authorities certainly hope that it will be overwhelmingly positive, and will pave the way to Poland's full EU membership starting from May 1, 2004. Joining the EU can be considered the crowning moment in Poland's economic and political transition that started almost 14 years ago. My authorities needed to invest a lot of their energy in concluding the complex negotiations process and ensuring a successful result of the referendum, but they are firmly convinced that the full integration with the EU remains the best option for Poland's future. However, the forthcoming EU membership also opens several new challenges for the economic policymaking in my country. Among the most important ones are certainly the need to simultaneously pursue the real and nominal convergence objectives, to ensure the most efficient use of the EU funds, and to select the most appropriate path to joining the euro area.

Recent developments and prospects: recovery long in coming.

Last year's staff report referred to a "nascent recovery" that could prove "strong and durable". In this year's report, staff again uses the same term (with more stress on risks and fragilities) which may suggest that this expected upturn has an unusually long "incubation" period. The delayed and hesitant global recovery, and in particular the weak economic conditions in Europe, certainly contributed to this unfavorable outcome, but the ongoing slump in investment as well as some other domestic factors also played an important role. Several developments, however, suggest that the last year has brought some further improvement, and that the Polish economy, gradually but steadily, has been gaining strength and reducing its vulnerabilities. The quarterly GDP growth rate increased from 0.4 percent in the first quarter of 2002 to an estimated 2.2 percent in the first quarter of this year, and - according to official projections - the growth rate for the whole 2003 can still reach about 3 percent. Private consumption continues to be relatively strong and the recent exports performance is quite encouraging. After increasing, in US dollar terms, by 13.6 percent in 2002, the Polish exports expanded by an annualized rate of 23.6 percent in the first quarter of 2003. Improved competitiveness of the Polish producers, declining unit labor costs and some real depreciation of the zloty contributed to such favorable outcomes, but the indicated growth rates have also been somewhat inflated by the recent weakness of the U.S. currency. While it would not be appropriate to read too much from some short term indicators, the April data on industrial and retail sales (+ 8.3 percent and + 11 percent, respectively) as well as the recent improvement in business sentiment can also be seen as encouraging signals. The enterprise profitability and the labor productivity have been improving as well, while the real wage growth remained moderate. The still declining, albeit at a slower pace, investment and the depressed construction sector continue to be the weakest spots and the biggest drag on overall activity. The unacceptably high level of unemployment, even after its recent small decline, and the very low labor participation ratio remain the source of major concern, and there is rather little ground to expect a rapid improvement in this area.

My authorities agree that it would be premature to speak of a robust recovery, but they also see a number of positive developments and share the staff's view that the Polish economy has some "distinct strengths" to support the long-awaited upturn. These include, among others, the absence of inflationary pressures, a significantly improved external position and a more competitive private enterprise sector. The approaching EU membership, the somewhat weaker zloty and the lower interest rates, as well as more moderate global energy prices should also improve the prospects for the Polish economy. However, the strength of the upturn and the sustainability of the future growth will crucially depend on the success in introducing the envisaged major reform of public finances, on the acceleration of structural reforms and on the timing, scale and durability of the recovery of Poland's major trading partners.

Addressing the Fiscal Challenges

My authorities are fully aware of the need to implement a decisive fiscal adjustment in order to significantly reduce the fiscal deficit and prevent an excessive increase in public indebtedness. This is not an easy task for any government, but in the current Polish circumstances it is additionally complicated by such factors as low level of economic activity, very inflexible structure of the budget (with at least 2/3 of expenditures, not counting public sector wages, being considered mandatory), the need to accommodate a large increase in EU-related spending and the minority character of the present government. Fortunately, both the external pressures resulting from the EU integration process and the constitutionally-set public debt ceiling, reinforced by two lower thresholds stipulated by the Public Finance Act, provide very strong incentives for the government to resolutely address the fiscal problem.

What has been achieved in 2002, and what largely continues with this year's budget, is the stabilization of Poland's fiscal position after it was brought to the verge of collapsing by the pre-election spending euphoria in 2001. The most recent data indicate that the 2002 fiscal results very closely match the original budget assumptions, which may imply an unchanged, or even slightly improved, structural position. This is a rather welcome achievement given the weakness of the cyclical position and the much lower then expected level of inflation. The 2002 general government deficit, when estimated using my authorities' understanding of the ESA95 rules (with open pension funds considered part of the government sector), has reached 3.9 percent and is projected to only slightly increase (to 4.1 percent) in 2003. However, the unadjusted deficit levels (6.3 and 6.5 percent, respectively) are much higher and, if left unaddressed, would imply an unsustainable fiscal position, soon leading to breaching the legal debt ceiling. While the implementation of the 2003 budget is proceeding broadly as planned, this year's budget was not yet meant to bring a decisive turnaround in the overall fiscal position. This extension of the consolidation phase reflects both the political reality and the current budget's broader objectives of establishing the foundations for the acceleration of growth, protecting the employment level and advancing Poland's preparations to the EU accession.

To address the medium-term fiscal challenges, the Ministry of Finance has prepared a comprehensive fiscal reform program with a key objective of creating conditions for achieving a high and sustainable growth while reducing the budget deficit to below the 3 percent Maastricht criterion by 2006. The initial version of this program has been outlined in the staff report and broadly welcomed by the staff. The reform program also aims at rearranging the structure of Poland's public finances in order to both release the resources needed to meet Poland's obligations towards the EU and to ensure the most efficient absorption of the funds expected from the EU. Some key measures proposed to achieve these broad growth and adjustment objectives include streamlining the tax system by eliminating most tax reliefs and exemptions and selectively reducing some tax rates, enhancing the flexibility of public expenditures by eliminating the still-pervasive indexation and valorization rules, and increasing fiscal transparency (and achieving some savings) by liquidating a large number of special accounts as well as some extrabudgetary funds and public agencies. At this stage it is still not possible to present the detailed content of the program, because it has yet to be formally approved by the government. The implementation of the program would also require the adoption by the parliament of a large number of new laws and/or amendments to existing regulations. The draft of the reform program itself has also been already amended as a result of an extensive series of public consultations. Some of the newly proposed measures include a deeper reduction of the corporate tax rate (to 19 percent) to stimulate investment demand, the introduction of an additional, lower personal income tax bracket, and the introduction of a uniform tax rate of 19 percent for all forms of capital income (including capital gains). The revenue impact of some of these measures is still being evaluated.

Monetary Policy

The recent inflationary trends and prospects allow to declare already today that the Polish monetary authorities have achieved their medium-term target (set in 1998) of reducing inflation to below 4 percent by 2003. The headline CPI inflation recorded in April was negligible (0.3 percent year-on-year) while two out five core inflation measures calculated by the National Bank of Poland (NBP) have even shown negative values. Staff expects the end-2003 inflation to reach almost two percent, but this projection may prove too cautious (as it happened last year when the actual inflation of 0.8 percent was significantly below staff's 3.6 percent estimate). While I recognize the difficulty with forecasting inflation in Poland, such too conservative projections could prove problematic if they were to guide staff's advice on the stance of monetary policy. The NBP does not publish any official inflation forecasts but one of the members of the Monetary Policy Council recently suggested that the end-year inflation figure could be in the range of 1 to 1.5 percent.

The NBP has continued implementing its policy of gradual interest rate reductions. Through a series of nineteen cuts the main reference rate has been reduced from 19 percent in February 2001 to the current level of 5.5 percent. The real interest rates have also been reduced but at a somewhat slower pace. The NBP justified these reductions by pointing to low and declining headline and core inflation indicators, significantly reduced inflation expectations, broadly favorable developments in monetary aggregates, wage moderation and weak external conditions. In turn, the main factors constraining the pace of monetary easing have been identified by the NBP as concerns about the developments in private savings, uncertainty regarding the actual and future stance of fiscal policy, depreciation of the zloty in the course of 2002 and the lagged effects of the earlier implemented nominal rates cuts. The relatively tight monetary policy not only resulted in bringing inflation much below the relevant Maastricht criterion, but also helped to reinforce the central bank's anti-inflationary credentials and contributed to a substantial reduction in the external current account imbalance. However, the progress in reducing inflation coincided with a significant slowdown in economic activity and with a large rise in unemployment. The nature of the relation between these developments remains the subject of an extensive public debate in Poland. The critics of the NBP policies would point to the fact that, even after the recent declines, the real interest rates in Poland remain much higher than in most other European countries and should be reduced further. The question of the link between the disinflation process and performance of the real economy is not merely of academic relevance since it may also determine the risk of renewed inflationary pressures, if and when the long-awaited recovery materializes. Fortunately, with subdued inflation expectations, large unemployment (reducing the risk of any major wage pressures), and the obvious necessity of ultimately improving the fiscal position (in view of the envisaged euro adoption), the near- to medium-term outlook for inflation in Poland appears to be relatively benign.

With inflation brought down to a very low level, the NBP decided to adopt a new medium-term strategy focusing on stabilizing instead of further reducing inflation. The NBP is convinced that the direct inflation targeting framework is best suited to achieving this objective. The new strategy envisages that this framework would also be implemented after the entry into the ERM-2, provided, of course, that the fluctuation bands are not set too narrowly. Starting from 2004, the NBP proposes to adopt a new, continuous inflation target of 2.5 ± 1 percent. This relatively ambitious target (expressed, as before, in a headline CPI measure) has been set at this level, among others, in order to facilitate the fulfillment of the relevant Maastricht criterion. The NBP has already started adjusting the instruments of its monetary policy to the rules and practices adopted by the Eurosystem, and this process will continue under the newly-approved strategy.

Moving Towards the Euro

The questions of when to enter the ERM-2, when to adopt the euro, and how to approach the issue of choosing the level of central parity are certainly among the biggest dilemmas facing not only Poland, but also all remaining accession countries. In the process of deciding on these issues we count on good cooperation with our future EU partners, with the Commission and with the ECB. What is needed is full clarity regarding "the rules of the game", and in particular the width of the ERM-2 fluctuation band and the method of assessing the observance of the exchange rate stability criterion. In the Polish case, of great importance is also the pending Eurostat decision on our request to consider the open pension funds as part of the general government sector. The rejection of the Polish method of calculating the ESA95-conform fiscal deficit would significantly complicate the task of meeting the relevant Maastricht criterion, and could lead to delaying the timing of adopting the euro. My authorities also count on being able to benefit from the Fund's advice on how to approach the issues of entering the ERM-2 and adopting the euro. After all, by its very nature, the IMF should aspire to be a "center of excellence" for exchange rate policy matters.

Poland's preliminary official position on the euro area entry has been specified in October 2002 by the joint Ministry of Finance and NBP working group on Poland's integration with the EMU. The declared policy is to aim at joining the EMU at the earliest possible date while paying due attention to macroeconomic conditions and to the need to accelerate the process of real convergence. The initial intention was to be able to meet the Maastricht convergence criteria by 2005 (without prejudging the date of the actual switch to euro). My authorities recognize, however, that this tentative target may no longer be feasible and should not be forced if the process of fiscal and structural reforms does not advance as currently envisaged, and/or if the macroeconomic conditions turn unfavorable. The zloty's central parity to be negotiated with the EU partners prior to the ERM-2 entry should take into account the market rate in a selected reference period, and should be set at a level that creates conditions for a sustained economic growth without exchange market pressures. The new monetary policy strategy approved by the Monetary Policy Council (MPC) has also embraced the objective of striving for an early adoption of the euro, possibly in 2007. The MPC is convinced that the benefits from joining the euro area significantly outweigh the costs of loosing monetary policy independence.

Structural Reform Agenda

The staff report puts a lot of stress, and rightly so, on the need to accelerate structural reforms. My authorities fully share the view that without further advancing the structural transformation of the Polish economy it will not be possible to sustain a high growth rate, reduce unemployment and fully benefit from the ongoing EU integration process. Among the most important structural reform measures is undoubtedly the long-awaited relaxation of labor market regulations. The changes to the Labor Code introduced in 2002 aim at increasing the flexibility of employing and laying-off workers and lowering costs for the employers. One of the potentially very important measures is the differentiation of minimum wage for first-time jobholders. The legislative changes have been accompanied by several other measures to improve the situation on the labor market, including training, public works and the "First job" program promoting employment of young graduates. While the introduction of the earned income tax credit for employees, as suggested by the staff, is not currently being considered (among others, in view of the current fiscal situation) a somewhat similar measure in form of a tax credit for new small enterprises maintaining at least an unchanged level of employment has been approved in October 2002. The large program to support enterprise restructuring, based on a set of new laws approved in 2002, benefited more than sixty thousand mostly small enterprises and also contributed to protecting the level of employment.

The staff suggests that the pace of privatization has recently slowed down in Poland. While it may be confirmed, in part, by the lower level of revenues from selling the state assets, it also reflects the less attractive and/or more complex nature of the remaining enterprises which are slated for privatization, and a reduced interest on part of both foreign and domestic investors. My authorities, however, intend to proceed with the implementation of their medium-term privatization strategy which envisages that after the completion of the divestment process by 2005, Poland would have an ownership structure broadly similar to other European countries. The recent examples of the ongoing efforts to reduce the state ownership include the continuing negotiations with two investors bidding for the large steel conglomerate Polskie Huty Stali and the tender for the privatization adviser for the largest (and one of the few remaining) state-owned banks (PKO BP).

Anti-Money Laundering and Preventing Terrorism Financing Activities

In February 2003 Poland formally ratified the 1999 UN Convention on the Suppression of Terrorist Financing. However, many of the stipulations of this Convention had already been implemented earlier, including through changes to the penal code and through the adoption of the Act on Counteracting Introduction into Financial Circulation of Property Values Derived from Illegal or Undisclosed Sources. In 2002, the General Inspector of Financial Information (GIF) notified the public prosecutor's office of more than one hundred suspected transactions with a total of more than 100 million zlotys. It also ordered suspension of 26 transactions with a value of over 32 million zlotys. In the coming months the Polish regulations will be further revised to make them fully conform with the relevant directive of the European Union. In July 2004 the GIF intends to start operating the specialized IT system registering all transactions exceeding 15000 euro.

Mr. Reddell submitted the following statement:

Key Points

Securing greater flexibility in the Polish economy is probably the single greatest challenge in the next few years, to enhance growth prospects and to provide needed flexibility upon adoption of the euro.

Providing an environment that supports that absorption of the un- or underemployed 40 per cent of the labor force is a key dimension of that challenge.

Fiscal adjustment should remain a priority, to support structural reform and to provide the needed cyclical flexibility once the exchange rate tool is no longer available.

Foreign exchange intervention may have more of a role than the papers suggest.

We broadly share the staff assessment of the challenges facing the Polish economy, and so will restrict our comments to a few areas.

Perhaps the biggest challenge facing Poland is securing sufficient flexibility to enable it to both realize its longer-term growth and income potential and to do so successfully inside a currency union, in which it will be depriving itself of a major shock-adjustment tool. If the undoubted microeconomic benefits of joining a currency union are not to be undermined by greater macro adjustment costs, laying economic foundations characterized by a high degree of flexibility and resource mobility should be a priority, for Poland and for the other transition economies. But flexibility does not appear to be an obvious feature of the Polish economy. With the highest unemployment rate in the OECD, a staggeringly inefficient use of labor in the agricultural sector, and reports of other industries with little prospect of long-run viability, it appears that at least 40 per cent of the total labor force is not gainfully employed. Supporting them is a huge drain on the productive sectors of the economy, and the labor itself is an underutilized resource.

Sadly, it is not obvious that there is any widespread social consensus that far-reaching change is needed. All indications suggest a deep ambivalence about the way ahead, a dissatisfaction with what the changes of the last decade have delivered, and a reluctance to pay the price of making possible the sorts of living standards that Poland's future western European partners enjoy. We must hope that EU accession, and the authorities' goal of adopting the euro at the earliest opportunity, will together provide the impetus for further dramatic change in the next few years but it is something of a gamble. There is clearly a need for courageous and compelling political leadership to rebuild trust and to convince and carry the public on the nature of the reforms likely to be needed. That is likely to be a multi-year challenge.

Turning to specifics, we would endorse the staff's call for robust fiscal adjustment. The combination of the Maastricht fiscal criteria and Poland's own laudable constitutional limits on public debt argue for adjustment. But so too, as staff note, does the need to make space to accommodate materially lower interest rates, if Poland is to successfully make a relatively quick transition to adopting the euro. In addition, overlaid on all this, the sort of far-reaching adjustment many sections of the Polish economy still need to undergo is unlikely to occur without substantial fiscal costs: at present, there would appear to be little scope to accommodate such additional transitional expenditures. As both a fiscal indicator and a pointer to the slow pace of structural reform, it is disappointing to note that (according to a recent EIU report) Poland's own Treasury Minister considers that 2003 privatization revenues now seem likely to be little more than half the level assumed in this year's budget.

In this regard, we note that staff focus their labor market reform suggestions (paragraph 38) on "pull" factors, designed to draw workers into employment. Such policies clearly have their place, and have been used in a number of other countries. Nonetheless, given that the helpful selected issues paper highlights that long-term income replacement rates for the unemployed in Poland are relatively high by international standards (and much higher than those for the short-term unemployed), we were surprised not to see more weight placed on proposals for change in this area. It is always difficult to secure support for changes in this area, but do not appear to be something that should be neglected or omitted in the Fund's advice to the authorities (especially in view of the asymmetric indexation provisions on social transfers).

For the record, we would add our voice in support of the line taken by staff over the use of the NBP revaluation reserve. Transferring some of these reserves to the government may or may not be appropriate, but that decision should be based on a careful assessment of the NBP's own need for capital. Any such transfer would change nothing of substance in fiscal policy.

And finally, we wonder about the merits of foreign exchange intervention, as discussed in paragraph 23. The MPC considers that a pure float is the best exchange arrangement for Poland at present and staff endorse this view. For a country planning to irrevocably give up its own currency within the next few years, the logic of this position is not immediately obvious. Moreover, well-executed interventions are probably more likely to be successful in relatively thinner and less liquid foreign exchange markets, such as those of the transition countries. While there does not appear to be any immediate need to consider intervention, the authorities may like to consider Australia's record (as another medium-sized economy) of rare, profitable, and moderately effective intervention over many years. Maintaining a high level of foreign exchange reserves would appear to be prudent insurance, as staff note, but insurance only has value if one is willing to make a claim.

Mr. Daïri submitted the following statement:

We thank the staff for an interesting report and the background papers and Mr. Szczuka for his comprehensive statement. The Polish economy appears to be poised for an economic recovery and a return to a path of fast growth. However, and notwithstanding the welcome news on the growth front in the staff supplement, this outcome is not assured. Whether the nascent recovery will be a gradual and fragile one, or one that is more durable and robust, will critically depend on the quality of macroeconomic and structural policies going forward. The Polish authorities will need to act with boldness and vigor if they are to meet their desired goals of faster growth and employment creation, and achieve income convergence with Western Europe.

In the macroeconomic sphere, the key to achieving sustained growth will be a rebalancing of the policy mix towards more vigorous fiscal consolidation. Poland's "doggedly" high structural fiscal deficit primarily reflects the existence of overly-generous and ill-targeted social transfers and subsidies. As the background paper highlights, meeting the constitutional limit on debt sustainability and the Maastricht criteria will require that major fiscal adjustment be taken at an early date with a focus on reductions in social spending. In this context, it is regrettable that the 2003 budget does not include initiatives to cut future structural spending although we take some comfort from the recently-proposed fiscal reform program which sets out a vision of the government's intentions in this critically important area. However, there remains the concern that the reform program may not enjoy widespread political support and could therefore be subject to pressures to dilute it, and, depending on the growth outturn, the reforms in terms of their efficacy may fall short of what is needed. More extensive measures—including reforms of the pension system and social benefits, and a reduction in subsidies—could well be needed to stay within the strictures of the debt limit and the Maastricht fiscal criterion.

Monetary policy has performed well in reducing inflation expectations and supporting growth, especially considering the recent depreciation of the exchange rate. We welcome the recently-announced medium-term monetary policy strategy which incorporates the new inflation target for 2004 and beyond. Staff make the observation that, allowing for Balassa-Samuelson effects, the inflation target may be too low , heightening the risk of nominal appreciation. This once again underscores the importance of improving the macroeconomic policy mix in a sustainable way—a key requirement before central parity for ERM2 is set.

The banking system appears to have weathered the turbulence it encountered in 2002 quite well largely because of banks' swift response to the difficult financial situation through aggressive cost cutting measures and increased provisions. Nevertheless, both the cyclical position of the economy and the depreciation of the exchange rate contributed to a large increase in nonperforming loans. The situation in 2003 is likely to remain difficult and could place further pressure on loan portfolios. On the more positive side, a strengthening of growth impulses in the economy could help improve bank asset quality and ease the present inhibitions on lending to potential borrowers. The recent reduction in foreign currency borrowing is to be welcomed. However, since it is not clear whether this is a transitory phenomenon, the formation of a unit in the NBP to monitor this and other external vulnerabilities is a prudent step.

The authorities' intention to speed up the pace of privatization and restructuring is welcome. Nevertheless, we agree with the view that the objective of the privatization process should be to maximize receipts and minimize social disruption, rather than meet a deadline. Privatization should also lead to discernable improvements in economic efficiency. Clearly, however, one must guard against attempting to restructure enterprises that are fundamentally nonviable and where it is more appropriate to accept the inevitability of liquidation.

The authorities are right to be concerned about the high level—and increasing—unemployment rate which places Poland as the worst performer among the OECD countries. The changes made to the labor code in 2002 were important steps and should begin to bear fruit as the economic recovery gathers strength. Given the severity of the unemployment situation, staff are correct to urge deeper reforms, especially aimed at reducing disincentives to work through, inter alia, an earned income credit to low-wage earners and strengthened job placement services. Staff recommendations in this area merit the authorities' careful consideration.

Mr. Vittas submitted the following statement:

We wish to commend the Polish authorities for their success in completing the negotiations for accession to the European Union and for signing the Accession Treaty last April. We also thank staff for a well written set of papers and Mr. Szczuka for his insightful statement.

Poland's recent economic performance has been adversely affected by the combination of entrenched structural problems, partly associated with transition, inadequate fiscal adjustment, and an overly ambitious monetary policy. Fortunately, the policy mix has recently improved, contributing to a modest brightening of short-term macroeconomic prospects. We broadly agree with the outlook presented in the staff report, which is in line with the Spring 2003 forecast of the European Commission. It points to a pick up of growth in 2003 and more so in 2004, although regrettably at a pace that will not be sufficient to make a significant dent in the persistently high, and indeed still rising, unemployment rate.

The need to complete the final steps towards EU membership, coupled with the authorities' aspiration for early adoption of the euro, provide strong incentives for tackling remaining weaknesses in the policy framework. If political resistance to reform is overcome and the response to these incentives is adequate, Poland's economic performance would strengthen further over the medium term, leading to a gradual narrowing of the gap in living standards with present members of the Union.

Fiscal Policy

We concur with the authorities and the staff that a deep reform of public expenditure policies is essential and urgent. Several good reasons support such a priority, including the need to: a) further improve the policy mix; b) prevent debt levels from breaching constitutional limits; c) cope with substantial expenditure pressures stemming from accession; d) allow Poland, upon accession, to comply with the fiscal policy requirements of the Treaty and the Stability and Growth Pact; and e) avoid, as the selected papers show, risks to debt sustainability, should negative output shocks occur.

The rebound in growth which is expected for this and next year offers an opportunity to make good progress in addressing this issue. The fiscal reform plan proposed by the Minister of Finance is a step in the right direction but it should be protected from political pressures to further water it down. In any case, we share staff's judgment that more extensive measures will be needed to ensure that the Maastricht fiscal criterion is reached by 2006.

The staff rightly points out that the proposed use of valuation gains on the NBP foreign exchange holdings to close the gap between targeted and projected deficits in 2004 amounts to little more than window-dressing. It is a source of concern to the extent that it indicates reluctance to take the requisite action to deal with the underlying problems. The alternative of using the revaluation reserve to retire foreign debt also raises some questions as regards its compatibility with EMU requirements and cannot, at any rate, be considered as a measure that promotes fiscal sustainability over the medium term.

Monetary Policy

As the staff report points out, monetary policy has succeeded in taming inflation expectations. However, it seems to have done so at a considerable cost to economic activity in the short term. Indeed, inflation has been declining much faster than forecast, undershooting the official targets by a wide margin. This confirms that the current policy of gradual interest rate cuts is appropriate, although its pace and dimension could still prove too timid, ex-post. We concur with the authorities that it is now desirable for monetary policy to shift its emphasis from disinflation to maintaining price stability. However, the definition of price stability, as indicated by the mid-point of the official target range, should take into account the significance of Balassa-Samuelson effects and it is also important that the target be pursued symmetrically. In particular, given the level of unemployment and the emergence of some, admittedly sporadic, signs of deflation, it would be appropriate to take prompt action to correct any persistent deviation of inflation from the lower end of the target range.

The monetary policy stance will also have to take the evolution of the zloty into consideration. The recent depreciation is welcome insofar as it has helped to strengthen competitiveness and to counteract any domestic deflationary pressures. It would be interesting to hear from staff whether it considers this development to be consistent with medium-term fundamentals and whether it sees any reasons to expect significant pressure on the zloty as EU accession, including ERM-II participation, comes closer.

ERM-II and Euro Membership

The EU authorities have established a set of clear and coherent rules and procedures that should guide all acceding countries in their quest for participation in ERM-II and the adoption of the euro. To begin with, it should be noted that, upon accession, new Member States are expected to treat their exchange rate policy as a matter of common interest. While a disciplined and responsible monetary policy, directed towards price stability, is necessary for sustainable exchange rate stability, sound fiscal and structural policies are equally essential prerequisites. Acceding countries are expected to join the ERM-II, although not necessarily immediately after accession, and eventually the euro. The most important rule for participation in ERM-II is that all relevant decisions (including on the timing, the central rate and any subsequent changes in it, and the appropriate fluctuation margins, if other than the standard $\pm$ 15 percent) are taken by mutual agreement as they affect all parties involved and not just the Member State applying for participation. ERM-II is a mechanism designed to facilitate real and nominal convergence and provides a degree of flexibility to accommodate the varying degrees, pace and strategies of economic convergence.

Euro membership will require fulfillment of the Maastricht convergence criteria, including a minimum stay of two years in the exchange rate mechanism without severe tensions. The assessment of exchange stability against the euro will focus on the exchange rate being close to the central rate while also taking into account factors that may have led to an appreciation, in line with what was done for present members of the euro area.

The timing of ERM-II participation and the subsequent euro membership should be assessed in this perspective. The authorities' desire to accelerate the process is understandable and laudable. However, the timing should be determined according to what serves best the macroeconomic and transition needs of Poland, taking into consideration whether the appropriate entry conditions, including the achievement of a sound fiscal position, have been met. In addition, the choice of central and conversion rates will need to be made with a view to avoiding the risk that imbalances reappear once the entry decision has been taken.

Unemployment and Structural Reforms

The decision to join the euro should also take into consideration the still severe structural problems in labor and product markets. Joining monetary union without having tackled such problems could generate further adverse effects once nominal exchange rate adjustment is foregone.

High and, until recently, increasing unemployment reflects adverse cyclical conditions but especially structural imbalances in the labor market.

The latter are, partly, a consequence of the transition process but also of more recent developments leading to skill mismatches and a wrong incentive structure that discourages more active job search. The selected issues paper also clearly illustrates the key role of regional discrepancies in unemployment rates and the consequences on aggregate unemployment.

This evidence leads to two general considerations. First, policies are needed to improve skills, address regional imbalances, and reduce skill mismatches. Second, reforms in labor markets should proceed hand in hand with policies to improve the functioning of product and service markets. As shown inter alia in the recent WEO papers, simultaneous reforms in both labor and product markets would significantly improve the performance of the euro area countries. There is no reason to believe that the same does not apply for new EU member states.

Privatization

While recent steps to advance labor market reform are welcome, the pace of privatization remains disappointing. It is true that many of the remaining state-owned firms are unattractive to markets and their liquidation would negatively impact on employment. Resisting privatization, on the other hand, would continue to add pressure to the budget and further delay product market reform. Both consequences would adversely effect performance in a monetary union.

Conclusion

Poland has had considerable success in reforming its economy and preparing it for successful membership of the European Union. The emerging recovery in economic growth improves conditions for reinvigorating structural reforms and pushing forward needed public expenditure reforms. We wish the authorities success in pursuing these still challenging tasks, reducing unemployment and accelerating income convergence.

Mr. Kanaan and Mr. Shbikat submitted the following statement:

At the outset, we would like to thank the staff for the set of rigorous reports and Mr. Szczuka for his helpful statement.

Economic growth in Poland has dropped markedly over the past two years in tandem with the weakening global economy, and reflecting the tapering of the effect of the early-transition investment boom. While the slowdown has further worsened employment conditions, it was accompanied by a declining inflation, which was sustained by a prudent monetary policy. Against this background, the authorities adopted expansionary macroeconomic policies, notably through pronounced cuts in the policy rate.

While recently there have been signs of some pick up in economic activity, partly in response to these policies and the better export performance, the underpinnings of growth both on the supply and demand sides remain weak, indicating that the pace of recovery might not be strong enough to reduce unemployment. In particular, private investment continues to decline, while labor market rigidities still constrain employment growth. It is also well to keep in mind that Poland's export growth prospects are clouded by unfavorable external conditions, especially the weak economic outlook for Germany, the country's main trading partner.

Moving forward, the authorities need to focus on putting in place the appropriate conditions to strengthen the ongoing recovery and achieve higher and sustainable economic growth over the medium term. In this regard, priority should be accorded to adopting an appropriate macroeconomic policy mix, to shift part of the burden of maintaining a stable macro environment to fiscal policy and allow some easing of the monetary stance. The latter should be formulated with a view to allowing Poland to minimize deflation risk, while at the same time facilitating a smooth accession to the EU, including through an appropriate exchange rate. In this regard, the recent cut in the policy rate is a step in the right direction. It is also important to speed up the reform process, notably in the areas of privatization and labor market, in order to help boost investment and remove impediments to employment growth. In what follows, we will focus on some macroeconomic policies and structural reform issues that are of particular importance in the period ahead.

On monetary policy, we commend the National Bank of Poland (NBP) for the skillful and flexible conduct of monetary policy. The stance of monetary policy has been appropriately adjusted in line with the overall economic conditions in the country and the anticipated price pressures, leading to a significant decline in inflation. However, with inflation now under one percent, and below the lower bound of the target range, the NBP, in our view, should be mindful of deflation risk, particularly given the weak nature of the recovery and the expected widening of the output gap. In fact, given that real interest rates in Poland are still relatively high compared to those in the EU, the NBP has room to further relax monetary policy until inflation falls comfortably within the range of the inflation-targeting regime. In this connection, coordination of fiscal and monetary policy takes on added importance in the period ahead. Restrained fiscal policy would enable the NBP to adopt an easier monetary stance to reduce interest rates and avoid upward pressures on the exchange rate, thereby enhancing domestic investment and safeguarding competitiveness. To increase the degree of coordination, it is important to seek a swift resolution to the ongoing tension between the government and the NBP on the revaluation reserve account. In this regard, like staff, we emphasize that any resolution to this issue should preserve the ability of the NBP to conduct monetary policy independently.

In addition to supporting monetary policy, tightening the fiscal stance and implementing structural fiscal reforms would be critical in the period ahead in many respects. In particular, without improving the structural fiscal position significantly over the next few years, public debt could exceed its constitutional limit of 60 percent, and it would be difficult for the authorities to meet the Maastricht criteria. This requires, on the revenue side, adjustment to the current tax structure, notably by reducing some tax rates and exemptions, improving tax administration, and broadening the tax base, with a view to increasing tax efficiency. On the expenditure side, reducing public employment to control the wage bill, and restructuring expenditures, most importantly through a reduction and better targeting of social transfers and subsidies, would be necessary to ensure the achievement of the fiscal targets, as well as free up resources to co-finance essential projects with EU grants.

Also, it is important that reform measures be taken to enhance the flexibility of public finances through the use of automatic fiscal stabilizers, especially in view of the added importance of fiscal policy after entry into ERM2. To this end, eliminating wage indexation and revenue earmarking would be steps in the right direction. Finally, with the EU accession approaching, and to avoid the costly adjustment associated with delayed measures and revenue shortfalls, we encourage the authorities to implement these fiscal reforms in a timely manner, and with the appropriate sequencing. It is also important that fiscal targets be formulated on the basis of realistic growth projections. On this latter point, the authorities would be well advised to carefully consider the staff's concern that, under more cautious growth assumptions, the envisaged measures under the government's program would achieve only one-third of the adjustment needed to stabilize the public debt ratio below 55 percent of GDP by 2006.

Other structural reform efforts should be geared toward enhancing employment growth. Unemployment has been increasing despite positive economic growth, suggesting that the problem is to a large extent structural in nature. The authorities are encouraged to address the structural impediments to employment growth the staff outlined in the Selected Issues paper, notably the mismatch between labor supply and demand, which resulted partly from privatization and economic restructuring. Enhancing flexibility in the labor market, in our view, would be the key to eliminate these mismatches. In this regard, we welcome the recent changes to the Labor Code, which aim at lowering costs and easing restrictions on employers, and encourage the authorities to pursue further labor market reforms, especially in the area of enhancing regional labor mobility. In addition, reducing the currently generous social benefits and high tax wedge would be essential to increase incentives to work and reduce non-wage labor costs.

The resumption of the privatization program and the restructuring of public enterprises, in addition to facilitating the fiscal consolidation effort, would be a major step to reinvigorate private investment, reduce inefficiencies in the economy, and align the ownership structure close to that in EU countries. While we generally agree with the authorities on the “restructure-first, privatize –later” approach, like staff, we believe that unviable enterprises should be liquidated rather than restructured for future privatization. This could save time and reduce the burden on the budget of costly restructuring. Finally, as privatization and restructuring might initially exacerbate the unemployment problem, the authorities need to put in place training programs to help retrenched workers find new jobs.

With these comments, we wish the Polish authorities continued success.

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

We would like to thank the staff for the focused reports for this Consultation, including an insightful analysis in the selected issues paper, as well as Mr. Szczuka for his candid statement. Over the past two years, macroeconomic performance in Poland has deteriorated, resulting in a marked deceleration of the rate of GDP growth, a pronounced contraction in investment, a widening fiscal deficit and a persistent increase in the unemployment rate which is now the highest in the OECD. The policy mix aimed at reverting these developments has had only partial success and points to the monetary policy constraints which emerging market economies typically face in the context of weakening growth and an unfavorable fiscal dynamics. Excessive reliance on the recovery in external demand and in particular in Germany add to the near-term difficulties. Nonetheless, the economy is also uniquely placed with the necessary corrective measures to take full advantage of the expected EU accession in the medium term, while important steps have been taken to enhance fiscal transparency over the past two years.

We note staff’s assertion that in the near future, the recovery will remain subject to uncertainty as investment growth has been slowing in response to an apparent overhang from the early nineties and the increasing unemployment and the dynamics of wages could threaten private consumption. At the same time, government consumption is now facing the constraint imposed by the sizable and growing fiscal gap and the level of the gross external financing requirement, giving rise to some roll-over risk concerns when European markets for polish exports are likely to remain weak.

As others, we consider that the macro-economic policy mix in Poland, has put an excessive onus on monetary policy as the rate of output growth decelerated. On the one hand, public expenditure has remained high while attempts to curb social transfers have met political resistance. At the same time, the revenue stream has been gradually decreasing, translating into an expanding fiscal gap. As a result, monetary policy as the main instrument to deal with inflation pressures was forced to tighten to protect the current account. This has implied that the private sector has had to face much tighter monetary conditions than desired given the cycle.

Staff's analysis on debt sustainability and the fiscal risks on the way to EU accession highlight the critical importance of rapidly advancing fiscal consolidation. The base scenario under unchanged policies provided would imply an increasing debt burden for the next ten years, and the overshooting of the interim debt/GDP ceiling by 2004. Moreover, the underlying assumption of a rate of growth above 5 percent per year from 2005 through 2009, and in excess of 4 percent subsequently could be on the optimistic side. Perhaps staff could comment on the factors supporting potential output growth in excess of 4 percent per year in Poland well into the medium term? Since the sensitivity of the debt burden to a real shock is very high, and shocks have been recurrent, there would also appear to be a non-negligible probability of a similar confluence of events occurring within the next business cycle, when gross external financing needs could surpass 30 billion dollars per year by 2005. Roll-over risk in such a scenario could make the country vulnerable to volatile market conditions. All these factors lead us to the unavoidable conclusion that Poland needs to undertake significant fiscal adjustment soon.

In this sense, we welcome the authorities' recognition, as reaffirmed by Mr. Szczuka, of the need for structural fiscal reforms. However, while we recognize the political economy constraints, we regret that identified corrective measures were not introduced in the 2003 budget, and that the Minister of Finance's recently proposed public finance reform program in staff's view still falls short of the needed adjustments. In this regard, the transfer of revaluation reserve accounts at the BNP is no substitute for needed structural fiscal consolidation in 2004. Most of the proposed structural reforms, including pension reform and reductions in subsidies, will require a strong political base of support which regretfully is not yet in place. We hope that the near certain date of EU accession will provide the incentives to push forward with that reform agenda, and by so doing allow Poland to take full advantage of the process of economic and political integration.

At the core of the fiscal adjustment is the efficiency of the growing share of transfers and subsidies, representing over 21 percent of GDP, up from 18.5 percent in 1998, including the automatic adjustment mechanisms that introduce an upward biased inertia in expenditures, and could compromise meeting the Maastricht criteria as scheduled, a risk highlighted by Mr. Szczuka in his statement. On the revenue side, measures to stop the persistent decline in revenue collection, including a rationalization of tax exemptions are key. These actions, if taken, would be conducive to an improved policy environment which would allow the automatic stabilizers to operate after adoption of the Euro, under the easier monetary conditions prevalent in the Euro area. Perhaps staff could comment on whether EU related tax harmonization could impose a negative bias to revenue growth?

On the monetary side, we agree with staff that there is room for further interest rate easing, given the favorable inflation prospects for the next two years. We welcome the inflation targeting framework, and concur that a widening of the band would be advisable. However, given that neither inflation—nor deflation—are major concerns in the current environment, interest rate easing could contribute to stimulate the economy, given the sluggish output growth performance. Staff's comments on the scope for real interest rates to decline would be appreciated.

On the financial side, credit growth remains weak, profitability in the banking system is falling, and currency mismatches have been growing. In this context, we wonder what kind of financial support from strategic owners is envisaged, given the large portion of foreign owned institutions and the prospect of increased competition that could create additional pressures on bank balance sheets.

With regard to other pending structural reforms, we welcome the authorities intentions to speed up the privatization process, within the logic of maximizing fiscal proceeds while minimizing the social consequences of the divestiture process. In this regard, we have two caveats. First, we wonder whether staff considers the regulatory framework adequate. Second, we wonder how significant were the arrears restructurings in financially distressed enterprises, and whether there are plans to continue with this process. The recapitalization of state-owned enterprises by shares of other state-owned enterprises seems to point towards that direction. Advancing structural reforms is crucial for enhancing the efficiency of the economy, in a context where new investment is needed to absorb the high unemployment. The fact that productivity growth in important sectors of the economy is lagging is reflected most clearly in the agricultural sector, which although employing 22 percent of the population produces only 3 percent of the country's GDP. Once again, EU accession presents an optimal opportunity to generate the needed base of political support for the widespread structural reforms needed to modernize the Polish economy.

Finally, we commend the authorities for their commitment to tackle corruption and other governance issues related to money laundering and financing of terrorism, by addressing many of the issues outlined in the 2001 fiscal ROSC. We encourage them to press ahead with the pending recommendations. With these remarks, we wish the Polish authorities every success in dealing with the historic challenges of the unprecedented transformation process set in train.

Mr. Portugal and Mr. Tombini submitted the following statement:

We commend the staff for a valuable set of papers, including two high-quality and useful papers on fiscal and labor market issues. We thank Mr. Szczuka for his insightful and comprehensive statement.

The Polish economy recorded a strong expansion in the late nineties, mostly driven by a surge in fixed investment, but also supported by a steady contribution of private consumption. The pace of the expansion, however, cooled off considerably in 2001 and 2002, as signs of an investment overhang emerged. More recently, private consumption appears to have picked up gradually, although partly at the expense of a further drop in domestic savings. Export performance is also improving—as a result of enhanced competitiveness—which is helping to prevent a widening of the current account deficit. In coming years, investment is expected to rebound, as the economy prepares to join the EU in 2004 and continues to absorb foreign savings. In spite of existing weaknesses in the policy environment, as the staff underlines, the economic structure in Poland presents some distinct strengths including, inter alia, a relatively competitive corporate sector, a low level of external indebtedness, a reasonably well-functioning labor market, and a somewhat depreciated exchange rate.

Monetary policy has been guided by a strict inflation-targeting framework since 1998, with the National Bank of Poland enjoying de facto and de jure independence. The results have been indeed impressive with a considerable degree of disinflation being achieved. Looking forward, the policy framework should focus on preserving low inflation, as suggested by the authorities. With the benefit of hindsight, the tightening in 2000 may have been higher than required for meeting the pre-defined disinflation path, leading the NBP to breach the inflation targets from below. Poland's experience with inflation targeting suggests that there may be room to exercise flexibility in pursuing and designing inflation targets, without necessarily compromising the credibility of the monetary authority. In this respect, we share the staff's view that perhaps the design of the IT framework could be slightly more flexible in allowing for wider band than the ± 1 percentage point. Likewise, we share the staff's concern with the target level of 2.5 percent, particularly, considering the likely convergence effects in the near future.

While the current monetary policy stance has been appropriately supportive of the economy, fiscal policy has been excessively buoyant, with the overall government deficit close to 6 percent of GDP, as a result of existing structural rigidities in both the revenue and expenditure sides. The primary result, which is supposed to counterbalance interest payments, has been consistently negative too, around 3 percent of GDP. Around half of all government expenditures are directed to transfers and subsidies. We agree with the staff and the NBP that the current economic environment argues for a more balanced policy mix, where greater fiscal consolidation would reinforce and facilitate the conduct of monetary policy, allowing, for instance, the implementation of a more aggressive easing of monetary conditions. Greater fiscal consolidation would also be key to prevent a real appreciation of the Zloty in the run-up to the adoption of the euro, improving the prospects for a successful accession process.

With the cooling of the expansion, debt-to-GDP ratios are fast approaching the 50 percent threshold, where Polish law calls for offsetting measures to be adopted. These criteria are even more stringent than those of Maastricht, for it states the same 60 percent as the utmost limit, but counting in risk-weighted guarantees. To let numbers approach the statutory threshold is not a comfortable option, for the event of short-run mandatory cuts is inevitably associated with low-quality adjustments. The sheer size of the required trend reversal also points to the need to take positive steps as soon as possible, and not only after political uncertainty is removed in 2004.

Most of the recent fiscal slippages are linked to a social safety net intended to smooth the effects of job destruction as the economy reshapes itself. In principle, this is a commendable objective. However, Poland might benefit from a more targeted effort. Structural skill mismatches and low social mobility can partly be mitigated, especially by more focused training programs. We also agree that there is a need to give further impulse to labor market flexibility. Staff studies show that not only structural unemployment may have experienced an upward shock, but that actual-long term unemployment has now risen well above OECD averages. While dismantling the social safety net before wider employment opportunities are available is not a reasonable proposition, increasing the incentives to work vis-à-vis unemployment benefits makes a lot of sense. The key in shaping the reforms is to produce a broad system of incentives for an individual to seek work, while mitigating transitional costs and avoiding a rush that would force inefficient matching.

We commend Poland on its impending EU entry and likely participation in the next wave of euro enlargement. Markets are already pricing in a sizable removal of credit risk, as spreads on the sovereign continue to fall, most recently to levels below 100 basis points. Nevertheless, the authorities recognize that a critical question remains open, notably the one related to the monetary framework to be adopted during ERM2. We share their concern about the co-existence between the exchange rate band and the inflation targeting framework, in particular, knowing beforehand that countries running large fiscal deficits are the usual candidates to have their pegs being tested. This prospect calls for a firmer fiscal consolidation in the near future.

As for the financial sector vulnerabilities, we are encouraged by the reverse in foreign exchange-denominated credit since late 2002. We hope that this recent reversal is not a temporary one, but rather a trend towards lower levels of corporate and household indebtedness in foreign currency. As we have pointed out in previous consultations, the idea of having a fractional banking system in a currency other than the local currency is worrisome. Regardless of the implicit safety net provided by the EU accession process, the evolution of foreign currency denominated deposits should be closely monitored by supervisors. To that effect, we are encouraged by the recently formed unit within the NBP to monitor such sensitive area.

With these remarks, we wish the Polish authorities all the best in these challenging times.

Mr. Lushin and Mr. Lissovolik submitted the following statement:

We thank the staff for an insightful set of papers on Poland as well as Mr. Szczuka for his helpful statement. Poland as one of the front-runners of transition has attained important results, with low inflation laying the foundation for high rates of economic growth in the future. The latter, however, has stumbled in recent years, which further exacerbated the problem of high fiscal imbalances. Unemployment is the highest in OECD countries, whilst sectoral reform, particularly in the sphere of agriculture is lagging. The difficulties faced by Poland need to be expeditiously addressed particularly in view of the challenges posed in the short to medium-term by the exigencies of EU accession.

The challenges of Poland's accession stem partly from a rise in uncertainty in the run-up to EU membership and the entry into the euro area (see para 10). In the fiscal sphere there is some uncertainty regarding the methodological issues pertaining to the reconciliation of Poland's ESA and GFS accounts. In the monetary sphere, the uncertainty regarding the permissible width of the exchange rate band (2.25 percent or 15 percent) clouds the policy outlook for Poland in its preparations for ERM-II. Given the uncertainty in the economic outlook, we agree in principle with the staff that excessive policy activism needs to be avoided, with both fiscal and monetary policy geared to incremental changes.

Notwithstanding the above considerations, however, there is a tension between incremental policy changes under uncertainty and the urgent need to address macroeconomic imbalances, especially in the fiscal area. Here the main problem is that the more fiscal adjustment is delayed the greater the fiscal policy response will have to be to redress past imbalances. With the delayed fiscal adjustment, even a greater burden will be placed on changes in monetary policy. Accordingly, in order to reap the full benefits of accession to the EU ex-post, prompt policy adjustment ex-ante is of prime importance.

Further on fiscal issues, we believe that the institutionalization of the indexation process on the expenditure side (see para 14) together with the likely political opposition to cuts in social benefits make expenditure adjustment difficult. Under these circumstances and given the high level of the fiscal deficit, even a relatively strong effort to implement expenditure adjustment would still be insufficient to redress the problem of high deficits. Accordingly, expenditure reform would need to be complemented by a comprehensive effort to raise revenues, with particular emphasis accorded to strengthening the tax administration.

One of the results of fiscal laxity is the rise in the public debt, which may break the 50 percent of GDP barrier in the course of this year. While the level of public debt is still some way from the critical 60 percent of GDP level, it is already within the domain where constitutional norms warrant corrective actions. In our view, the results of staff's analysis presented in para 18 of the report point to the fact that medium-term measures contained in the public finance reform program, while welcome, fall short of the needed adjustment to credibly stabilize the debt to GDP ratio at 55 percent by 2006. Both constitutional norms and the Public Finance Act call for preemptive action in order *not to endanger* the limit of 60 percent of GDP placed on public debt, which implies that in case fiscal adjustment is delayed (or is insufficient) in the coming years, the country may be eventually forced to run fiscal surpluses. The latter clearly puts even further strains on the already sore political environment for policymakers.

The issue of fiscal accounts and the discrepancy between ESA and GFS statistics is of a general nature and has featured prominently in the recent reviews of Poland as well as in other accession countries. In Hungary, for example, the issue of discrepancies between financing and deficit data in particular need to be given attention. In Poland two major issues stand out – the treatment of transfers of the revaluation reserve from the NBP and the issue of the inclusion of second-pillar pension funds in the general government. If these items are excluded from the general government in accordance with the ESA methodology, the overall deficit rises notably and elicits added adjustment incumbent upon Poland in accordance with the convergence criteria.

Given the centrality of fiscal accounts in assessing the readiness of CEEC countries to accede to the euro area a major effort needs to be undertaken to clarify the methodology pertaining to the compilation of fiscal accounts. In this respect we greatly welcome the work undertaken by the Statistical Department of the Fund together with the representatives of the Ecofin to harmonize GFS and ESA accounts. Our understanding is that as of now GFS-2001 is fully compatible with ESA, which opens up the possibility of surmounting existing discrepancies in fiscal accounts in the observable future.

In the sphere of monetary policy, we are concerned about the episodic disagreements between the NBP and the Finance Ministry, which impede efforts to rationalize the macroeconomic policy mix. One of the key issues in these disagreements has been the transfer of the revaluation reserve to the budget. In our view, the overriding concern in this debate should be the preservation of the ability of the NBP to independently conduct monetary policy. We cannot see any mode of transferring these funds to the budget that would be conducive to improving the management of public assets and liabilities.

With respect to the inflation target we tend to concur with the staff that a wider band as well as a higher target would be warranted. On the exchange rate, as the staff report rightly notes, there is a host of question marks regarding the permissible exchange rate band for the zloty under the ERM-II as well as the choice of the central parity. With respect to the latter issue, it will be important to avoid any sizeable appreciation of the zloty, which is likely to be hampered by the operation of the Balassa-Samuelson effect. As for the permissible band, it is clear that the narrower the band, the less the room for maneuver for the Polish authorities in crafting their monetary policy, the more distant the entry into the euro area is likely to be.

On the external front the moderation of the current account deficit in recent years has brought it down to relatively low levels compared to Poland's vis-à-vis in the region. At the same time we note that this is paralleled by a decline in FDI, as exemplified by the transfer of operations of some of the multinationals to neighboring countries. The causes of the latter phenomenon may in part be attributable to the relatively high labor costs as well as the slowdown in structural reforms, in particular the privatization process.

On the structural front, the key problem is the high unemployment. While the problem has been addressed in part by the Polish authorities through a set of decisive measures that we welcome, we agree with the staff that there does remain a sufficiently wide array of steps that may be undertaken to effect a reduction in unemployment rates. In particular we see a need to address current disincentives to actively seek work that are inherent in the current system of social benefits, as well as raising the efficiency of employment agencies in facilitating job placements.

Another important issue in the structural sphere is the slowdown in the privatization process, which results in insufficient restructuring of the corporate sector in recent years and slows the flow of deficit financing to levels that are frequently below initial projections. Perhaps the rule of "restructuring first and privatizing later" may have become too restrictive in advancing privatization during the later stages of transition and in a political climate that is no longer as favorable to corporate restructuring.

In the trade sphere, we note that the reduction of Poland's relatively high import tariff to EU levels will be beneficial for Poland and its trading partners. At the same time the effects of the adoption by Poland of EU's anti-dumping regime will adversely affect third parties. Moreover, the liberalization momentum would be forthcoming after EU expansion only if it avoids the "protectionist bias" in the conversion of the anti-dumping regime of accession countries to EU standards, which may emerge in case accession countries are allowed to retain some of their own anti-dumping duties after joining the EU.

Problems in the sphere of trade liberalization feature not only with respect to third countries, but also amongst the accession countries themselves. In this respect, we note that in spite of the existence of CEFTA and the imminent accession of the region to the EU, at times there do appear frictions in the economic sphere that hamper regional cooperation. One of the areas of concern is agriculture, where after the stand-off between Poland and Hungary that was resolved in 2000, occasional disagreements resurfaced as evidenced by the agricultural trade disputes directed to WTO's dispute settlement body in 2001 (Slovakia and Poland), as well as more recently in April 2003 (the Czech Republic and Poland). Also, of particular concern is the introduction of anti-dumping duties, of which the most recent example has been the anti-dumping duty on Czech rubber leveled by Poland at a rate of 21 percent. The aforementioned anti-dumping duty together with the latest trade dispute directed to the WTO come less than a year before the accession of both the Czech Republic and Poland to the EU, when trade policy is to be delegated to the EU and such disputes will presumably have to disappear. It is our hope that as EU accession draws nearer regional cooperation in the economic sphere will be reinforced.

With respect to sectoral reform, we believe that the staff report correctly identified the main challenges ahead, namely the financial sector and agriculture. With respect to the former, we welcome the Polish banks' response to the difficulties in the sector that have emerged recently. Further improvements in banks' operations, restructuring and prudential regulation are called for in view of the likely increase in competition after the accession of the country into the EU. Restructuring is perhaps even a more pressing issue in the agricultural sector, where productivity gap with the rest of the EU is unlikely to be compensated by sufficient EU transfers.

Finally, as an aside, we noted that there were a whopping 5 (five) references to the Russian crisis in the staff report, which compares to 3 in the 2001 and 2002 staff reports respectively. With respect to the PIN, we found the reference to the Russia crisis (last paragraph) difficult to comprehend and to reconcile with the reference to the recent re-orientation of Polish exporters to rising CIS markets (first paragraph). More generally, even though almost five years have passed since the August 1998 events, the staff repeatedly makes references to the crisis in rationalizing Poland's underperformance in employment as well as in export growth (see for example para 12 of the Selected Issues paper, or para 30 of the Article IV report). Apart from the fact that ex-ante any such effects could not have been exorbitant if only because as noted in the staff report Russia accounted for merely 3 percent of total Polish exports, we stress the lack of timeliness of such references, whose expiration date is long overdue.

With these remarks we wish Polish authorities every success.

Mr. Andersen submitted the following statement:

I thank staff for a well-written set of papers and Mr. Szczuka for his helpful statement. I am in broad agreement with the staff appraisal and can also associate myself with the thrust of the preliminary statement by Mr Vittas. Over the years, Poland has made impressive progress in macroeconomic stabilization and structural reforms and for a long period experienced sound economic growth. However, after being a frontrunner among the transition economies for a number of years, Poland is now facing more significant challenges with slow growth, a deteriorating fiscal position, falling investments, and much too high and increasing unemployment.

The authorities would seem well advised to make full use of the likely strengthening of the cyclical position and imminent EU entry to rebalance the policy mix through a strengthening of the fiscal policy and accelerating their structural reforms. Such stability-oriented policies have their own merits and would support the still fragile recovery underway. They would also be essential in preparing Poland for effectively harvesting the potential significant benefits as member of an enlarged EU.

Fiscal Policy

More ambitious and sustained fiscal consolidation should be an essential ingredient of the necessary rebalancing of the policy mix. Thus, I fully share staff's assessment that Poland's exposure to fiscal risks is significant and it is likely to increase in future if the fiscal policy remain unchanged. In the last couple of years the fiscal deficit has increased significantly not only because of the slowdown in growth, but also reflecting a loosening of the policy stance brought about by higher mandatory expenditures. Furthermore, with the fairly small size of automatic stabilizers, the cyclically adjusted general government fiscal deficit remains consistently high. For 2004, the fiscal adjustment appears rather small and to be mainly cyclical, as the budget will have to accommodate additional spending pressures resulting from accession. Possible upward revisions of fiscal balances due to the ongoing process of bringing fiscal data in line with the ESA 95 standard should also be taken into account. Looking ahead, Poland will as EU member have to fulfill the EU Stability and Growth Pact upon membership and its requirement of a fiscal situation close to balance or in surplus in the medium term, which underscore the need for more decisive and sustainable fiscal consolidation, including further adjustments beyond 2004 formulated within a clear and coherent medium-term framework and based on prudent assumptions.

As emphasized by staff and Mr. Vittas in his statement, there are several good reasons to support the need for a deep reform of public expenditures. While the recently presented new medium-term fiscal policy plan unfortunately would imply a less ambitious consolidation path than foreseen earlier, it includes a number of important and reasonable reform proposals. including a reduction in subsidies to local governments and elimination of the automatic indexation of social transfer payments. Abolishment of a number of tax exemptions and unduly high social transfers with automatic adjustments should help eliminating distortions and increase efficiency of resource allocation. I share the authorities views about the relevance of reducing taxation rates, however cautiousness and careful monitoring of the pace of lowering the corporate and income taxes is also needed, especially in light of pressing expenditure needs. On the expenditure side the planned reduction of redundant agencies and abolishment of the indexation are steps in the right direction, whereas capital expenditures offer less room for savings due to the significant investment needs.

Although containing welcomed measures, some of the proposals have apparently only received lukewarm support, and the plans passing seems highly uncertain at present. On the use of valuation gains on the NBP foreign exchange holdings, I concur with Mr. Vittas remarks, including his emphasis on the need to take the requisite action to deal with the underlying fiscal problems. Moreover, under more cautious growth assumptions, these measures would achieve only one third of the adjustment needed as estimated by staff. Therefore, I concur with staff that more ambitious measures are needed, including concerning health care reform, equalization of mandatory retirement ages for men and women, tightening eligibility for disability pensions, and reduction in subsidies.

Monetary and Exchange Rate Issues

The monetary authorities should be commended for bringing down inflation and inflation expectations allowing a shift in strategy focusing on stabilizing instead of further reducing inflation. While further lowering of interest rates may be needed and past reductions could, perhaps have been somewhat more aggressive with the benefit of hindsight, the urgency for additional monetary easing has somewhat diminished with the sharp depreciation of the zloty and a rebound in private credit growth recently. Furthermore, in balancing the various considerations, I agree with staff that it is necessary to take into account the monetary transmission mechanism of past interest rate reductions and also for the monetary policy authorities to be appropriately responsive to credible and sustainable improvements in fiscal policy.

On ERM-II and euro membership issues, I fully concur with the remarks made by Mr. Vittas. The agreed framework needs to be respected, including the avoidance of any public pre-announcements of a preferred entry central rate for the zloty and fluctuation bands. While I very much look forward to welcome Poland entering the ERM-II, it is important that the authorities ensure that a general economic policy framework is in place consistent with the objectives of the mechanism before entering the mechanism. Moreover, it should be borne in mind that the objective of ERM-II is exchange rate stability, despite the wide fluctuation bands. Joining ERM-II means pursuing price stability through a stable euro exchange rate as the main objective for monetary policy. Thus, upon entry in the mechanism interest rates will have to be set with the aim of keeping the exchange rate stable. The fact that interest rates are reserved for this purpose, in turn, requires a stability-oriented framework for fiscal policy, and the risk of market pressure within the ERM-II would argue in favor of erring on the side of prudence when formulating and implementing fiscal policy. Thus, participation in the ERM-II should help to achieve the necessary convergence as emphasized by Mr. Vittas and should not be seen as a mere waiting room for the adoption of the euro.

Structural Reforms and Privatization

It is encouraging that the structural changes made in recent years have led to a strengthening of the competitiveness and financial position of the corporate sector. However, with almost 1/5 of the labor force being unemployed, I concur with Mr. Vittas that the still severe structural problems in labor and product markets need consideration and join his and staff's policy recommendations.

Moreover, it is important to continue monitoring closely both banking sector developments and external vulnerabilities, including the risk associated with foreign exchange denominated lending. The necessary restructuring of the agriculture sector represents a serious challenge for the authorities. Furthermore, the need for accelerated privatization deserves emphasis. Reforms in coal mining, steel and railways sectors are crucial to reduce contingent liabilities and to enhance the efficiency of the economy.

Mr. Kitahara and Mr. Watanabe submitted the following statement:

General Remarks

The years 2000–2001 were quite difficult ones for Poland. The depth of the economic slowdown contributed to a sharp rise in unemployment, and the high level of joblessness is now the government's main economic problem. In 2002, the economy began to recover, but the recovery is still fragile. The slow pace of growth after the mid-1990s can be attributed to a number of factors, including weak economic conditions in the euro area, and domestically, a large fiscal deficit, high interest rates, monetary tightening, and a large swing in investment, which have caused a decline in consumption and a downturn in business activities. These domestic factors in particular have increased the pressure to restructure the corporate sector, leading to an increase in unemployment. More important, the slow pace of growth in recent years has also drawn attention to another major policy challenge: a more-balanced policy mix. The strains between fiscal and monetary policy have dominated policy discussion from the mid-1990s onwards, but the authorities have still to find a way to deliver the desired policy mix of fiscal consolidation and a more relaxed monetary policy. Achieving progress on this issue will be important not just for Poland's economic prospects but also for its chances of fulfilling the Maastricht criteria required to enter the EMU, which the authorities wish to see happen as early as possible. Despite these challenges, we have no doubt that the Polish economy shows promise, as evidenced by the fact that non-privatization FDI has stabilized significantly in recent years.

The staff highlights two main challenges that need to be addressed expeditiously: undertaking structural expenditure reforms and accelerating other structural reform. Since we broadly concur with the thrust of the staff's appraisal, we will focus our comments on several areas related to these two principal challenges.

Fiscal Policy

The selected issues paper highlights the fiscal risks and vulnerability through an investigation of the government's contingent liabilities and a stress test to gauge the exposure of the budget to fiscal risks. The paper concludes that greater borrowing requirements do not in themselves pose an immediate threat to the sustainability of public finances and that the current fiscal stance is not unsustainable in a technical sense, provided a correction is forthcoming, since Poland still benefits from a low debt burden by international standards. However, the recent deterioration in public finances has implications for economic policy generally:

As long as fiscal consolidation is delayed, the authorities will have correspondingly less room to use discretionary spending and the automatic stabilizer for counter-cyclical purposes in times of slow economic growth such as Poland has experienced in recent years.

The large fiscal imbalances have encouraged upward pressure on inflation, a larger current account deficit, and, in policy terms, a correspondingly tighter monetary policy bias, with negative effects on economic growth.

The implications for the private sector have also been negative, as greater public borrowing requirements have tended to crowd out lending to small and medium-sized enterprises (SMEs), and domestic investments have been declining in recent years. Fiscal consolidation should support domestic investments by reducing overall dissaving.

Past experience of fiscal consolidation suggests that focusing on improving revenue performance tends to be less sustainable in the long term than reducing government expenditure. This is especially the case in Poland because of upward pressure on its already very large proportion of nondiscretionary spending, as evidenced by the fact that mandatory spending on social security and extra-budgetary items alone has constituted over 80 percent of central government spending in recent years.

Taking these factors into consideration, the fiscal policy objectives appear to be rather straightforward in the sense that fiscal consolidation should be pursued decisively; with more efforts made on the structural expenditure front. The recently proposed fiscal reform is a welcome step toward fiscal consolidation and is essential for establishing the credibility of the authorities' intention to cut the structural deficit. However, the proposed reform may be insufficient to return the public finances to a sound footing given that less attention has been given to cutting structural expenditures. Fiscal consolidation should focus more on reducing recurrent structural expenditures, such as public sector retrenchment, further reform of pensions and healthcare, and reducing social benefits and subsidies. The latter could adversely affect the socially vulnerable, however, and the authorities need to examine carefully whether such reforms would be politically feasible.

Monetary Policy

Since the introduction of the inflation target (IT), monetary policy has been successful in reducing inflation. The new medium-term monetary policy framework, which includes the IT and a floating exchange regime, will help Poland keep inflation within the target range. Since early 2001, the Monetary Policy Council (MPC) has employed a substantially relaxed policy stance, and as there are no signs of any threat to the inflation target at this stage, there may be room for further rate cuts. Taking into consideration recent monetary conditions, we believe it is appropriate that the MPC's monetary stance shifted from reducing inflation to stabilizing it.

Maintaining the floating exchange rate regime will lessen external vulnerability associated with large and volatile capital flows. Also, the recent currency depreciation will support the monetary strategy and improve external competitiveness. As staff rightly points out, however, careful consideration needs to be given to the likelihood of an emerging nominal currency appreciation. To this end, improving the policy mix is a key to preventing a significant nominal appreciation that would pose a risk of setting an overvalued rate before the central parity for ERM2 is established.

We believe that an independent monetary policy is one of the most important pillars of good macroeconomic management and is a prerequisite for the desired stronger policy coherence and coordination between fiscal and monetary policy. That said, it is regrettable that the plans to improve the policy mix are being hampered by tensions between the government and NBP on use of the NBP's revaluation reserve to close the fiscal gap. We fully concur with the staff that consideration should be given to optimal public debt management, appropriate capitalization of the NBP, and the level of foreign exchange holdings; and, needless to say, any decision must ensure the NBP's unfettered ability to conduct monetary policy.

Structural Reform

Structural reform is key to increasing external competitiveness and ensuring sustained growth in the medium term, and the authorities' intention to push ahead with privatization is critical in this regard. We share the staff's concern that frictions between government agencies or with foreign investors could detract from Poland's position as a good location for foreign investment, and we urge that they be resolved as soon as possible. We hope that these concerns will recede if the authorities make concrete progress on specific privatization projects. As for the restructuring of nonviable enterprises, the authorities need to proceed carefully, taking into account their social and political viability.

Tackling unemployment is a significant challenge, and the authorities should focus on improving the functioning of the labor markets. The recent labor market reforms are welcome; however, further efforts will be needed in order to eliminate labor market rigidities. Consideration might be given to adopting in the near future the staff's valuable suggestions highlighted in paragraph 31 of the staff paper.

The restructuring of the agriculture sector has been limited, and the rural economy continues to lag behind. The restructuring of this sector is key to raising efficiency, improving resource allocation, and ultimately increasing growth. Consideration should be given to reforming farm pensions as well as subsidies.

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

Mr. Kremers and Mr. Litman submitted the following statement:

I would like to commend the staff for well-written reports. I also would like to thank Mr. Szczuka for his insightful statement.

ERMII and EMU accession

The staff's recommendation of adopting the euro as soon as possible seems to be motivated by its belief that there is a need to strengthen the authorities' resolution to implement structural reforms promptly. However, it should be emphasized that the reforms may inflict social pain before their benefit would be felt. Given Poland's high unemployment, the reforms aimed at privatizing public enterprises, reforming agriculture, and changing social benefits are politically unpopular. Therefore, a wide ownership of the reforms is crucial for their successful implementation.

Although we agree with the staff that the ultimate adoption of the euro can yield large benefits, we feel that the staff does not pay sufficient attention to the risks entailed in its ambitious strategy. Most importantly, the staff fails to recognize the potential tension between nominal and real convergence. In this respect, we would like to stress the importance of a realistic and sustainable nominal convergence path that is not only focused on meeting the Maastricht criteria at the earliest possible moment. The clear risks of aiming for a quick access to EMU deserve more attention. For instance, a too rapid consolidation path could be counterproductive for the real convergence process, as this process will require substantial public expenditure on education, governance, and infrastructure in the coming years. The 15 percent effective depreciation of the zloty since early 2002 has been a welcome boost and adjustment tool for the Polish economy. Poland may be served by a somewhat longer period between EU accession and participation in the euro area. After all, retaining for some time a certain degree of nominal exchange rate flexibility would allow Poland to accommodate pressures arising from the catching-up process. Moreover, exchange rate flexibility would enable Poland to absorb asymmetric shocks as long as the domestic economy is not flexible enough to adjust itself internally.

The staff mentions (in paragraph 10) that the Polish authorities were eager for clarification as to whether the exchange rate would need to remain within wide or narrow bands for two years prior to euro adoption. In this respect it should be noted that euro candidates who enter ERM II will be assessed for readiness to adopt the single currency conform the Treaty. The assessment of exchange rate stability against the euro will focus on the exchange rate being close to the central rate while also taking into account factors that may have led to an appreciation. However, the assessment period in ERM II ("waiting room") should only be seen as the last phase in the mechanism. It would be advisable for Poland to first make use of the flexibility ERM II offers, by explicitly allowing for wide bands and the possibility of parity realignments in an early stage (i.e. without holding on to an unrealistic parity for too long).

Monetary and Exchange Rate Policy

We concur with the staff's view that the inflation target of the NBP (2.5 percent) is rather ambitious—especially given an estimated Balassa-Samuelson effect of 1-2 percent—and is fully geared towards meeting the relevant Maastricht criterion. The recent Polish experience clearly shows that a too-ambitious nominal convergence can come at the cost of less progress in real convergence. A side-effect is that the low—and lower than expected—level of current inflation rates makes it difficult to limit real increases in transfers to households and public sector wages. Therefore, it may be advisable to consider a higher inflation target, for some time, with a wider band. Given the large fiscal deficit, we understand the NBP's reluctance to cut the interest rate. However, a policy of frequent small interest cuts might validate the NBP's view that the present level of interest does not damper growth, at the same time enabling the NBP to continuously assess inflation pressures.

The 15 percent effective depreciation of the zloty since early 2002 has been a welcome boost and adjustment tool for the Polish economy. A too high interest rate may lead to unwarranted appreciation of the zloty.

As regards revaluation reserve, we encourage the staff to take a clear stand on this important matter. We believe that the revaluation reserve should not be part of a budget. Moreover, we urge the MoF to respect the independence of the NBP.

Fiscal Policy

The authorities want to fulfill the Maastricht criterion concerning public finance in 2006. However, two caveats are in place. First, staff rightly points out that the Polish authorities may be too optimistic about future growth prospects, and, subsequently, underestimate the fiscal deficit. Second, the second-pillar pension funds are planned to be included in the general government budget, although it is not sure whether this will be approved by Eurostat. Therefore, it will be hard for the authorities to reach government-net-borrowing below 3 percent GDP by 2006.

It should be noted that once Poland will join the euro area, the obligations under the Stability and Growth Pact will become binding. The most important obligation, namely fiscal consolidation (interpreted as being close to balance in the medium term) may actually be too stringent for Poland in the years to come. Poland's EU-accession and the ongoing convergence process will require substantial public investment in areas such as infrastructure, governance, and education.

Therefore, in order to improve the government finances, we urge the authorities to focus on structural expenditure and tax reforms over the medium to long term.

Structural Policies

The authorities prefer the "restructure-first, privatize-later" approach. We urge the authorities to reconsider such approach, as it might considerably delay the privatization process. Moreover, we do not believe that in principle governments have special skills in restructuring enterprises, and vested interests may unduly influence the decision which enterprises to restructure and which to liquidate. Given the high unemployment, we understand the authorities' concerns that some investors might seek short-term profit by cutting production. Yet, we believe that the proper screening process may select the long-term investors over the short termers.

Recently, the privatization of the largest Polish insurance company (PZU) has been postponed. Also, three Polish banks are still state-owned. The halting privatization in the financial sector may have serious adverse consequences for the pace of real convergence, as an inefficient financial system puts a brake on the much-needed process of reallocation of resources and structural convergence. Therefore, we urge the authorities to a renewed privatization effort in the financial sector.

While we agree with the staff that the restructuring of agriculture is crucial to improve resource allocation, we share the authorities' concern. Rapid restructuring might aggravate the already high level of unemployment. Therefore, the authorities will need additional time to shape and to mobilize large public support for this reform.

Governance

While we noted the effort that authorities are making to improve governance, it should be pointed out that according to the Transparency International, Poland with the score of 4.0 occupies a much lower rank than most accession countries. Given the abundance of evidence that corruption adversely affects investment and subsequently growth, we urge the authorities to do their utmost to improve governance.

Mr. Usman submitted the following statement:

We thank the staff for the detailed report regarding economic developments in Poland, and Mr. Szczuka for a very helpful statement, which provides further useful insights of the Polish economy. After a decline in GDP growth over the last two years, the Polish economy is now showing signs of recovery. The strength of the recovery will, however, be enhanced by the continued implementation of sound macroeconomic policies, increased investment, and a stronger growth in exports, which would be facilitated by economic recovery of the Euro area, particularly in Germany. Since we are in broad agreement with the overall thrust of the staff paper, we would limit our comments to a few issues.

Fiscal Policy

Fiscal policy has been expansionary over the past two years against the backdrop of weaker growth performance, which resulted in a widening of the general government deficit, mainly because of the working of automatic stabilizers. We note the authorities' intention to follow a tighter fiscal policy stance for this year, as indicated in the 2003 budget. Nevertheless, as the staff note, since GDP could be lower than projected in the budget, revenue targets may consequently not be achieved. While we could support the authorities' intention to exercise expenditure restraint to ensure that the fiscal position does not deteriorate further, we could understand their caution not to implement structural expenditure reforms at this time, given the fragile political environment.

Monetary Policy and Exchange Rate Developments

We commend the authorities for continued implementation of sound monetary policy, which successfully reduced inflationary expectations. We observe that the authorities have appropriately eased their monetary policy stance by lowering interest rates, which could provide some stimulus to growth performance. It would also be important at this juncture that the authorities implement an appropriate monetary/fiscal policy mix, to ensure that output growth is firmly entrenched.

A number of factors contributed to the depreciation of the currency, including the lowering of the interest rates. The weaker currency could contribute to improved export performance over the medium-term, and we concur with the staff that the authorities should ensure an appropriate macroeconomic policy mix to avoid undue appreciation of the zloty. We are also pleased to note that the authorities have refrained from intervening directly in the foreign exchange market, and to allow the exchange rate to act as a shock absorber in the economy.

Financial Sector and Structural Developments

While the overall banking system in Poland is still considered to be sound, the weaker economic environment has contributed to the reduced profitability of banks, as well as increased nonperforming loans. We welcome the assurances by the staff that nonperforming loans are fully provisioned for, and that banks have taken the actions needed to ensure their profitability. Given the fragility of the economic recovery, however, banks will remain under pressure during the rest of 2003; we would therefore urge the authorities to keep a watchful eye on the financial environment.

We welcome the authorities' commitment to pursue their privatization initiative after it came to a halt during 2001/02. We are particularly pleased, however with the emphasis that future attempts should focus on minimizing social hardships.

Labor Market Conditions

Unemployment in Poland, which ranks highest among OECD-countries, remains a serious concern to the authorities. We commend the initiatives implemented by the authorities since mid-2002 to tackle this problem, however, we are cognizant that reducing high unemployment should be a medium- to long-term undertaking. The staff recommend further changes to expedite the process, and we would urge the authorities to give these suggestions serious consideration.

Finally, the Polish people will soon decide through a referendum on whether to join the European Union. Whatever the course they decide to take, we wish them and their authorities every success in their future endeavors.

Mr. Rutayisire submitted the following statement:

We thank Staff for the well-written set of papers. It is encouraging to learn that the economy of Poland is recovering from a major slump in 2000-01. Overall, recent developments are positive, but the recovery remains hesitant and concerns stay put. In the short term, the persistence of mismatches and rigidities in the labor market holds unemployment at high levels; misallocation of resources in and to the agriculture area keeps this sector prone to inefficiencies; and banks' assets continue to deteriorate as evidenced by rising nonperforming loans since 1999. Alongside these economic indicators, political uncertainty add stress to short-term prospects.

The medium-term outlook shows a more optimistic picture provided that the post-90s structural reforms are consolidated and furthered, and that the authorities adopt and maintain sound macroeconomic policies in light of the country's adhesion to the euro area. In this context, one must be mindful of the constraints that the European Exchange Rate Mechanism (ERM2) will add to the authorities' monetary policy. Another medium-term challenge to Poland lies on the need to reverse rapidly the continuously declining savings and real investment. The realization of the medium-term economic predictions depends on Poland's capacity to address its growth-impairing investment level, as well as to implement structural reforms to curb the weaknesses mentioned above.

Fiscal Policy and Reforms

The incessant rise in government deficits is worrisome and calls for tightening fiscal policy. We agree with - and commend the authorities for- the view that they must consolidate the fiscal stance to help unlock savings, investment and growth by broadening the tax base and reducing the generous tax exemptions. However, we also share the view of staff that such reforms must include more transparency in fiscal management, especially when it relates to taxes. While we praise Poland's authorities for progress achieved in spending discipline and fiscal transparency over the last two years, we also encourage them to take promptly further actions aimed at fulfilling the recommendations of the Report on Observance of Standards and Codes (ROSC), particularly the harmonization of accounting standards, the timely and frequent dissemination of data, and transparency in the recapitalization of state-owned enterprises. Benefits of these governance measures will also give positive signals to investors.

On the expenditures front, one notes that the GDP share of government spending still equals that of private investment. It is important that the Polish economy becomes less dependent on government. Such uncoupling can be achieved through the provision of regulatory and financial incentives to foreign as well as domestic private investment. In addition, restructuring of state enterprises and privatization should be given another boost as the post-90s momentum seem to vanish. We would like to insist on the need of transparency in such actions.

Monetary Policy

We appreciate the authorities' clear stance for intervention-free foreign exchange transactions. However, one must be mindful that the access to the ERM2 will add constraints on this front. We would like to have better understanding of the authorities' commitment to an inflation-targeting role of their monetary policy (until full accession to the euro area), especially at times of strong currency appreciation that might induce the authorities to intervene in foreign exchange markets in fear of competitiveness loss or for concern of meeting the currency band.

On the particular setting of the inflation-target, we agree with Staff that the authorities must fully take into account all anticipated inflationary effects. Thus, without endangering the policy mix needed and recommended by Staff, (tight fiscal policy coupled with loose monetary policy) we call for caution in the current strategy of cutting interest rates.

Financial Sector and Vulnerability

As regards the banks' response to the deterioration of their assets, notably the quality of loans, while we agree with the full provisions of nonperforming loans with conservative collateral valuation, we regret the use of employment as a variable of adjustment for banks. A preemptive approach should be preferred and would avoid employment cuts and credit shrinkages. In this regard, alongside Staff, we welcome the development of a credit information database, and recommend the authorities to enforce prudential standards.

Polish banks are greatly exposed to exchange risk. Indeed, their assets, particularly housing loans, are largely denominated in foreign currency albeit a recent drop in foreign-currency corporate borrowing. This, coupled with further zloty depreciation, would put banks' portfolios at major risk. Thus, the authorities should consider strengthening banking prudential standards related to external vulnerability, alongside the newly-created vulnerability-monitoring unit of the National Bank of Poland.

Structural Reforms

We would like to call for a renewed boost in the restructuring of state-owned enterprises and privatization to alleviate cost inefficiencies of enterprises. Staff's view against restructuring nonviable enterprises and the recommendation to liquidate them are founded. However, we would raise our concern that caution be used when an entire sector is at stake.

This Chair joins the staff in welcoming changes to the Labor Code in mid-2002 and liberalization measures intended to lower costs and easing restrictions on employers. Deeper structural rigidities on the labor market must be addressed by the authorities. They include removing regulations that stall labor demand; eliminating disencentives to work (in this regards, it is important to reallocate the generous benefits from unemployment to employment and skills); and creating the conditions for improved labor mobility in line with the staff's appraisal.

As regards the unfavorable shocks to labor market, one may examine the extent to which Poland's accession to EU will affect current adverse shifts in the wage-setting curve, after all one can expect that the markup parameter can be affected by a changed output-sensitivity of employment, for instance.

Regarding the agricultural area, it is crucial that the authorities address the inefficiencies affecting this sector. Particularly, we encourage them to correct the low productivity that characterizes the polish agriculture. More importantly, we call on the authorities to eliminate agricultural subsidies that hamper fair and competitive global trade.

On a final note, we greatly appreciate Poland's willingness to provide debt relief to poorer countries in Africa and Latin America.

We wish the authorities of Poland full success in their future endeavors.

Mr. Wei submitted the following statement:

We thank the staff for the candid and well-written reports and Mr. Szczuka for his very informative and helpful statement.

Although Poland's robust growth momentum has subsided since 2000, it remains a leading transition economy in terms of productivity growth, disinflation and its prudent institutionalized macroeconomic policy framework. Nevertheless, as staff points out, during the early transition period, many structural problems have accumulated—investment overhangs, high unemployment and increasing pressure on the fiscal account. In this sense, we encourage the authorities to win broad public support and take swift corrective actions to bring the economy back on a sustainable development track to embrace EU accession next year and future EMU entry.

As we broadly concur with the staff appraisal, we will comment on the following aspects—fiscal, monetary and exchange rate policies, unemployment and the labor market and financial sector development.

Fiscal Policy

The economic downturn over the past two years has contributed to the deteriorating fiscal balance and a steady increase in public debt. We note staff's concern that if the economic recovery is slower than forecasted for this and the coming years with no change in fiscal policy, public debt may exceed 60 percent of GDP—the Constitutional Debt Limit. At the same time, we sympathize with the authorities who face these difficulties at a time of sluggish growth when the fiscal stabilizer is called to play. In this connection, it is imperative that the authorities speed up structural fiscal adjustment to avoid a "big-bang" fiscal correction in the near future and provide scope for the fiscal stabilizer. It will be also be instrumental in boosting domestic savings.

With little room for maneuver on the revenue side, there is much pressure on a structural balance adjustment on the expenditure side. We join staff in encouraging the authorities to press ahead with pension and social benefit reform while realizing how difficult it is for them to proceed. The "de-indexation" of fiscal spending could also be considered. Meanwhile, phasing out the widely used government guarantee to SOEs is an important way of reducing the contingent liabilities and the government's debt burden as well as market distortions. In addition, privatization receipts can also help finance the fiscal deficit. The revaluation of the National Bank of Poland's (NBP) foreign exchange holdings can only be a one-off measure.

Monetary and Exchange Rate Policy

The NBP should be commended for its success in reducing inflation expectations under the inflation target regime, thus providing room to adopt an accommodative monetary policy to boost growth. In this vein, we welcome the consecutive rate cuts by NBP early this year, including the latest 25 basis points cut at end-May. Nonetheless, given the moderate consumer confidence and declining investments, we wonder how long it will take to reverse the historically weak credit growth and from which sectors the credit expansion will start.

On the inflation target, in view of the moderate upward inflation pressure, we believe the 2.5 percent target rate is within reach. Regarding the estimation of the 1–2 percent Balassa-Samuelson effect, we would like to argue that the recent wage moderation and high unemployment might dampen this effect. Staff's comments are welcome.

The current floating regime has served the economy well and we welcome the recent depreciation of the zloty in enhancing external competitiveness. However, the appropriate central parity for Poland's entry to ERM2 is still unclear. It will be a huge challenge for the authorities to keep this parity for a relatively long period while maintaining the inflation-targeting regime at the same time.

Unemployment and the Labor Market

Structural factors have been responsible for the continuous rise in the unemployment rate and the authorities need to take sweeping actions to further liberalize the labor market and generate job opportunities. We warmly welcome the revised Labor Code last year aimed at lowering costs and easing restrictions on employers as well as the measure to reduce the minimum wage requirement for young first-time jobholders. At the same time, we encourage the authorities to try every means to boost private sector development—so crucial in generating jobs for those laid-off from the state-owned enterprises. We welcome the authorities' program to support enterprise restructuring, which has benefited more than 60,000 small enterprises and contributed to protecting the level of employment. In addition, as put forward in the selected-issue paper, enhancing in-work benefits and improving the skills of the unemployed are valuable lessons learned from other countries' experience when tackling long-term unemployment problems. We also take staff's view that given the current difficult fiscal situation, room for targeted tax cuts may be limited.

Before concluding, we welcome the authorities' willingness to provide debt relief to Mozambique and Nicaragua and to seek a solution with Tanzania.

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

Mr. Alowi and Mr. Jamaluddin submitted the following statement:

We thank the staff for their well-written set of papers and Mr. Szczuka for his informative statement. The Polish economy has been growing steadily in the late 1990s and in 2000. However, the economy experienced imbalances during 2001–2002 following the slowdown in global economy. In 2002, although the GDP growth increased marginally to 1.3 percent compared with 1 percent in 2001, the slack in the economy remains evident. Investment continued to decline and the unemployment rate increased further while the weak European market constrained the scope for exports. Nevertheless, on the positive side, the authorities are to be commended for their effective efforts in reducing the inflation rate.

We are in broad agreement with the staff's appraisal and find that the policy recommendations are appropriate. We shall, therefore, limit our comments on a few areas for emphasis.

Economic Outlook

The staff's medium term scenario projects that growth will increase to 2.6 percent in 2003 and rose further to a range of 4-5 percent in 2004-2007. We tend to agree with the staff's projections and believe that the authorities are aware of the risks ahead, in particular in 2003. The domestic demand, in particular consumption, which is the major contributor to growth, would have to improve strongly to support the growth projection in 2003. The expected turn around in the growth of investment in 2003 is welcome. With the high projection on FDI, it is believed that the expected pick up in investment will be mainly driven by foreign investors. However, with the continued uncertainty in the global economy, whether such significant improvement in FDI will materialize remains to be seen. Another main challenge in the immediate term is the high unemployment rate. We note that the unemployment rate has been in a double digit growth for quite sometime. The rate declined slightly in 1997 but has showed a rising trend thereafter. The staff's paper on Selected Issues highlighted that the unemployment rate in 2002 was the highest compared with the rate during the past ten years. It is unfortunate that the period of high economic growth in the past years failed to reduce the unemployment rate and the expected higher economic growth in 2003 will also be accompanied by high unemployment rate. With these issues, the key challenges to the authorities now are to effectively pursue prudent macroeconomic policies and structural reforms to ensure the sustainable economic growth over the medium term.

Fiscal Policy

We welcome the recently-proposed fiscal reform and share the view of the staff that the reform would be the first step toward budget consolidation. As staff points out, reducing distortion in the tax system and improving the flexibility of budgeting would improve incentives for investment and employment. We commend the imposition of the limit on the public debt to GDP as the public debt has been on an increasing trend. We see that sustaining fiscal consolidation in the coming years is crucial and will be the key to ensure that the public debt remains within constitutional limits. Reforms to pension and social benefits, reduction in subsidies, cuts in public employment and further improving tax administration are measures that staff proposes be given special focus. We can agree with staff on these measures but under the current domestic situation, the authorities may face difficulties in obtaining political support in implementing some of the measures. We are pleased to note that in order to address the medium-term fiscal challenges, the authorities have prepared a comprehensive fiscal reform program with a key objective of creating conditions for achieving a high and sustainable growth while reducing the budget deficit to below the 3 percent Maastricht criterion by 2006.

Monetary Policy

We note that the monetary policy has been successful in bringing down inflation. Based on the latest updates by staff, the Monetary Policy Council further reduced the key policy interest rate by 25 basis points at end-May. This latest small reduction seems to be in line with the recommendation made by staff in the report. We support this cautious strategy and agree with staff that a still-widening output gap and high unemployment should keep inflationary pressures subdued in 2003-04 even with some reduction in interest rates in the near term. The low interest rate environment could also stimulate the domestic demand, the main contributor to economic growth. Nevertheless, further reduction in the interest rate should be implemented in a cautious manner in light of the uncertainties about budgetary intensions and the impact of large cumulative interest rate reductions.

Financial Sector

We note that the financial sector has been able to weather strains in the past years. Nevertheless, as staff points out, the current state of the banking institutions is less encouraging and the sector would face difficulties in 2003. Bank profits have dropped as nonperforming loans rose and the value of bank's equity holdings fell, and lending decelerated. The authorities agree that weak economic growth could produce poor financial results and a further shift in bank assets from credit to government securities. The high share of housing loans, particularly those denominated in foreign currency, rising unemployment and the depreciation of zloty which may cause further deterioration in the quality of loan portfolios are other reasons for concern. At the same time, we also share the staff's concerns that the banks' respond to the situation through restructuring operations, increasing provisioning and adopting cautious lending practices will put constrains on borrowers. We see that resolution to this situation is crucial to ensure that the private sector, in particular the small and medium size firms and other potential borrowers that are involved in the more productive economic activities have access to credit and thus support economic growth in the immediate term.

Structural Reforms

Finally, on the structural issues, we support staff recommendations for the authorities to address all structural problems facing the economy. In particular, the issue of an increasing unemployment rate should be given greater attention. The staff's paper on Selected Issues discussed in detail this issue and we support staff's recommendations in this area. We also commend the authorities for their intention to address the serious structural problems in the agriculture sector and their plan to speed up privatization and enterprises restructuring.

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

Mr. Szczuka noted that his authorities were pleased with the outcome of the referendum on EU accession. The preliminary results of the referendum showed a turnout of close to 59 percent, with 77.5 percent in favor of joining the EU. Political developments had also gained some momentum since the election. The president had started consultations with the leaders of the main political parties on how to strengthen the government, while the Prime Minister had rather unexpectedly expressed support for the idea of introducing a flat income tax. That suggested that the final shape of the fiscal reform might still be subject to some extensive political debates.

The staff representative from European I Department (Ms. Schadler) made the following statement:

> On whether the staff's estimate of potential growth is realistic, it should be noted that it was worked out from a production function approach. Historically, there has been a very high ratio of investment to GDP, as high as 25 percent during the late 1990s. It has since come down to about 20 percent, but staff's projections, which are the basis for determining the capital stock, see it going back up to about 23 percent, which is rather conservative given that Poland is about to join the European Union and should benefit from higher investment then. Another aspect of the production function is labor input, which should be strong since unemployment is very high. Looking ahead, there should be room for sizable gains in labor input as unemployment drops to the NAIRU, and there may even be some drop in the NAIRU following changes in legislation to improve labor market flexibility. Moreover, we estimate a TFP growth at about the historical average for the last seven or eight years of 2½ percent. All together, that gives us, looking ahead, a potential growth rate between 4 and 4½ percent. It sounds high from the vantage point of the last few years when growth has been very low, but, in fact, all through the 1990s, most of the estimates of potential growth were in the range of 4 to 6 percent. Therefore, I think our estimate, which is at the lower end of that range, is based on conservative assumptions and is fairly realistic.
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> On monetary policy, there was a question on the scope for reductions in real interest rates, which are now at around 6 percent based on backward-looking inflation, and closer to 4 to 5 percent based on forward-looking inflation, which we think will pick up a bit. This is about as low as interest rates in Poland have ever been. While they look high compared to other Central European countries—indeed they are a couple of percentage points higher than most other Central European countries—it is not clear how much lower Poland is going to be able to go. Our advice was to push at nominal interest rates and see when the tolerance for lower interest rates really begins to wane. I would expect that Poland is entering a period where lower real interest rates are feasible, but reductions are likely to come only in small increments from this stage on.
>
> There were questions about credit growth in general, and what would lead to a pick-up in credit growth in particular. In the last couple of months, we have seen increases in year-on-year credit growth. By April, in real terms, credit growth to the private sector was about 5 percent. I do not have any information on what sectors are going to lead this increase in credit growth, and such information would be very speculative at this stage. What I can say is that I think the pick-up will probably be fairly slow, because there were some fairly pronounced cyclical factors underlying the sharp slowdown in credit. Banks are very cautious; they have high non-performing loan ratios

right now, and it takes a while for banks to want to venture back into taking risks of that kind.

On whether there might be a role for intervention, whereas the staff has strongly supported the policy of nonintervention that the National Bank has followed for the last several years, this can really be seen as a question of theology. On balance, we feel that the experience with nonintervention in Poland has been rather good. Markets understand the system, and the signals coming from the National Bank are quite clear. We have been through a period where we were concerned about the extent to which the market participants were hedging their exposure in foreign exchange; and during this very rapid appreciation that took place over the last few years, we clearly were concerned about possibly inadequate hedging. We have the sense that this recent round of depreciation has probably made those borrowing in foreign exchange more cautious, and I believe that any intervention on a sizable scale, even if it were episodic, would probably muddy the signals that are being sent.

On whether the recent depreciation is consistent with medium-term fundamentals, I think it is. Poland's competitive position now has improved, and it is back to late 1990s levels. Indicators of profitability appear to be strong, especially for this stage of the cycle. We have no specific ideas about the pressures that EU accession or prospects for euro adoption are going to put on the value of the zloty, but we think that there will be Balassa-Samuelson effects on the order of 1 to 2 percent a year. Given the authorities' very low inflation target, that would suggest there will be upward pressure on the zloty. However, there is always a chance of speculation as people start considering what the effects of EU accession will be on capital inflows, and so I certainly would not venture a guess on which way the market is going to move, especially in the short term.

On whether Poland's high unemployment might dampen the Balassa-Samuelson effects, that is a possibility in the short run, as in the last year or two. Over the medium term, however, the high unemployment will probably have less of an effect because the Balassa-Samuelson effects are fundamentally driven by two factors: the fact that there is going to be a productivity catch-up, particularly in the traded goods sector, in Poland vis-à-vis the European Union; and the fact that workers in the traded goods sectors will get paid their marginal product. Over time, those two factors, which I think are rather robust expectations, will set the stage for medium-term Balassa-Samuelson effects.

On whether EU-related tax harmonization might hurt revenues, a few kinds of tax changes are envisaged to better harmonize the tax system in Poland with that of the European Union: excise taxes will rise, there will be an elimination of some exemptions from VAT, and there will be lower import duties. In the short term, 2004-6, the effects will probably be slightly negative, on the order of 0.1 to 0.2 percent of GDP. Over the medium term, however, as the derogation on VAT exemptions expires, the revenue effect will probably be very slightly positive. All in all, the effects will be small.

On the financial sector, it is not clear what kind of support strategic investors will be providing. Presently, the financial sector supervisors have informed us that capital adequacy ratios are comfortable and that NPLs are fully provisioned, and there is no immediate need for a capital injection. However, bank profits right now are fairly low and NPLs are fairly high, and it is certainly possible that support could be needed at some stage. The supervisors made it clear that they treat subsidiaries of foreign-owned banks in Poland just as they would a domestic bank. If there is a problem, they approach the owners, they explain that additional capital is needed, and the owners—whether they are foreign or domestic—have thus far always been forthcoming in providing the capital. Overall, we were satisfied that the supervisors are treating foreign banks in a straightforward, transparent manner, and are not in any way taking into account ownership structures that might lead them to act differently in their supervisory capacities.

We have no indications that there may be problems with the regulatory framework. There are plans to privatize at some stage companies in certain sectors where regulatory issues do arise in other countries, so it will certainly be important to stay attentive to those regulatory issues. However, there are no immediate concerns. The World Bank had been planning to do a competition policy review, but upon further examination, decided that it probably was not necessary for them to get involved, as they did not see any particular problems on the horizon, and most of these issues were being handled in discussions with the European Union.

On adopting the euro, there seems to be a perception that the staff is actively encouraging the authorities to pursue an early adoption. This is not the case. The staff report only notes that the authorities are very keen on early euro adoption and are proceeding with plans to move ahead to adopt the euro as quickly as possible; and that the staff does not see any problems with the case that they are making and, in fact, can see many positive aspects in it. However, we certainly would agree with some of the cautionary points in Directors' statements—for example, that full ownership of the fiscal adjustment on the part of the Polish authorities is absolutely essential. This cannot be just motivated by some external goal that is not necessarily itself fiscal in character. The authorities have to understand that the fiscal adjustment is in the interest of Poland; but I think that this is not a point of too much contention in Poland, either. Certainly the discussion is about the domestic need for fiscal adjustment and not just about meeting the Maastricht criteria. The staff is preparing a paper in which the various considerations of the timing of euro adoption, and other issues related to euro adoption, will be spelled out and assessed. Therefore, we do not at this stage have a view, beyond saying that the arguments we heard the Poles making by and large seem valid to us.

Some Directors suggested that retaining an independent monetary policy, and in particular a flexible exchange rate, would help Poland over the next few years as the real convergence takes place, especially in addressing asymmetric shocks vis-à-vis the euro area. However, in the work the staff is doing, there is little evidence that asymmetric shocks are more of a problem for Poland than they are for most other existing euro area countries. This does not necessarily mean that some other euro area countries are not having problems with asymmetric shocks, too—that is not an issue I would go into now. But given that euro adoption is a requirement of eventually joining the European Union, there is no indication that waiting is going to reduce the severity or frequency of asymmetric shocks. Moreover, one of the aspects of the study that the staff is doing is to look at how effective exchange and interest rate policies have been in addressing asymmetric shocks. Without wanting to prejudge the conclusions of the staff's study, so far it is not clear that they have been particularly effective in addressing such shocks, and there are many other mechanisms for doing so.

On the recent large depreciation, some Directors noted that it may have exceeded the 15 percent band that ERM2 would involve and asked whether this had not been of great help to Poland in addressing the weakness in growth. I can only say that there are many people who feel that the appreciation before the depreciation was part of what led to the problem. So you could simply say that the depreciation was undoing the harm that had been done by the appreciation. In any event, this is a very complex area and it is not one on which quick judgments are very useful. Careful examination of the data is essential.

On the setting of the central parity for ERM2, we may have touched a little bit of a raw nerve here. The authorities did not say to us that they were going to set the central parity at the prevailing exchange rate at the time that they enter ERM2. There is a statement in the staff report that says that the authorities anticipated that, at the time the central parity was set, the prevailing exchange rate would likely not be too far away from an appropriate level. That statement was made in the context of discussions that we were having about the conduct of monetary policy, the medium-term monetary policy framework, and how this would segue into the setting of the central parity and ERM2. The authorities are certainly well aware of and in agreement with the notion that the central parity will be a joint decision by various parties, and not a unilateral one. There was no sense in the discussion that they thought that, and that certainly was not the spirit in which the statement was written in the staff report. But they do look around at the other countries that chose central parities for ERM and in general these were set at the prevailing market exchange rates, with some exceptions.

On governance, it is true that the Transparency International results show that Poland suffers from perceptions that it has governance problems, and it does not come out particularly well vis-à-vis other Central European countries in the Transparency International general survey. However, it should be noted that surveys of actual measured aspects of corruption, particularly bribery, tend to show Poland as having fewer problems than other Central European countries and many emerging market countries. It is a common problem that surveys tend to yield worse results when they ask about perceptions rather than about actual observations of bribery or corruption. Therefore, we should be very careful in making statements, particularly in documents like the summing up, on governance issues. It is important to be evenhanded and to be sure that in this very complex area we are reflecting the actual data fairly.

Mr. Bischofberger made the following statement:

I thank the staff for a well-written report and Mr. Szczuka for his comprehensive and informative statement. And, of course, we congratulate the Polish authorities for yesterday's successful EU-referendum. The referendum has paved the way for full EU-membership by May 2004.

Poland's main challenge now is to achieve stronger and sustained growth and to significantly reduce unemployment. A better macroeconomic policy mix and further structural reforms are key in this respect. These measures are also important prerequisites for a smooth entry into ERM 2.

We are in broad agreement with staff's conclusions and recommendations. Furthermore, I can associate myself with many points made by Mr. Vittas in his preliminary statement. Therefore, I will be brief and confine my comments to three issues, namely fiscal adjustment, structural reforms and monetary and exchange rate policies.

First, on fiscal adjustment, we concur with staff and other Directors that an early implementation of structural fiscal adjustment will be key. Therefore, we regret that the 2003 budget does not include initiatives to reduce future spending to achieve this goal. We are, however, encouraged to hear from Mr. Szczuka that the Polish authorities are fully aware of the need to implement decisive fiscal adjustment. In this regard, we welcome the proposed public finance reform program. This program would be a welcome step in the right direction. However, it is important that the reform program will not be "watered down". Indeed, like Mr. Vittas and Mr. Andersen, we feel that more needs to be done. Decisive structural fiscal adjustment along the lines proposed by staff is essential, if the authorities want to achieve early entry into ERM 2. On the specifics of ERM 2 and euro membership, I support the remarks made by Mr. Vittas in his preliminary statement.

Second, besides fiscal adjustment, deep structural reforms are a prerequisite for strong and durable growth and significantly lower unemployment. While the fiscal reform plan would improve incentives for investment and employment, further structural reforms are needed. We concur with staff and many other Directors that privatization has an important role to play. In this regard, we are reassured by Mr. Szczuka's statement that the authorities intend to proceed with their medium-term privatization strategy. Furthermore, we welcome the reform of the labor market code in mid-2002. But we would like to emphasize that further measures are needed, including a reform of the social security system to increase incentives to work. Here, we fully support staff's analyses and recommendations in the very useful selected issues paper.

Third, we are somewhat concerned about the ongoing tensions between the government and the National Bank of Poland (NBP). We strongly support staff's view that preserving the ability of the NBP to conduct monetary policy independently is paramount. On the use of revaluation reserves, therefore, we fully support Mr. Vittas' point that the revaluation of reserves and their use should be in accordance with ESA95 and EMU requirements. Also, we would like to emphasize that foreign exchange market interventions are no lasting solution to enhance external competitiveness.

In conclusion, Madam Chair, an improved macroeconomic policy mix together with deep structural reforms are key to achieving strong and sustainable growth. We are aware of the political challenges ahead. However, the improving cyclical position and imminent EU entry provide an opportunity for early and forceful action. We wish the Polish authorities every success.

Mr. Basdevant made the following statement:

We would first like to thank the staff for an interesting set of papers, and Mr. Szczuka for his informative statement.

As for today's discussion we would like to discuss several issues further, namely, fiscal policy, monetary policy, the adoption of the euro and structural policies. Basically we feel that monetary policy might have been too tight, that the authorities should be very cautious regarding the possibilities of adopting the euro too soon and finally that structural reforms must be pushed forward, and this without any delay.

Regarding fiscal policy, the situation is worrisome, particularly with the perspective of monetary union accession and policy coordination within EU members. The reforms proposed by the government are ambitious. Nevertheless, the adjustment needed is still very important, particularly on pensions and social expenditures. We feel that the staff might underestimate the difficulties that the government will face to move forward with these reforms, as there might be strong political pressures to pursue a more demand-oriented policy, which will worsen the fiscal stance.

Over the last eighteen months the policy mix might not have been optimal. A tight monetary policy has induced a substantial reduction in inflationary pressures, but this was concomitant with the slowdown of economic activity and a high unemployment rate. Nevertheless, the progressive reduction in the refinancing rate of the central bank from 19 percent to 5.75 percent is definitely encouraging. We also welcome the fact that the objective is now to stabilize inflation at around 2.5 percent which is consistent with the Maastricht criteria. Nevertheless we would like to stress that continued fiscal discipline will be a key ingredient for a prolonged stabilization of inflation and low interest rates.

The long run objective remains the adoption of the euro. We call for a very cautious approach regarding the timing of this process, as there is still a strong gap to fill regarding real convergence: the GDP per capita is approximately only 42 percent of the EU average. Thus we suggest that the authorities be very cautious regarding a rapid adoption of the euro that could jeopardize real economic growth.

Regarding the banking sector, we would like to underline the need for strengthening the Polish public banks that have a very low productivity. This highlights the need for restructuring this sector.

More generally we strongly encourage the authorities to make every effort to move forward on structural reforms and to improve labor market flexibility. We particularly recommend an ambitious privatization program and we welcome the efforts made by the authorities on labor market legislation. Growth will mostly com from the positive effects resulting from these reforms, and, together with a sound fiscal policy and the continuation of an appropriate monetary policy, this will pave the way for a sustained and stable growth path and eventually the adoption of the euro.

Finally, regarding the potential transfer of the revaluated reserves to the budget, we share staff's concern regarding the independence of the central bank. Thus, although there might be some advantages in this operation, as mentioned in staff's report, we would like to underline the need to protect central bank's independence.

With these comments, we wish the authorities all the best.

Mr. Szczuka noted that foreign banks had received about one billion zloty, the equivalent of about US$270 million, in dividends last year. In view of that high contribution from the Polish banking sector, it was hoped that foreign banks would provide support to the banking sector if such support was ever needed. At that stage, it was not. The Polish banks were very well capitalized, with an average level of reserves of about 14.5 percent, which was one reason why dividends had been so high. Moreover, he was sure that the staff would agree that supervision was quite tough in Poland.

The staff was perhaps a bit too concerned with the increasing foreign exchange loans, Mr. Szczuka continued. The share of such loans was no longer growing, the prospect that they might start growing again was not strong, and the difference between the foreign exchange denominated rates and the zloty rates were much smaller now—in fact had almost disappeared—because the spreads on the foreign exchange loans were higher than on the zloty loans. In addition, since many people had been burned on the foreign exchange market, they provided an example to other people to be more cautious when borrowing in foreign exchange. Finally, the share of non-performing loans in foreign exchange loans was quite small, at only 3.6 percent compared to more than 20 percent on average. Mortgage loans were also only 5.8 percent. Altogether, for the time being, even if the trends were worrying, the increase in foreign exchange loans and in housing loans was improving the quality, statistically, of the banking portfolios.

Several Directors referred to the need for further pension reform, Mr. Szczuka noted. In that regard, it should be noted that Poland had been implementing a very comprehensive and enviable pension reform since 1999. That would improve the fiscal position in the long term but unfortunately imposed quite a big burden—up to 2 percent of GDP—on the Polish budget for the moment, given the need for transfers to private pension funds in order to capitalize them.

Directors had also referred to the need for budget subsidies, Mr. Szczuka remarked. While he agreed that it was always important to reduce such subsidies further, the scope for achieving savings there was quite limited. Moreover, it should be noted that they were much lower in Poland than in may other countries. They tended to amount to only about 1.5 percent of GDP in Poland, compared to 3.4 percent in Central Europe.

He had noted with interest Mr. Portugal's and Mr. Tombini's reference to the spread on Polish bonds falling to a level below 100 basis points, Mr. Szczuka said. While there had been some recent improvement on the spreads, the spread on Polish bonds had been below 100 basis points ever since 1996, when he himself had the job of issuing bonds at the Polish central bank. The problem was that staff, despite his repeated interventions, had largely failed to recognize that, by using the EMBI + index, which included basically only the Polish Brady bonds, the spread was irrelevant in a sense. With the ongoing retirement of the Polish Brady bonds, the actual spreads had remained basically unchanged for the newly issued bonds, and the EMBI spread had gone down from 250 to 80 basis points without any underlying change. It was the measures used by the staff that were wrong, and that might have misled the authors of the preliminary statements. The staff would probably revise the paper in that regard, and issue a correction to the relevant graph.

It was unfortunate that no one had praised the debt management in Poland, as it was quite good, Mr. Szczuka stated. Another $1.1 billion in Brady bonds had been retired in April and more than $1 billion in the past year. Altogether only $1.5 billion Brady bonds remained, from a high of $8 billion. The rest would probably also be retired as soon as there was money for that. About $2.3 billion in new bonds had also been issued in the euro market the present year, for ten years with a spread of about 62 basis points.

The issue of the revaluation reserves was a sensitive one in Poland, and he had deliberately avoided mentioning it in his preliminary statement, Mr. Szczuka said. It was unfortunate that it was being picked by Directors, because it did not deserve so much prominence, and should be solved at a technical rather than political level. He personally broadly shared the staff's position that the issue should be settled in the broader context of evaluating an appropriate level for the country's foreign exchange reserves, and the central bank's own capital. Moreover, the method of creating and releasing the reserve should be verified, as recently suggested by the auditors of the central bank, particularly because it appeared that the current NBP rules on the reserves might be more stringent than the ones in the ECB. There were some calculations showing that even if the central bank were to sell all of its foreign exchange reserves, it would still sit on about one quarter of the current revaluation reserves, which meant that the method of releasing the reserves was too conservative. It was certainly true that transferring part of the reserves to the budget would not solve any long-term problem in the fiscal area, but perhaps it would be a price worth paying to help the Minister of Finance to secure sufficient political support for the broad reform of the fiscal sector, which was always advocated by the central bank. In any case, the issue of the revaluation reserve did not pose a serious or direct threat to the central bank's independence. The staff could confirm that the Polish Central Bank was among the most independent in the world, and that extensive legal and operational independence could hardly be eroded by finding a compromise solution to the issue of reserves. After all, several central banks that had in the recent past transferred part of their reserves—often including also unrealized revaluation gains—to the budget were still being perceived as quite independent. These banks included the US Federal Reserve Bank, the Bundesbank, the Swiss National Bank, and the Swedish Riksbank. However, he did not recall any Board discussion on those countries making reference to such transfers as threats to the effective conduct of monetary policy.

Mr. Alazzaz made the following statement:

> The Polish economy's difficulties appear to be lessening but the prospects are fraught with uncertainties. The scant economic recovery that started last year is inching ahead and inflation is subdued. Moreover, Poland's improved credit ratings bode well for the future. That said, unemployment is high, the fiscal position is weak, and the current account position is expected to slightly weaken. An early reversal of these unfavorable trends will require an effective strategy of mutually-supportive macroeconomic measures and structural reforms.
>
> Improving the policy mix is a priority. Indeed, a tighter fiscal stance should not only reduce the burden on monetary policy and help strengthen the current account, but also enhance confidence and encourage private sector

savings and investment. I, therefore, endorse the authorities' stress on fiscal consolidation over the medium-term. The public finance reform program, which aims to keep public debt below 55 percent of GDP, is welcome. The 2003 budget is of help in that regard. However, in view of a likely shortfall in revenues due to lower than expected GDP, further efforts will be needed in order to broadly achieve the fiscal target.

Turning to next year and beyond, I welcome the measures specified in the reform program. However, additional measures may be required if medium-term growth projections do not materialize. In this regard, the staff has made a number of useful proposals to help address this issue. I welcome Mr. Szczuka's reassurance regarding the authorities' efforts in this area.

Turning to monetary and exchange rate policies, the sharp decline in inflation has facilitated a welcome drop in interest rates over the past year. An improved policy mix along with low inflation should facilitate further reductions in interest rates and thus encourage investments and boost the recovery. The depreciation of the exchange rate should also enhance growth prospects by stimulating exports.

It is encouraging that Poland's financial system appears to be basically sound. Indeed, the banks have responded quickly to the deteriorating financial situation by cutting costs, increasing provisions, and restricting credit. However, the staff rightly points out that continued vigilance is needed as loan quality could deteriorate further, especially given the sharp increase in foreign currency lending and the depreciation of the exchange rate.

Strengthening competitiveness, enhancing export performance, and preparing for accession to EU also require advancing structural reform. In this regard, the authorities' plan to accelerate the privatization drive bodes well for the future. However, such efforts could lead to shedding of labor and further exacerbate the unemployment problem in the short run. To this end, it is essential to push ahead with labor market reform in order to enhance job creation. In this connection, the changes to the Labor Code that were introduced last year are steps in the right direction. Further efforts along the lines detailed by the staff in paragraph 31 should be considered. It is also important for the authorities to resist pressure to put in place schemes that are distortionary and costly to the budget. To this end, I fully agree that restructuring the agricultural sector is a priority.

With these remarks, I wish the authorities further success.

Mr. Abel made the following statement:

Poland is reasonably well prepared for its impending accession to the EU. How much Poland will benefit from EU membership will largely depend on her domestic economic policies.

After a satisfactory performance up to the end of 2000, Poland's economic growth slowed from 4 percent to around 1 percent in 2001 and 2002 as external conditions deteriorated. This slide was halted during the second half of 2002 by strengthening of Polish industrial production and exports. Expanding consumption (which continues today) was the major force increasing the GDP growth rate from 1 percent in 2001 to 1.4 percent in 2002. Staff projections indicate a GDP growth over 2 percent for 2003. Investment, however, continued to fall. Foreign trade has made a positive contribution to GDP growth, and the current account balance has improved. The positive performance of exports came from continuing improvements in labor productivity and efficiency resulting from labor shedding. Poland's unemployment has reached almost 19 percent, the highest among OECD economies.

Inflation has continues to decline. The exchange rate remains moderately changeable, but the probability of a major change seems low as long as solid capital inflows continue to be attracted by Poland's prospective EU accession.

A possible cause of the investment collapse would be distortions of the macroeconomic policy mix by the large fiscal imbalances, which would call for a monetary tightening that would slow investments and growth. Long overdue expenditure reforms would be the key to rebalancing the skewed mix of fiscal and monetary policies. For Poland, such imbalances have been especially persistent, and a continual cause of the sluggish economic performance of the past two years.

Poland's budget should be designed to stimulate economic growth, rather than to support the continued postponement of reforms. Fiscal consolidation will require rethinking the social security system and reducing structural expenditures rather than capital spending. The social security system remains hugely inefficient. Poland's disability benefits absorb 4 percent of GDP, compared with 2.5 percent in socially generous Sweden and 1.7 percent in the Czech Republic.

Poland's infrastructure is among the poorest in Eastern Europe, and discourages what might otherwise be sizable inflows of export-oriented FDI. According to a recent analysis by J.P. Morgan, poor infrastructure has been identified as a major deterrent by investors who have recently considered investing in Poland.

The longer fiscal consolidation is delayed, the less room Poland will have to support growth with discretionary spending and automatic stabilizers, due to the limitations imposed on policy by the constitutional fiscal rules.

In the short run, structural reforms and fiscal consolidation are unlikely to support growth and the urgently needed industrial renewal. But delaying them will make slow growth episodes like the present one unnecessarily painful and long-lasting at a time when rapidly increasing per capita income is the key to convergence with the EU.

It will be possible for Polish GDP growth to accelerate in 2003–2004 if the business climate improves in the EU generally and in Germany, Poland's largest EU trading partner, in particular. Otherwise Poland's growth rate will be roughly the same as in 2002.

Poland's benefits from EU membership will also depend on a prompt fiscal consolidation that would make room to fully exploit future EU transfers that require pre- and co-financing. As to EU pre-accession funds, the effectiveness of Poland's use of PHARE funds from 1990 to 2001 was 61.6 percent. If Poland can maintain this level of effectiveness, the net effect of EU transfers on domestic demand will be positive although not large. The trends in Polish domestic demand therefore remain mainly dependent on domestic policies.

The reform agenda should be more ambitious than it now appears. The correction of macroeconomic policies can no longer be avoided even if the planned euro introduction is delayed. The desire for an early EMU accession will require reforms that are not just faster but are also more radical, in order to obtain sustainable results is a shorter time.

Mr. O'Loghlin made the following statement:

The staff has provided a comprehensive treatment of recent developments and prospects in the papers before us, for which I thank them. The key challenges, as staff indicate, are to reignite structural reform and to strengthen the fiscal position through expenditure reform—and, as Mr. Szczuka notes in his helpful statement, to select the most appropriate path to joining the euro area.

Since we agree with the staff's core policy recommendations, my remarks will be limited to a few points that seem to me to warrant particular emphasis.

Macroeconomic Policy Mix

The sluggishness of the international and EU economies have certainly played a major role in Poland's recent poor economic performance. But it is critical to recognize that domestic factors also, must share the responsibility for below-potential growth. The prevailing weak fiscal situation and the associated restraint in monetary policy, together with an apparent easing in the pace of privatization-cum-enterprise restructuring, cannot be supportive of investment confidence and economic activity. However challenging it may be, policy must be rebalanced - with determined fiscal consolidation opening the way to monetary easing, and renewed efforts towards structural reform enhancing the basis for investment and for strengthening economic activity more broadly.

Entry to the Euro Area

Substantial fiscal consolidation is also vital to participation in the euro area. Achieving it will pose difficulties of a political character. Leaving those—and the issue of an appropriate entry-level for the zloty—aside, the question remains whether Poland would profit more from earlier euro entry with stronger immediate fiscal effort—or from a less ambitious entry schedule and a somewhat longer time-frame for fiscal (and other relevant) reform. We share the concerns outlined in, for example, Mr. Kremer's preliminary statement. Perhaps the staff might outline their perspective on the economic benefits and costs of early euro adoption?

Fiscal Policy

The budgetary outlook remains weak, reflecting near-term modest growth prospects, high social spending, and the costs arising as Poland seeks to fully utilize the EU co-financing which will be open to it upon membership.

It is vitally important to make room for the latter, both for its own sake and because of the pro-development bias which EU programs tend to impart to domestic spending plans. That must be achieved initially without weakening an already-fragile public finance position, and sustained while bringing the fiscal deficit within the Maastricht range.

EU co-financing will work to offset the negative demand implications of a domestic fiscal tightening. It's coming on stream affords a once-off opportunity to achieve significant fiscal consolidation with less downside for economic activity than in other circumstances.

Reliance on transfers from the NBP, as is apparently planned for 2004, is no solution. With overall non-interest spending above 40 per cent of GDP and public investment somewhat under 3 per cent of GDP, adjustment should fall primarily on current expenditure. In view of the high level of social spending—transfers and subsidies, at 20 per cent of GDP, are well above OECD averages—and its relationship with weak labor incentives as shown by the staff analysis, it seems clear where the bulk of adjustment should fall.

Labor Market

Certainly, a 7 percentage point decline in labor utilization over just four years, as outlined in the Selected Issues paper, must be almost unprecedented. The authorities are to be commended for the wide range of labor market measures introduced since mid-2002, but the question remains whether they go quite far enough. In this context I strongly support the staff's call to tighten eligibility for disability pensions; and to increase mandatory retirement ages. And, while the differentiation of the minimum wage for young first-time job-holders seems eminently sensible, is there not also a case for differentiation of minimum wages on a regional basis? On the other hand, I have misgivings about the suggestion to strengthen work incentive by providing in-work benefits. If out-of-work benefits are so high as to unduly dampen incentive, restraining those benefits rather than providing countervailing in-work benefits seems the more appropriate course in a budgetary situation which calls for consolidation.

Conclusion

In the round, Poland can look to the future with some optimism. Inflation appears to be well under control. Recent strong growth in export volumes—despite sluggish export markets—points to a competitive economy. Membership of the EU will both offer new market opportunities and support Polish efforts to improve the basis for further economic expansion. A plentiful labor force and relatively low costs should act to encourage foreign investment. And Polish policymakers seem well-apprised of the broad policy requirements to position their economy both to benefit from upturn in the international economy and to garner the full potential of membership of the European Union.

May I end by welcoming the Polish people's affirmation in the weekend referendum of their wish to join the European Union, and say that we look forward to their finally becoming part of the Union during Ireland's Presidency.

Mr. Epstein made the following statement:

Poland's economy continues to show resilience in the face of the global slowdown, particularly the weakness in Europe, although the combination of cyclical, structural and policy obstacles continues to threaten this progress. In many ways, this year's Article IV consultation appears to resemble much of the same situation as last year, and Poland's economy seems to be facing similar challenges, such as better aligning the fiscal-monetary policy mix. Moreover, and notwithstanding progress in labor market reforms, the authorities ought to accelerate key structural measures, like privatization and restructuring of public enterprises, where low productivity has weighed on growth. Otherwise, inflation remains low and the economy is experiencing some recovery in the pace of output growth, albeit gradually. We agree with the overall thrust of the staff appraisal and have a few additional remarks for emphasis.

In the fiscal area, we share the staff's views on tax reform, including the need to render a stronger and more transparent tax administration. On the expenditure side, it appears that the lower-than-expected inflation outcomes have actually made it tougher to adjust fiscal policy, as inflation-indexed welfare payments were already set at a higher level, leading to an increase in expenditures as a percentage of GDP. This points out the need for better coordination of policy and for continued reform in the structural component of fiscal policy.

As to the fiscal outlook in the medium term, we welcome the recently proposed public finance reform program, which represents a first and important step in Poland's fiscal reform efforts, although we note the concerns mentioned by the staff in paragraph 18.

We appreciate the staff's discussion of the difficulties inherent in meeting the Maastricht criteria in the area of monetary policy. If we assume a baseline 1-2 percent of inflation due to the Balassa-Samuelson effect, then it seems that in the medium-term achieving an inflation rate close to that of the Euro-zone's best countries will indeed be difficult. Also, per paragraph 24, it appears that the recent history of the Zloty exchange rate movements would seem to indicate that the ±15 percent band would not pose a great problem. In that vein, we would be interested to know the staff's reaction to EU Minister Solbes' recent statements indicating that new EMU candidates should be able to demonstrate two years of stability within a ± 2.25 percent band.

On the structural front, we are somewhat encouraged to see that the authorities are pressing forward with labor market reforms, but given the persistently high unemployment rate, we agree with the staff that further efforts to eliminate remaining rigidities are needed and measures to improve incentives to work should be considered. As we noted in last year's Board discussion, we remain concerned about the slow pace of privatization—or lack thereof, particularly in the financial sector. However, we join the staff in cautioning against restructuring nonviable enterprises, where cost efficiency was not likely to be achieved, and would also recommend liquidation.

In the financial area, we note the increase in NPLs, although banks appear to be well supervised and adequately capitalized and able to cope with the current slump.

We welcome Poland's recent (February 2003) ratification of the UN Convention on the Suppression of Terrorist Financing. As Mr. Szczuka noted in his helpful statement, many of the provisions of this Convention had already been implemented earlier, including through changes to the penal code. Indeed, Poland has been very supportive of international efforts to block the funding of terrorists, and we urge the authorities to continue their efforts.

Finally, we welcome the improvement in Poland's debt management and the authorities' intention to include collective action clauses in all its international bonds by next year. We also commend the authorities' well-established tradition of consenting to the publication of the staff papers, and wish them success in their policy endeavors.

Mr. Brooke made the following statement:

All the main points have been made at this stage, so I will just make a few brief remarks.

We thought this was a good set of staff papers, and we very much support the main recommendations and conclusions that staff reach.

On the fiscal and monetary policy mix, we agree with staff and other Directors that further efforts towards fiscal consolidation are needed and that the speed of progress that is being achieved in this area is somewhat disappointing. That being said, we are encouraged by the constitutional amendment on the debt ceiling, and we hope that this will provide enough of an incentive for the authorities to make the needed adjustment to the deficit. In terms of the areas for adjustment, I would broadly endorse the comments made by other Directors and by staff.

On monetary policy, it will come as no surprise that we—the United Kingdom—very much agree with those Directors who said that, while the movement towards adopting the euro is clearly providing a rallying point for the reforms and structural changes that are needed in the economy, real convergence should come first, and the timing of entry should not be rushed. It would not be in anyone's interest—Poland's or the other euro member countries'—for Poland to enter before it is ready.

On structural reforms, I very much agree with those who expressed concern about the very high level of unemployment and also the large regional variations. While the reforms that have been implemented to date are encouraging, we still feel that more needs to be done. In particular, we are mindful of the negative impact on unemployment that is bound to come at some point down the road from reforms to the agricultural sector and, as Mr. Epstein has just commented, from the large number of state-owned enterprises which are not making profits at the moment and may not be viable. This underscores the need for further labor market reforms. I would also note that the Polish Confederation of Private Employers recently did a large survey of their members on the obstacles faced by their companies towards entrepreneurial activity and business more generally, and taxation and labor market laws were prominently cited by the respondents to that survey. We would like to underscore the importance of making progress in that area.

Mr. Moreno made the following statement:

Prior to our comments we thank staff for the well-written set of papers they have prepared for today's discussion, and Mr. Szczuka for his candid statement.

Poland's recent macroeconomic performance has deteriorated resulting in weak economic growth, a significant widening of the fiscal deficit, and a continuously growing unemployment rate, which is the highest among OECD countries. Weak economic conditions in Europe and the adjustment of the investment overhang from the early nineties have negatively affected the economy. But at the same time, an inadequate policy mix and a not ambitious enough reform process have worsened the effects of these negative shocks. The challenge ahead for Poland is to regain a higher growth trend, reduce unemployment, and strengthen real convergence with the EU. Fiscal consolidation and accelerated efforts on structural reforms remain the central policies to achieve these goals.

We broadly share the staff assessment and most of the comments made by Directors. Particularly we associate ourselves with the remarks made by Mr. Vittas in his preliminary statement. We would like to concentrate our comments on three areas: the path to EU integration, the policy mix, and structural reforms.

First, it is important to stress the role of EU integration in the Polish economic transition. The compromises derived from the strategy of early EU accession have guided policy measures, and strengthened the credibility of the reform process. We congratulate Poland for the successful completion of accession negotiations with the signing of the Accession Treaty on April 16. The preliminary results of the referendum of accession to the EU held yesterday show a majority of 75 percent, which will strengthen the government's ability to complete the reforms to the full accession.

Looking ahead, euro adoption can also provide an additional anchor for the macroeconomic framework over the medium and long term by determining the path of fiscal and monetary adjustment. As Mr. Szczuka points out, the timing of the adoption of the euro is yet to be decided. This timing does not have to be an immediate decision and should be sensitive to developments in the real economy. The nominal convergence path marked by the Maastricht criteria should be coupled with a clear direction towards real convergence with the EU. Once the decision is made, it will be important that the authorities formulate a clear medium-term framework for euro adoption to strengthen the credibility of the process.

Second, the authorities need to undertake a decisive fiscal adjustment, which will increase the margin for further monetary easing. Both the authorities and staff recognize that a sustained fiscal consolidation is a central strategy for economic recovery. Beyond the effects of the economic slowdown, a loosening of the policy stance has significantly increased the fiscal deficit in recent years. The authorities need to reverse this trend, which will require significant fiscal reforms.

In this respect, the authorities' medium-term reform program, which has yet to be proposed in a final draft and approved by Parliament, is a step on the right direction. However, the program does not seem ambitious enough. The structural balance is only expected to come down from 4.7 percent in 2003 to 4.3 percent in 2006, which coupled with expected growth rates up to 6 percent of GDP in 2006, does not appear an ambitious adjustment path. The adjustment seems to rely mainly on cyclical factors, which according to staff's projections are overestimated. Given Poland's high output volatility, there is a high risk of getting off target in case of a negative shock. Furthermore, the proposed adjustment is not compatible with the requirements of the SGP, which calls for a fiscal situation close to balance or in surplus. Further fiscal efforts might be warranted.

This being said, we welcome the nature of the measures included in the fiscal reform program; particularly, the increase in fiscal transparency, the elimination of indexation of public expenditures, and the abolishment of tax reliefs and exemptions. Like Mr. Andersen, we would caution against the lowering of income and corporate taxes, which might place an excessive burden on the expenditure side in reducing the deficit. Tax cuts might be delayed until the reduction of the deficit is consolidated.

We would welcome staff comments on the effectiveness of the fiscal rule limiting the ratio of public debt to GDP to 60 percent. This rule does not seem to have been effective in controlling public finances in the past, given the margins that the authorities had to increase public debt. The authorities are now passed the 50 percent trigger which calls for corrective measures. The rule might become too restrictive in the event of a negative shock that increases the debt levels through the effect of automatic stabilizers. Should the debt ratio get close to the limit, fiscal policy would become procyclical in order to comply with the constitutional limitation and, thus, would have further destabilizing effects on the economy. The rule should probably be revised in order to take into account the cyclical behavior of the budget. In the medium term, it will have to fit into the general framework of the SGP.

On monetary policy, we welcome the NBP's new focus on prize stabilization as inflation is certainly no longer a threat. The 2.5 percent inflation target is appropriate and will give margin for further monetary easing, which in any case should be preceded by adequate fiscal consolidation. Like Mr. Vittas, we would advise the authorities to manage the inflation target symmetrically by taking prompt action to correct any persistent deviation from the lower end of the target range (± 1 percent).

Finally, on structural reforms, priority should be given to the labor market. A sustainable reduction in the unemployment rate can not rely only in the positive effects of higher expected growth, and requires structural reforms which will shift downwards the wage-setting curve in the labor market. The timely selected issues paper on the labor market identifies policy recommendations which should be given due consideration by the authorities. We concur with staff that beyond regulatory measures to facilitate labor demand, and active labor market measures of training to tackle skill mismatches, the authorities should take action to redress the negative incentives to work.

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

The representative from the European Central Bank (Mr. Wijnholds) made the following statement:

I am very pleased to learn that Poland has chosen so overwhelmingly to become a member of the EU. We are looking forward to close cooperation.

In light of the earlier discussion on Polish monetary policy, I would like to say that, while there has been some feeling among some Board members that Polish monetary policy may have been too restrictive in the past, in the situation of fiscal dominance that Poland faced, it should be recognized that it is very difficult to get monetary policy right. In that context, some understanding is called for. Now that inflation has come down so much, we welcome the change in strategy towards stabilizing inflation. It does show how far the country has come. Nevertheless, as others have pointed out, important challenges remain for Poland; I need not spell them out.

I would like now to move to some more formal remarks on behalf of the European Central Bank.

Given that Poland is still in the pre-accession phase, the ECB refrains from formally assessing its monetary policy at this juncture. In fact, before joining the EU, accession countries are solely responsible for their monetary and exchange rate policies. It is only with EU membership that exchange rates become a matter of common interest and that the multilateral discussions regarding the pursuit of stability-oriented policies will become official and more binding. In this context, we are pleased to see that virtually all acceding countries have enhanced stability-oriented macroeconomic policies in recent years and have focused monetary policy towards achieving and maintaining price stability over the medium term. Overall, we believe that this has positively contributed to economic developments in the region.

The ECB notes that most acceding countries, including Poland, aim at joining the euro area as soon as possible. While we follow the discussion in the countries about monetary integration strategies with great interest, it is too early to make any firm country-specific assessments on their strategies. What we can stress, however, is that it is of vital importance to ensure that the convergence process, both in nominal and in real terms, is sustainable. As for nominal convergence, this relates particularly to fiscal consolidation and the sustainability of lower inflation. Fiscal consolidation should clearly be pursued in a sustainable manner. However, this might be at risk if increasing pressure to join the euro area as soon as possible were to imply that the authorities make use of one-off measures to quickly cut the fiscal deficit to below 3 percent of GDP. Likewise, the current achievements with respect to nominal convergence might be at risk if inflation rates were compressed too rapidly too soon and do not leave sufficient room for the completion of price liberalization and the consequences of the catching-up process. Only if macroeconomic policies are pursued that are considered sustainable also over the medium and longer term can macroeconomic stabilization within a future enlarged euro area be achieved.

The ECB has taken note of the plans of the Ministry of Finance to make use of part of the revaluation reserves of the National Bank of Poland and is examining from a legal perspective whether this might have implications for central bank independence. Such implications would not be acceptable as central bank independence is a key requirement for EU accession and therefore needs to be fully preserved.

After adjourning at 3:55 p.m., the meeting reconvened at 4:05 p.m.

The Deputy Director of the European I Department (Ms. Schadler) made the following additional remarks in response to questions and comments from Executive Directors:

On exchange rate movements during ERM2, the staff's view is that the plus or minus 15 percent band which might be the official band for ERM2—

as I understand it—would pose little problem for a country like Poland, which has already operated over the last five to six years within plus or minus 15 percent of the average rate over that period. Therefore, assuming that the central parity were chosen with some kind of conservative approach, the plus or minus 15 should be fully consistent with continuing inflation targeting. On the other hand, a band of plus or minus 2 ¼ percent—which is also being discussed—would present a different situation altogether. The question then would be whether it would be necessary to give up inflation targeting, and what could be done instead. Perhaps one option might be a fixed rate, rather than a band with 2 1/4 on either side. All of these things will be clarified over the coming period, and as I said earlier, the staff will have more views on this in the context of the paper that it is preparing on euro adoption.

On why the staff suggests that there be consideration of in-work benefits when out-of-work benefits could be cut, especially at a time when budgetary considerations are very important, the answer is that out-of-work benefits are not always high relative to the poverty line, even though they are high—at times, in certain conditions, and for certain kinds of people—relative to possible earnings. Therefore, it is possible to have poverty traps even when there are relatively low out-of-work benefits, if the in-work minimum wage is also very low. In those circumstances, it might be necessary to consider in-work benefits in addition to any sort of streamlining of the out-of-work benefits system.

On the constitutional limit on public debt, it has not been effective so far because debt is well below the constitutional limit, and thus it is not a constraint at all. As debt approaches the 60 percent, there are several gradations in the severity of the response that is required. Some responses start when debt exceeds 50 percent, and others when it exceeds 55 percent of GDP. In principle, the system is set up to prevent debt from ever reaching the 60 percent of GDP limit, and as a result it really should avoid pro-cyclicality problems. The question is how effective the measures that have to be taken at the thresholds of 50 percent of GDP and 55 percent of GDP will be.

Mr. Szczuka made the following concluding statement:

I would like to thank all Directors for their comments, and Ms. Schadler for her very comprehensive and thoughtful responses to the questions posed. As usual, I will convey all the messages of the discussion to my authorities, and I hope that they will make good use of this advice.

As noted by many Directors, the key challenge facing the Polish authorities is fiscal reform. The authorities recognize this, and should not be accused of not trying to address this issue. They have been doing so for a number of years, but have been faced with many problems, including growing rigidities in structural spending, limited room to cut subsidies or raise taxes, and the need to expand public investment ahead of EU accession. Only very painful measures to cut social spending are possible. Moreover, reducing wages in the public sector would require reducing employment in the public sector, which of course in turn implies advanced structural reforms. That is being debated very intensively in Poland now, in the context of the new fiscal reform program. Of course, we also hope that some recovery in growth will help to reduce the pain in this process, and that increasing transfers from the EU will help to support the structural transformation. However, those transfers will have a rather perverse effect on the budget. Initial calculations indicate that the budget will lose in the early phase. That means that the authorities have no choice but to change the structure of the budget already for the next year, so as to accommodate all the EU-related spending. Some degree of fiscal reform, therefore, is simply an absolute necessity, and cannot be delayed.

The second main issue that we discussed today is the question of the exchange rate regime and the way of approaching the issue of the euro entry. Ms. Schadler responded quite comprehensively to these questions. The authorities find it key to have some clarification of the way of assessing the observance of the exchange rate stability criterion before joining the EMU. This issue will be fully clarified in further discussions with our EU partners, but my understanding at this stage is that the band for the ERM2 participation is plus or minus 15 percent. That is the only “legal standard” for the fluctuations.

A separate question is how to assess exchange rate stability before joining the EMU, and in that regard specific advice was given by Mr. Kremers and Mr. Litman that Poland should perhaps enter the ERM2, use the full room for plus or minus 15 percent, and only later on think about narrowing the fluctuations of the exchange rate. I do not yet recognize what would be the benefit of staying longer in the ERM2, if Poland were to ultimately keep the exchange rate in the plus or minus 2 1/4 band for two years in any case. There was also nuanced advice provided by Mr. Vittas and Mr. Andersen. Mr. Andersen indicated that the ERM2 is mostly for exchange rate stability, while Mr. Vittas felt that its purpose was more to help foster real and nominal convergence. Of course, these are issues which are not entirely clear, and will be clarified in the process. I believe clarification is also important for the staff because its advice for the monetary policy framework will be very different with a more narrow band.

Enhancing growth, of course, is also an overarching objective. The staff’s selected issues paper stresses that the current macroeconomic situation really poses the biggest risk for the stability and sustainability of public finances in Poland. And in turn, growth prospects are certainly linked to the speed of fiscal adjustment. Higher growth is essential for convergence, where there is still a long way to go, as well as for reducing unemployment. With regard to the latter, growth alone will not solve the problem. That is why the authorities have done quite a lot in labor market reform. For example, there were a number of programs to support new entrants to the labor market, and they resulted in about 250,000 new entrants this year—the fastest increase in Europe. Nevertheless, more efforts are certainly needed. Even if I do not believe that Poland is in such bad shape as Mr. Reddell indicated, in that I think there is probably only about 25 percent of unemployment and underemployment, rather than 40 percent, that is still a very significant number.

There were many calls to advance the process of privatization and restructuring of enterprises. I do agree with that in general, but, as I indicated earlier, I think the focus on the financial sector is wrong, because privatization in the financial sector is very well advanced and the only remaining bank of any importance that is still state-owned is in the process of privatization already. Where problems remains is in the energy sector and a few other hard industries, such as steel, or the defense industry. Some Directors also advised liquidating the companies that are not viable. Out of the 411 state-owned companies, however, more than half are already in the process of liquidation or bankruptcy. Clearly, the authorities are not trying to support companies, which are not viable in the long term.

The Polish Minister of State Treasury—who is in charge of privatization—was quite surprised by the comments made by both staff and some Directors that the conflicts with foreign investors could have a negative impact on the flow of direct investment, because Poland is clearly very keen on creating the most favorable conditions for foreign investors while also encouraging domestic investment. Foreign investors, for example, provided 78 percent of last year's privatization revenues, and data of the Polish Agency For Foreign Investment indicates that the total value of new foreign direct investment declined last year from 7.1 percent—one billion dollars in 2001—to six billion. But this is still quite a good number when one considers that there was a decline in privatization offers and a global decline in FDI by about 27 percent according to UNCTAD. The minister also reminded that for the total of 2,353 privatization deals there were only six disputes with investors, and those were mostly related to the investors' failure to deliver on their commitments regarding investment. Therefore, it does not appear to be a very large number. There is one quite well publicized arbitration procedure related to the privatization of Poland's largest insurance company, but the authorities are continuously making efforts to find a mutually acceptable solution to this very complex problem.

Again, I would like to thank all Directors for participation and staff for their big efforts in evaluating the situation and trying to find a balance between quite often conflicting positions amongst the Polish authorities themselves.

The Acting Chair made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They noted that the strong upturn in industrial output, the continued decline in inflation and the strengthening of the external position create favorable conditions for a cyclical recovery of the Polish economy notwithstanding a difficult external environment. Particularly encouraging is the strong increase in productivity, which together with wage moderation and the depreciation of the zloty, have resulted in a welcome strengthening of export competitiveness.

Notwithstanding these improvements, Directors cautioned that turning the nascent recovery into durable growth will be a major challenge, and will require decisive action to address Poland's problems of high unemployment, insufficient progress in structural reform, and a persistently high structural fiscal deficit. They therefore urged the authorities to use the opportunity provided by the improving cyclical position and imminent EU accession to further strengthen macroeconomic policies and speed up structural reforms. Directors welcomed in this regard the strongly positive outcome of the national referendum on Poland's accession to the EU, which they hoped will help create a new momentum in the reform effort.

Directors stressed the need for a substantial fiscal adjustment, in particular a deep reform of public expenditure policies, to reverse the recent deterioration in public finances and contain the rapid increase in public debt. They welcomed the recent fiscal reform proposals which, if fully implemented, would be an important first step toward budget consolidation. By improving the flexibility of budget formulation, the proposed measures would help redress recent real public sector wage and social transfer increases and permit expenditure restructuring needed to absorb EU funds. The reforms of the personal and corporate income taxes would reduce distortions in the tax system and lower poorly-targeted tax expenditure.

Looking ahead, Directors emphasized that more extensive measures will be needed soon to ensure that public debt remains within constitutional limits, reduce the vulnerability of public finances, and create further room for significantly easier monetary policy. They urged the government to build the required political and social support for a well-structured fiscal reform agenda, based on prudent growth assumptions, and focusing on pensions and social benefits, including farmer pensions and support, further reductions in subsidies, and cuts in public employment. Directors noted that substantial savings in these areas, along with measures to widen the tax base and further improve tax administration, will be key to containing the fiscal deficit while at the same time creating room for raising infrastructure investment.

Directors commended the National Bank of Poland (NBP) for achieving price stability and continuing to ease monetary conditions as inflationary expectations subside. With a still widening output gap, high unemployment and continued wage discipline in the corporate sector, they saw scope for further interest rate cuts without jeopardizing the inflation target. In light of the uncertainties about the effects still in the pipeline of past interest rate cuts, Directors considered the NBP's approach of small cuts appropriate, but urged against excessive caution in assessing inflationary pressures. The recent depreciation of the zloty has resulted in a welcome improvement in export competitiveness, but Directors noted that, to secure this gain and avoid undue appreciation of the zloty in the coming years, it will be crucial to continue to improve the macroeconomic policy mix, in particular through sustained fiscal consolidation.

Directors welcomed the authorities' intention to continue with inflation targeting after 2003 when the current target expires. They regarded the continuous inflation target of 2 ½ percent ± 1 percentage point as broadly adequate, although a number of Directors considered that a somewhat higher target and wider band would be advisable given the scope for price shocks and structural influences on inflation. Directors also generally supported the NBP's strategy of not intervening in the foreign exchange markets and felt that it helped address the risks associated with large capital flows.

Directors urged the authorities to work towards a satisfactory solution of the dispute between the NBP and the government over the use of the NBP's revaluation reserve. Drawing on international best practices, they emphasized that in dealing with this issue, careful consideration should be given to optimal debt management, the appropriate capitalization of the NBP, and a prudent level of foreign exchange reserves, particularly as participation in ERM2 approaches. Directors stressed the importance of ensuring the unfettered ability of the NBP to conduct monetary policy independently, and avoiding any delay in fiscal adjustment.

Directors welcomed the prudent way in which the Polish banks have responded to the difficult economic environment of the past few years, including the pressure on earnings resulting from the increase in classified loans. Continued vigilant supervision will nevertheless be needed, in particular, since the pressure on bank earnings might continue, and foreign currency-denominated housing loans remain sizeable. The formation of a special monitoring unit at the NBP was therefore welcome. Directors also welcomed the authorities' decision to include collective action clauses in international sovereign bond issues not later than upon joining the EU. They supported ongoing efforts to further strengthen the capacity to combat money laundering and the financing of terrorism.

Directors noted the authorities' objective of early adoption of the euro. While recognizing that decisions in this regard will be taken based on the rules and procedures within the competent European fora, Directors stressed that, to realize the benefits of adopting the euro, Poland will need to undertake major expenditure reforms and speed up the structural reforms that are key to strengthening its growth and employment prospects. Some Directors observed that, in view of the still considerable challenges ahead, Poland may need time to achieve greater convergence with the EU before adopting the euro.

Among priorities for structural reform, Directors highlighted in particular the importance of labor and product market reforms, stepped up privatization, and agriculture reform. They welcomed the recent changes to the Labor Code, but, in light of Poland's very high unemployment rate, saw a need for further steps to eliminate remaining rigidities, improve incentives to work, and enhance regional mobility and job training. Directors viewed with concern the slowdown of progress with privatization, and urged the authorities to push ahead with delayed privatization projects.

While Poland's statistical base is adequate for surveillance, Directors encouraged the authorities to improve the periodicity and timeliness of fiscal data for the general government. They welcomed the significant progress made in improving fiscal transparency, but highlighted the importance of a transparent recapitalization of loss making state-owned enterprises.

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

3. JAMAICA—2003 ARTICLE IV CONSULTATION

Documents: Staff Report for the 2003 Article IV Consultation (SM/03/188, 5/23/03; Cor. 1, 6/6/03; and Sup. 1, 6/9/03); and Statistical Appendix (SM/03/190, 5/27/03)

Staff: Boote, WHD; Fisher, PDR

Length: 55 minutes

The staff representative from the Western Hemisphere Department (Mr. Boote) submitted the following statement:

The following developments have occurred since the staff report was issued. They do not affect the thrust of the staff appraisal.

Growth is estimated at 3½ percent in the first quarter of 2003, based on a recovery in agriculture and tourism. The same growth rate is projected for the second quarter of the year. Twelve monthly inflation in April rose to around 7½ percent (6 percent in March).

The government on May 18 announced some measures to try and stabilize the Jamaican dollar after it had come under significant pressure in early May. These included the possibility of Bank of Jamaica intervention, a U.S. dollar-linked domestic bond issue (with an effective annual return of around 16 percent) at the time of issue, and a request to the private sector to avoid speculation. The exchange rate has since recovered from US$1=J$67 on May 16 to US$1=J$59 by June 5, 2003, still a decline of 16½ percent since January 1, 2003. Net international reserves declined to US$1.23 billion at end-May from US$1.34 billion at end-March 2003. Interest rates remain high with the 6-month T-bill rate over 30 percent per annum, and spreads on Government of Jamaica international bonds are currently around 950 basis points over U.S. Treasuries. In the staff's view, the announced measures are unlikely to have an enduring impact absent the determined implementation of fiscal restraint as envisaged in the FY 2003/04 budget.

Following representations by the private sector, the Finance Minister announced on May 20 replacement of the (tax deductible) 4 percent import change by a 2 percent (non-deductible) import charge, yielding the same revenue. The staff notes that the incentives provided to broaden the tax base by the original import change have been lost through the removal of its tax deductibility. Also the tax package was adjusted to extend the General Consumption Tax to gambling but not to a number of pharmaceutical drugs, medical aids, and agricultural inputs (as earlier proposed), with the result that the net yield increased by about J$1 billion (0.23 percent of GDP).

The Jamaica Teachers Association in May reached a wage agreement under which they will receive a retroactive 3 percent increase for the six-month period April 2002 to September 2002; from October 2002 onwards, their wages are linked to similar posts in the civil service (whose wages will be adjusted to 80 percent of the market comparators by FY 2005/06). The cost of the wage agreement with the teachers was included in the FY 2003/04 budget.

Moody's Investors Service downgraded Jamaica's foreign- and local-currency ratings on May 26, citing heightened credit risks posed by the government's defense of the exchange rate in the context of weak tourism receipts and its increased debt load. It lowered the rating for Jamaica's foreign currency bonds and notes from Ba3 to B1. It also cut the local-currency bond issuer rating to Ba2 from Baa3.

Mr. Bennett submitted the following statement:

Overview

The authorities of Jamaica wish to express their appreciation for the helpful advice and constructive feedback offered by the staff during the

Article IV consultation. They are strongly committed to maintaining macroeconomic stability and further enhancing the country's economic growth prospects and welcome the opportunity to exchange ideas on how best to achieve their desired objectives.

Fiscal year 2002/03 was an especially challenging one for the Jamaican economy. Mounting pressures on government resources due to extensive flood damage, the high cost imposed by crime and violence, and adverse interest and exchange rate movements at a time of marginal economic growth caused the public sector deficit to rise sharply. Speculative activity in the currency market gave rise to a rapid depreciation of the exchange rate and as the authorities intervened to maintain the stability in the exchange rate to reduce inflationary expectations, domestic interest rates were pushed up sharply. The public sector debt, already high, increased further to almost 150 percent of GDP at end-March. Appropriately, the authorities have sought to address these imbalances through strong up-front fiscal adjustment and continued structural reforms to enhance competitiveness and boost economic growth. They have publicly committed themselves to balancing the budget by FY2005/06 through determined implementation of revenue-enhancing measures and expenditure restraint. This goal is an ambitious one and will require that Jamaica continue to run substantial primary surpluses (in excess of 10 percent of GDP) for the next several years. The country's track record shows that it has the capacity to sustain results of that order.

Recent Economic Developments and Outlook

In 2002, economic growth continued to be sluggish but, nevertheless, positive, as external developments depressed activity in the tourism sector in the first half of the year and extensive flooding affected agriculture production. In FY2002/03, weaker exports earnings, higher imports, mostly related to increased oil prices, and higher external debt servicing led to a widening of the external current account deficit. This, coupled with the deterioration in the capital account, resulted in a fall in the NIR by about one-third. However, the gross reserves continue to be adequate, covering approximately 15 weeks of imports of goods and services. The twelve-month inflation rate fell from 7.6 percent the previous year to 6.2 percent by March 2003.

In 2003, the authorities are optimistic about the potential for a pick-up in economic activity (around 2.7 percent) based on a recovery in tourism, continued growth in bauxite production, and a rebound in agricultural production. The current account deficit should decline. The pass-through effects of the depreciating exchange rate is expected to push up the rate of inflation moderately. The Jamaican economy remains susceptible to potential short-term difficulties which the authorities are fully cognizant of and are strongly committed to tackling through concerted fiscal adjustment and structural reforms. Like most countries, the outcome will hinge heavily on developments in the world economy. A less optimistic scenario is likely if the global economy stagnates and dampens export demand.

Over the medium to long term, growth prospects are likely to remain favorable given the authorities' efforts to consolidate the public finances while promoting structural reforms to enhance competitiveness and hopefully underpinned by a pick-up in the global economy.

Fiscal Policy

Overall, the authorities have been prudent in the management of fiscal policy, evidenced by the high primary surpluses over the previous four years. Even in FY2002/03, strong fiscal discipline was maintained and a primary surplus of 7½ percent of GDP was recorded. Nevertheless, the central government deficit widened to 8 percent of GDP with higher expenditure, and lower tax revenues due to a sluggish economy. Public sector debt increased by 18 percentage points to about 150 percent of GDP at end-March 2003, with the majority of this change being attributed to a depreciation of the Jamaican dollar against the U.S. dollar, higher interest rates, and the assumption of loans from public entities (necessary to protect the authorities' good payment track record). These factors aside, the authorities continue to recognize the need for further fiscal consolidation to avert an unstable debt dynamic and are working assiduously to return to a more sustainable debt path.

In the recent budget, the government announced a policy package of mostly revenue- enhancing measures aimed at achieving a reduction in the central government's deficit to 5-6 percent of GDP for FY2003/04, with a primary surplus of over 12 percent of GDP. A broadening of the tax net to include a growing informal sector and strengthening of tax administration are expected to yield about 6 percentage points of GDP increase in tax revenue. Measures also include a new 2 percent non-refundable customs fee, the widening of the General Consumption Tax base, and higher duty on some categories of vehicle imports.

On the expenditure side, while non-interest expenditures are expected to be largely unchanged, interest expenditure is estimated to rise resulting in an equivalent increase in total expenditure as a percent of GDP. While mindful of the need for expenditure restraint, the authorities see little scope for further large expenditure cuts especially given the adjustment of previous years. The bulk of the current wage bill relates to police and armed forces, a direct cost of controlling crime, and teachers and nurses, where salaries are being bid up by recruiters from the United States and United Kingdom.

Monetary and Exchange Rate Issues

The primary objective of monetary policy is to maintain domestic inflation at low and predictable rates. The authorities believe that in a small economy, like Jamaica, movements in the exchange rate are important indicators of future inflation and so they have sought to avoid rapid movements while balancing inflationary and balance of payments objectives. As part of the exchange rate-based disinflation strategy, they have sought to maintain tight monetary and exchange rate policies that have been highly successful in keeping inflation in the single digits over the last seven years. However, over the last six months, interest rates have risen sharply. The BOJ plans to reduce interest rates as the exchange rate situation stabilizes and the fiscal position improves.

Overall, the financial system remains strong with prudential indicators for the commercial banking sector well above the minimum international standards. The BOJ continues to work towards enhancing the functioning of the financial system through measures to further strengthen prudential supervision and recently took steps to improve its capacity to supervise financial groups. Further institutional strengthening measures were undertaken by BOJ including building its capacity to assess market risks and improving its balance sheet by implementing a World Bank-sponsored recapitalization plan which reduced the proportion of below market-remunerated assets in its portfolio.

Corrective actions are also being taken to strengthen the regulatory regime for securities dealers. A Financial Services Commission (FSC) was established with the responsibility of regulating securities dealers and is currently implementing a program to reform the regulatory framework to include the introduction of interim and risk-based capital standards; the issuance of guidelines for margin trading; and the amendment of regulations to provide for registration and operation of mutual funds. In addition, proposals are being made for interim capital standards which will include a higher minimum entry capital requirement, a minimum capital to assets ratio, as well as measures to address the liquidity and interest rate risks.

In the foreign exchange market, the authorities are seeking to deepen the market with the introduction of electronic trading (including a platform for the auctioning of foreign exchange market intervention funds) and plan to abolish the 5 percent surrender requirement when market conditions permit.

Structural Reforms and Growth

The authorities' policy focus is to create an enabling environment for continued private sector-led growth that reduces poverty and improves the standard of living of the majority of Jamaicans. The maintenance of low inflation, the reduction of high security costs incurred by businesses through anti-crime measures, the strengthening of infrastructure, and adoption of other sector-specific growth-oriented policies are central to the attainment of this objective. Tackling crime and violence is especially critical to advancing economic growth and investment and so the authorities' efforts are appropriately focused on anti-crime measures. Competitiveness is to be addressed through labor market reforms which include plans to implement flexible work arrangements and the establishment of a tripartite productivity center to develop a framework for assessing national productivity developments. There is also a strong commitment to maintain exchange rate flexibility to preserve and further build on the strong depreciation in the real effective exchange rate experienced over the past several years and especially in the last two quarters.

Jamaica's trade regime is relatively open and further reforms of the current tariff regime are envisaged by the authorities in the context of broader international reforms, within CARICOM, FTAA, and WTO. With respect to agriculture, the authorities believe that protection is necessary to safeguard this sector given its importance to the economy, particularly in the employment of a significant portion of the rural poor. The authorities remained concerned about the adverse impact of continued agricultural-support policies of the U.S. and European governments on this sector.

Mr. Reddy submitted the following statement:

We thank the staff for a candid report and Mr. Bennett for his insightful statement. We are broadly in agreement with the thrust of staff's appraisal and have the following brief comments.

With a deteriorating fiscal situation, depleted international reserves and a high public sector debt to GDP ratio, Jamaica faces a challenging macroeconomic situation. Sharp exchange rate depreciation, coupled with and despite rising interest rates, has aggravated the problem. Unfortunately, a difficult external environment and extensive damage caused by floods contributed to slippages in last year's staff-monitored program. The authorities appear to be fully cognizant of the seriousness of the situation and we can look forward to steadfast implementation of the ambitious fiscal adjustment and structural reforms proposed by them. That said, it is essential to recognize that a crucial issue for the authorities is to carefully calibrate the degree, the composition and the pace of adjustment so as to minimize suffering and preserve the delicate social fabric. We consider it necessary to emphasize this point, given the already very high rate of unemployment and high crime rates, and a fragile social situation. In this regard, the authorities' greater reliance on revenue measures, as opposed to expenditure restraint, in the recent budget is understandable.

We have noted the divergence between the staff and the authorities on the desired response to a rapid exchange rate depreciation and the right mix of policies to promote faster growth. As the staff report itself acknowledges elsewhere, the Jamaican economy has, over the last decade, not only become comparatively open and more market oriented, but there has also been significant diversification away from dependence on agriculture and mining. However, real GDP growth in the last ten years never exceeded two percent and the average growth rate has been less than the rate of population growth. In such a context, the scope for acceleration of growth or even sustaining the momentum at the current modest levels primarily through further structural reforms and further liberalization of trade and external sectors may be rather limited. Infrastructure building, improved law and order and sector specific policies, being emphasized by the authorities, may indeed hold the key to unleashing faster growth. We can appreciate the views of Mr. Bennett on the need for protection of the agriculture sector, given its importance as a source of employment for a substantial section of the rural poor and given the adverse impact of continued agricultural support policies of the United States and European Union. Without detracting from the overall merit of external sector liberalization, including trade, the degree and pace of has to be guided by country specific circumstances.

We commend the conduct of monetary policy which has stemmed, to some extent, the speculative pressures on the local currency and maintained inflation at low levels. The intervention has to be seen against the backdrop of commitment to flexibility and build on the gains of strong real depreciation. Staff has referred to the increased vulnerability of the financial system due to the intermediation activities of the security dealers. This underscores the need to carefully synchronize the financial and capital liberalization with the strengthening of regulation and supervision and has lessons for other emerging market economies. We welcome the corrective actions proposed to strengthen prudential supervision, and in particular, the regulatory regime for the security dealers.

We wish the Jamaican authorities success in their challenging policy endeavors.

Mr. Mozhin and Mr. Palei submitted the following statement:

We commend the staff for being frank in their report about worrisome economic situation in Jamaica. Unfortunately, during the period since the previous consultation, the economic health of the country has continued to deteriorate. The Jamaican economy has suffered from the slowdown in tourism, from the flood, and from negative developments in the terms of trade. While the exogenous shocks have contributed to economic difficulties, the authorities' response to the shocks was not flawless. Most importantly, the authorities have failed to correct fiscal slippages that had derailed the first staff-monitored program. In 2002/2003, the central government primary surplus was 7.7 percent of GDP, and we do not disagree with Mr. Bennett that such a surplus would be viewed as a very significant achievement in many countries. However, it is also true that the primary surplus was below the target in the second staff-monitored program (SMP) by almost 3 percentage points of GDP. One of the more dramatic results of the authorities' failure to deliver in the fiscal area was a significant worsening of the situation in the financial markets. After being stable until the end of 2002, the spreads on Jamaica's international sovereign bonds have increased from about 500-600 b.p. to over 1000 b.p. before declining slightly more recently. And, according to Figure 6, by the end of March the six months Treasury-bill rate has doubled to 33.5 percent. The dismal fiscal performance coupled with significant depreciation of the Jamaican dollar has led to a jump of the public debt to 150 percent of GDP, which raises serious doubts about its sustainability.

The staff and the authorities seem to disagree on the appropriate exchange rate policy. The authorities believed that the pressure on the national currency was largely speculative and attributed it mainly to the exogenous shocks. They also see these shocks as temporary phenomena. Accordingly, the authorities hope for a reversal of these negative external developments. As they are worried about the pass-through effects from significant and rapid depreciation on inflation, they engaged in large-scale interventions in the foreign exchange market. The staff insists on a more flexible exchange rate policy. However, we have to admit that the arguments advanced by the staff are not entirely clear to us. In paragraph 7, the staff attributed larger than expected depreciation primarily to declining confidence in the macroeconomic situation and to the authorities' failure to stick to the SMP targets. One may conclude that corrections in macroeconomic policies could, therefore, re-establish investors' confidence, contain the speed of depreciation, and, maybe, even reverse it. Such a view is also based on the understanding that the exchange rate depreciation is only temporary. At the same time, in paragraph 34, the staff seem to take a rather different position by implying that the main reason for depreciation was the loss of competitiveness of the Jamaican economy as a result of significant real appreciation of the currency since 1995. To support their view, the staff referred to the declining market share of Jamaica in the tourism market and to the large current account deficit. If the latter explanation is true, the depreciation has to be viewed as a correction of overvaluation of the Jamaican dollar, and, consequently, such a depreciation would be considered permanent. The staff may wish to clarify their position. Should the free float be a better option under any of the explanations of the exchange rate developments?

The effectiveness of the monetary policy is impaired by the high public debt and by the shortage of instruments available to the Bank of Jamaica. Although we agree with the staff that the authorities should think about the ways of improving the conduct of the monetary policy, we are somewhat skeptical about the ability of the proposed improvements to make monetary policy more potent.

The main emphasis in macroeconomic policy mix should be on the fiscal policy. It is troubling that despite the warnings about fiscal slippages under the first SMP, the authorities had not risen to the challenge of fiscal consolidation under the second SMP. They continue to insist that little can be done to correct the fiscal balance on the expenditure side, although government spending in Jamaica now amounts to almost 40 percent of GDP. Their fiscal plan is based almost entirely on the improvements in tax administration and on the expectations of lower interest rates and higher growth. We share concerns about serious downside risks to the baseline scenario presented in the staff report, and urge the authorities to pay attention to the proposals advanced by the staff. The preparation of fiscal transparency ROSC, in our view, would be useful in the overall work to strengthen the fiscal accounts of the country.

We welcome the inclusion of the debt sustainability analysis in the staff report. Under the existing circumstances in Jamaica, the discussion of possible debt restructuring was entirely appropriate. We note here that, if the staff are correct that the Jamaican dollar was overvalued, the debt sustainability becomes even more questionable. The fact that a large part of the public debt is domestic while the banking sector is severely exposed certainly illustrates the magnitude of the problem the authorities are facing. However, an alternative of maintaining very high primary surpluses may not be feasible. There is also a big question regarding the appropriate magnitude of the needed belt-tightening. As it is stated in Mr. Bennett’s statement, the authorities see a need for a primary surplus of only 10 percent of GDP as a necessary medium term objective, while the staff insist on adjustment to the levels above 12 percent of GDP. At the same time, taking into account recent developments and based on the sensitivity analysis in Table 10, one can easily imagine a need for even higher primary surpluses. Overall, Jamaica is facing rather gloomy prospects and private sector involvement with a sufficiently large haircut may, indeed, be an unavoidable step in such a situation.

Having said that, we hope that the Fund staff will find an appropriate format for the continuation of the dialogue with the authorities, will advise the authorities on available alternatives, and will also provide technical assistance if needed. We wish the Jamaican authorities and the staff fruitful collaboration in meeting the difficult challenges ahead.

Mr. Mirakhor submitted the following statement:

We thank the staff for a well-written report, and Mr. Bennett for his informative statement. Against a background of intensified macroeconomic imbalances and vulnerabilities, the authorities deserve credit for formulating an ambitious policy package that aims at restoration of macroeconomic stability and promotion of higher and sustainable growth. Indeed, given the seriousness of the situation and potential downside risks, an early adoption of coherent and credible policies is essential to avoid a debt trap through strong and sustained fiscal adjustment and accelerated implementation of structural reforms. We concur with the thrust of the staff appraisal and their main policy recommendations.

Fiscal consolidation should remain the focal point of the strategy to restore fiscal and debt sustainability and to ensure a reduction in high real interest rates. While the authorities' commitment to maintaining strong fiscal adjustment over the medium term is praiseworthy, it is troubling to note that even with the rigorous implementation of a tight fiscal stance over the medium term, the debt burden would remain very high. Table 10 of the staff report illustrates the high sensitivity of the required fiscal consolidation to real interest rates and real growth. Restoring confidence in the policy stance would be essential to achieving macroeconomic stability and sustainable growth. Given the high domestic debt and the authorities' reservations on formal restructuring of the public debt, staff may wish to elaborate on other potential avenues for reducing the debt burden.

Anchoring fiscal retrenchment in a formalized medium-term framework, built around sufficiently high primary surpluses, should facilitate achieving the appropriately ambitious target of a balanced budget by 2005/06. On the revenue side, we welcome implementation of the tax measures announced in the last year's budget, designed to simplify the tax system and improve compliance and collection. However, efforts should continue to broaden the tax net to include the growing informal sector and to strengthen tax administration. On the expenditure side, civil service reform, public expenditure review, and suspension of the deferred financing program should help reduce costs while protecting social safety net expenditures. The authorities are also encouraged to undertake a fiscal ROSC exercise with a view to further improve fiscal management and transparency.

Monetary policy aimed at low and stable inflation by targeting base money, while avoiding rapid movements in the exchange rate, has yielded impressive results. Preservation of single-digit inflation for the seventh consecutive year despite large fiscal overruns justifies high credibility accorded to the authorities' disinflation strategy. This achievement notwithstanding, the task of liquidity management could be facilitated by rationalizing reserve requirements, relying on shorter-term interest rates, deepening the foreign exchange market, and reducing the central bank's market interventions. We also agree that regaining competitiveness in the face of the previous large real appreciation requires continued flexibility in exchange rate policy, buttressed by perseverance with productivity-enhancing structural reforms. On the financial sector, we are pleased to note that commercial banks are generally well-capitalized and liquid. However, the less stringent regulatory regime of securities market, given its large exposure to public sector debt, underscores the need for urgent strengthening of the supervision of non-bank financial institutions. The authorities are encouraged to consider requesting an FSAP review as early as possible.

High security costs, large debt overhang, and low productivity and loss of competitiveness have accounted for low growth over the last decade. It is, therefore, essential to adopt a comprehensive approach to structural reforms based on national consensus to stimulate sustained growth. Given the significant social and economic costs of high crime rates, there is every justification for taking further measures to improve security. Restructuring large loss-making entities would engender efficiency gains and lower quasi-fiscal costs. Greater labor market flexibility and economy-wide wage restraint could help contain the persistent rise in unit labor costs and boost competitiveness. In this context, we welcome plans to implement flexible work arrangements as well as to establish a tripartite productivity center. Removing regulatory barriers to small enterprises promises to improve the investment climate and expand employment in the formal sector. Moreover, while there is merit in further trade reform, we share the authorities' concern on the adverse impact on the economy of the continued agricultural support policies of major industrial countries.

Mr. Kremers and Mr. Gigineishvili submitted the following statement:

The staff report draws an alarming picture of the Jamaican economy with very weak fundamentals and most macroeconomic indicators moving in the wrong direction. During FY 2002/03 real growth amounted to only 1.5 percent; as a share of GDP, the fiscal deficit rose to 9.5 percent, the current account deficit widened to 12 percent, and the public debt soared to150 percent. International reserves declined by about one third. The Central Bank of Jamaica managed to contain inflation at annual 6 percent, but at the expense of very costly interventions and rising interest rates. Notwithstanding the central bank efforts to maintain exchange rate stability, the currency depreciated by some 27 percent.

We find these developments particularly worrisome making Jamaica especially vulnerable to the external shocks. Even though the staff recommendations are broadly appropriate, it is surprising that the mood of the report seems to be rather calm, when in fact the country seems to be exhibiting signs of pre-crisis conditions. The Executive Summary says that "Macroeconomic imbalances and vulnerability increased significantly", which may be misinterpreted to understate the seriousness of the situation. Staff comments are welcome.

The major problem seems to lie in an inappropriate policy mix, which has to be redesigned and rebalanced in an expeditious manner to restore macroeconomic stability in the country. The monetary policy stance is built around exchange rate stability, and the authorities are reluctant to increase exchange rate flexibility because of the expected inflationary effect of depreciation. With the deteriorating fiscal and external positions, and the rising debt the public confidence erodes gradually, exchange rate pressures mount, and the effectiveness of the central bank interventions decrease. Indeed, even though the central bank considerably raised interest rates and sacrificed a large part of its international reserves, the currency depreciated significantly boosting the public debt, the major part of which is either dollar-denominated or indexed to foreign currency. The growing debt and the rising interest rates increase the borrowing needs of the government, which in turn widens the external deficit and exerts additional pressures on interest rates, exchange rate and inflation. It is like a vicious circle, where macroeconomic imbalances reinforce each other making the problems even more difficult to handle. As we see it, a combination of large fiscal and current account deficits, liberal external accounts, and objectives to keep both exchange rate and inflation under control form an inconsistent set of policies that cannot be sustained.

In these circumstances, radical and swift adjustments in macroeconomic management seem to be needed to ease the strain and pull the country out of the risk of crisis. Two areas call for immediate attention and quick actions.

First, the authorities should significantly tighten the fiscal stance with measures on both revenue and expenditure sides. They have proposed a revenue-enhancing package to broaden the tax base and improve administration, which is expected to raise collections by 3 percent of GDP. However, to ensure sustainability of policies, more adjustments will be required on the expenditure side as well. The government has recently raised salaries to senior civil servants and parliamentarians. This decision could have been guided by a desire to retain and attract qualified staff and to reduce corruption. But given already strained budget, such wage increases are not well grounded unless accompanied by a comprehensive public service reforms and governance optimizing measures. We encourage the authorities to reconsider the budget with the aim to cut outlays and to use extra savings for reducing the stock of the debt. Reducing the budget deficit should help to reverse the processes described above and become a cornerstone of the stabilization.

Second, on the monetary policy front, we urge the authorities to shift the focus to the inflation objective and consider gradual easing of the exchange rate until full flexibility. This would reduce the need for costly interventions in the money market at rising interest rates, and make monetary policy more potent, especially if, as suggested by the staff, short-term liquidity management instruments are also introduced.

Flexibility of the exchange rate may indeed result in some depreciation, which as feared by the authorities, can aggravate inflationary expectations. However, as documented in the recent study by the Bank of Jamaica, responsiveness of prices to exchange rate movements has decreased substantially in the recent years and therefore the inflationary effect of depreciation is likely to be much weaker than expected by the authorities. At the same time, some real depreciation will enhance the competitiveness of the economy, which, as evidenced by the staff, has considerably suffered since 1995. If also supported be a tighter fiscal stance, the external balance is likely to improve and lift some of the strain from the exchange rate.

The sooner the authorities start to limit their interventions in the foreign exchange market, the smoother and less painful the transition to the new exchange regime will be. International reserves would be preserved and a sharp and quick depreciation avoided. On the other hand, if along with the mounting exchange rate pressures the authorities keep preventing the currency from depreciation, the central bank risks running down its foreign reserves until it can no longer support the exchange rate. Then it will be forced to let the exchange rate float overnight, resulting in a large devaluation with much more severe inflationary consequences than in case of gradual easing.

Mr. Portugal and Mr. De Silva submitted the following statement:

We thank the staff for an excellent report and Mr. Bennett for his helpful statement.

Macroeconomic conditions in Jamaica have deteriorated markedly, in line with the weakening of the fiscal consolidation process and persistent low growth. The Jamaican economy is now precariously poised on the brink of potentially serious financial difficulties, avoidance of which will call for considerable skill and, above all, commitment to strong fiscal discipline. Macroeconomic challenges are complicated by political fractiousness and a problematic social environment marked by high unemployment and associated high crime rates. As daunting as this picture appears, it is clear that the authorities do not now have the option of postponing the decisive policy action which, as the staff has pointed out, would still leave the debt ratio at a high level even with the most determined implementation.

The most pressing imperative for macroeconomic management in Jamaica is to stabilize the burgeoning debt situation that is now among the highest worldwide. Jamaica has shown strong commitment to economic liberalization and market-oriented policies, and on the fiscal front has also evinced credible adjustment efforts by running substantial primary surpluses over a period of four years. It is regrettable that the significant progress made in reducing the debt during the last decade has been so drastically reversed. While this has been largely as a result of the fallout from the financial sector crisis, it also reflects, more recently, expenditure overruns driven in part by wage increases, and non-implementation of budgeted tax measures, which contributed to widening the fiscal deficit to 8 percent of GDP in the last fiscal year.

We are heartened by the firm intentions of the authorities to strengthen the adjustment effort by aiming to increase the primary surplus by over 4 percent of GDP. The proposal to balance the budget over a period of three years is an ambitious challenge, but one that is hardly negotiable given staff projections that even this strengthened effort would have a near zero impact on the debt/GDP ratio. Like staff we are concerned about the one-sidedness of the proposed fiscal adjustment and wonder whether the authorities have been sufficiently aggressive in exploring potential avenues for reducing non-interest expenditure. This could provide much needed flexibility in the event that interest rate assumptions and the related debt-service projections prove to be optimistic. We view this as a credible risk as interest rates are currently much higher than envisaged in the budget with little immediate prospect of being reduced on account of the intensification of exchange rate pressures.

Exchange rate policy has sought to steer a difficult course between balance of payments and inflation objectives. This approach has met with mixed success as could be expected, given the disparity between these goals and the attempt to achieve them through the use of a single instrument. While inflation was reasonably well contained, the current account deficit has widened sharply. Under the circumstances, staff's recommendations for strengthening the anti-inflationary focus of monetary policy deserve strong consideration. The authorities' commitment to the exchange rate as an anchor for inflationary expectations intensifies the urgency of the required fiscal adjustment. It also calls for increased priority to be given to the implementation of structural reforms to promote faster productivity growth and strengthen competitiveness. In this regard, we welcome ongoing initiatives to improve the flexibility of the labor market. We also agree with staff on the need for a more ambitious agenda for structural reforms that would extend to public sector reform and removal of regulatory barriers to small enterprises, among other key areas.

We welcome the initiatives by the authorities to strengthen prudential supervision, including the updating of legislation to provide for improved supervision of financial groups. In the prevailing environment of high interest rates and weak economic growth, banks could very well face a heightening of credit risk arising from the increased debt-service burden of corporate and other customers. Against this background, we are pleased to note that prudential indicators for commercial banks are currently well above minimum international standards, and that the system is adequately capitalized. The move to improve the supervision of credit unions by transferring supervisory responsibility to the central bank is also welcome.

In closing, we are encouraged that the authorities plan to work closely with the Fund on the complex issues confronting the economy. We wish them well in their future endeavors.

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

Key Points

- Over the past fiscal year, Jamaica's economic performance worsened, adversely affecting the already significant high public debt.
- Competitiveness is hampered by the tight monetary and exchange rate policy.
- The large banks' holdings of government debt could affect the credibility and soundness of the system.
- Promoting growth and productivity requires a stable policy environment and implementation of structural changes.
- A significant fiscal adjustment, additional flexibility in monetary and exchange rate policy, and structural reforms are needed to restore stability and accelerate growth.

At the outset, we would like to thank the staff for a well written report and Mr. Bennett for his informative and comprehensive statement. Regretfully, over the past fiscal year, and in the context of an SMP, Jamaica's overall economic performance has been disappointing, as evidenced by the persistent slow growth; a further widening of the public sector and the current account deficits; a decline in the net international reserves; a depreciation of the exchange rate despite significant foreign exchange market intervention and interest rate increases by the BOJ; and a rapid increase in the public debt burden, one of the highest in the world. Moreover, the lack of implementation of structural reforms has contributed to the deterioration of external confidence.

Overall, the Jamaican authorities recognize the multiple challenges they confront in order to resolve the difficult economic situation, which is also highly vulnerable to exogenous and domestic shocks. In this vein, we are pleased to know, from Mr. Bennett's statement, of the authorities' commitment to reduce macroeconomic imbalances and to lessen the economic vulnerability through the implementation of a medium-term policy package that includes a strong fiscal adjustment, a flexible monetary and exchange rate policy, and structural changes that would address many of the impediments to growth. We encourage the authorities to make strong efforts in that direction. Such ambitious but needed strategy augurs well over the medium to long term, considering that economic stability is crucial to restore external credibility and to build the basis for sustained economic growth.

Fiscal adjustment should be a priority in the economic agenda. As underscored in the main staff report, the debt sustainability analysis and the economic indicators under the staff's baseline and worse case scenarios are reasons for concern. In this connection, we welcome the authorities' commitment to resume the process of fiscal consolidation, which would be a key element to lower the public debt burden, reduce real interest rates, and strengthen credibility in the country's policies. This action would contribute to improve the access to international markets, as well as to allocate more resources to priority areas. Given that the proposed fiscal target requires significant expenditure restraint, we wonder to what extent last February's increase in salaries of the senior civil servants and parliamentarians may be inconsistent with such effort, particularly considering the demonstration effect that this action may have on overall public sector wages. Staff comments would be appreciated. On a similar line, a rapid implementation of the authorities' plans to restructure inefficient public entities is imperative in order to improve their performance and avoid transfers from the budget that could endanger the fiscal expenditure targets.

We welcome the measures that the authorities will take in order to increase revenues, such as the elimination of tax exemptions, the broadening of the consumption tax base, the auditing of financial institutions, and actions toward the improvement of tax administration. Moreover, we encourage the authorities to follow staff's recommendations for a successful budget implementation through rigorous expenditures controls; the identification of contingency measures; and the incorporation of fiscal consolidation into legislation.

The prudent conduct of monetary policy followed by the Bank of Jamaica has successfully kept inflation at single digit levels for the last seven years. Nevertheless, the implementation of this strategy has costs, such as high interest rates, falling international reserves, and competitiveness losses, which generate doubts about its sustainability. While we recognize the authorities' concerns that a rapid nominal depreciation of the Jamaican dollar would increase inflation and the debt burden, we concur with the staff that more flexibility in exchange rate policy is necessary to regain competitiveness and to allow for a more effective management of monetary policy. At the same time, gains in competitiveness should be reinforced by structural reforms to promote faster productivity growth.

Structural changes are critical to achieving a stable macroeconomic environment and a higher and sustainable growth over the medium term. We concur with Mr. Bennett that actions to address impediments to growth, such as crime and violence, regulatory barriers to small enterprises, low productivity levels, poor education, and especially labor market reforms are crucial to promote private sector development and reduce the unemployment and poverty levels. Thus, we encourage the authorities to press ahead with their implementation.

In addition to all these considerations, we are concerned about the commercial banks' large exposure to public debt, which could adversely affect the credibility and the soundness of the system. Given the fragile fiscal situation, it may be prudent to assess the possibility to increase the current zero weight of the banks' holdings of government debt to calculate the capital adequacy ratio. Staff comments on this issue are welcomed.

With these comments we wish the authorities every success with the challenges ahead.

Mr. Martí and Ms. Mirabal submitted the following statement:

Introduction

At the outset, we thank staff for the comprehensive set of papers and Mr. Bennett for his informative and helpful statement. Jamaica gained full independence within the British Commonwealth in 1962. Economic conditions deteriorated during the 1970s led to recurrent violence and a drop-off in tourism. Elections in 1980 saw the democratic socialists voted out of office. Subsequent governments have been open market oriented, although during the 1990s the country was spoiled by political violence. The economy has moved away from reliance on traditional sectors such as agriculture and mining to tourism and other service-oriented sectors, but the growth has been sluggish since 1995. After five years of recession, Jamaican economy grew 1.1 percent in both 2001 and 2002. Serious problems include: adverse interest and exchange rates movements; low productivity and loss of competitiveness; large current account deficit; and a growing internal debt, the result of government bailouts to various sectors of the economy, particularly the financial sector. In addition, depressed economic conditions have led to increased civil unrest, including a mounting crime rate.

Fiscal Policy

Authorities have recognized the need for a strong fiscal adjustment and they are committed to balance the budget by the fiscal year 2005/06. In this regard, they have proposed a package of revenue enhancing measures to broaden the tax net and strengthen tax administration. The measures include a supplement percent on all imports, the widening of the General Consumption Tax base, and a higher duty on vehicle import. Authorities also plan to improve tax administration.

On expenditure side, although authorities recognized the need for expenditure restraint, they see little scope for large expenditure cuts, or reduction in wages. On this respect, staff is concerned that the adjustment relies exclusively on revenue measures. We would join to this concern, but we are somewhat skeptical on the possibility of reducing expenditure. Staff's comments will be welcomed.

In any case, we encourage authorities to keep their commitment to adjust fiscal position, particularly in the view of the high debt levels and the limited scope for restructuring the public debt.

Monetary and Exchange Rate Policies

Monetary policy formally targets base money with the aim of generating low and stable inflation. The Bank of Jamaica uses primarily instruments over 180 days to absorb excess liquidity and to reduce pressure on the Jamaican dollar. The staff sees scope for more flexible money market interventions focusing on shorter-term interest rates, particularly as the fiscal position improves. We would also see scope if fiscal position improve. On the contrary, the weight on interest rates would be too high and they should become volatile with negative effects on the economic activity, the government borrowing costs and the financial system.

On the exchange rate side, the Jamaican dollar has depreciated significantly during 2002/03 despite authorities' efforts to stabilize the real exchange rate. Given that Jamaica is a small open economy, authorities consider movements of the exchange rate as an important indicator of future inflation, used by private and public agents alike, as the exchange rate is a key component of domestic prices. According to staff, there remains scope for a more flexible exchange rate policy aimed a rebuilding competitiveness. In addition, structural reforms to deepen the market could enhance the stability in the foreign exchange market.

Financial Sector

We welcome steps taken to strengthen prudential supervision and the balance sheet of the Bank of Jamaica. However, we share staff's concerns about the large exposure of the financial system to public sector debt, given the fragile macroeconomic situation.

Structural Reforms and Growth

We agree with staff about the need for a higher growth in order to reduce the high public sector debt level and to address the social problems of unemployment, poverty, violence and crime. Regarding these issues, we welcome authorities' policy approach to maintain low inflation, take anti-crime measures, strengthen infrastructure, and adopt sector specific growth-oriented policies.

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

Mr. Ondo Mañe submitted the following statement:

Introduction

We thank the staff for the detailed and well-written report and Selected Issues paper provided to the Board.

During the past several years, thanks to the strenuous efforts in the economic liberalization and structural reforms, Jamaican authorities have reduced their intervention in the economy, thus opening the door for more market-oriented economy. Although some improvements have been achieved, difficulties persist with a heavy debt burden on public finances and low growth rates.

We welcome the measures taken by the authorities to reverse macroeconomic imbalances that have worsened during FY 2002/03. The challenge facing the authorities is daunting and we commend the government for taking strong actions to address the public sector shortfalls, the current account deficit and the decline of net international reserves, and to increase domestic interest rates to strengthen the exchange rate. We note that the policy mix adopted by the authorities to reduce the public sector debt is supported by a strong upfront fiscal adjustment.

Public Finances

During the FY 2002/03, Jamaica implemented a SMP program aimed at strengthening the fiscal position and laying the foundations for faster growth. However, the country continues to experience severe difficulties in the fiscal area. To preserve Jamaica's credibility on international capital markets and cope with the central government deficit, the government has embarked on revenue-enhancing and expenditure-reducing measures. However, it seems that efforts have focused more on actions to increase revenues and less to cut expenditures. As such, the objective of reducing the fiscal deficit from 8 percent of GDP for FY 2002/03 to 5–6 percent of GDP for FY2003/04 appears to be ambitious. Measures supporting this objective include a 4 percent surcharge on all imports and a higher duty on vehicles imports. The government also envisaged the broadening of the General Consumption Tax base, and the implementation of a contingency measure that consists of a 3 percentage point of GDP that should come from improvement in tax administration.

As regards expenditures, the projection focused on 39½ percent of GDP, which is somewhat higher than last year. While, non-interest expenditures may be mostly unchanged, interest expenditures will increase to 3 percent points of GDP. Wage expenditure is expected to be lower than previously, but there is room for improvement. We support the list of measures set out by the staff, particularly the rigorous expenditure controls. Since the authorities have not engaged in deep spending cuts, especially in the wage bill, we agree that it would be difficult to rely only on revenue improvement to achieve the budget deficit objectives. This has been compounded by the recent increase in the government wage, which at 12 percent of GDP is very high, making the objectives even more unattainable. We see merit in a comprehensive series of reforms in civil service could help alleviate the burden of the wage bill on the budget deficit, and at the same time, terminate the practice of off-budget spending.

On a more optimistic note, we welcome the authorities' determination to press ahead with structural reforms including merger, liquidation, and restructuring of state-owned enterprises, in order to improve the public sector performance as well as that of public entities that continue to make losses.

Monetary and Exchange Rate Policies

In the face of significant depreciation of the Jamaican dollar, the authorities have implemented an SMP, in order to stabilize the real exchange rate and strengthen the net international reserves position to preserve the confidence in the country. We see the merit in these policies and encourage the authorities to persevere in their efforts. While we support the independence of the central bank, we urge the authorities to reach a consensus with the Bank of Jamaica with respect to the rapid movements in the exchange rate. An identical perception of the issue by both the authorities and the BOJ would constitute the best way to achieve the inflation objective, which is among the important concerns of the government.

Here, a policy mix is to be taken into consideration since debt-servicing costs, which increase rapidly along with large depreciations of the exchange rate, are also at stake. Raising open-market instrument interest rates several times with a view to maintaining inflation low has its costs in terms of increased fiscal burden and sluggish growth. On the other hand, the government seems to count rather on fiscal adjustment than on real exchange depreciation to reverse the current account deficit and low competitiveness. Given the complexity of the situation, we call on the authorities to strike a balance between these policies, or implement a more flexible exchange rate policy, accompanied by strong structural reforms, in order to be in better position to attain the goals.

This being said that, we share the staff views that, as evidenced by the decline in goods exports, the sharp decline in the number of tourists and the deepening of current account deficit, Jamaica is suffering from competitiveness loss over years, and that immediate actions are needed to address the situation. We endorse the authorities' intention to eliminate the surrender requirement, the current multiple currency practices, and reduce their market intervention. Also, we encourage them to consider, without delay, their participation in the Financial Stability Assessment Program (FSAP).

We commend the authorities for providing the Fund with core statistical indicators and for participating in the GDDS, although Jamaica is not able, at this time, to collect International Investment Position (IIP). We are encouraged to note that further strengthening of the statistical system remains a priority for the authorities. Meanwhile, we call on the authorities to press ahead in subscribing to the SDDS.

Structural Reforms and Growth

For the medium–term, we share the staff agenda for structural reforms, including greater labor market flexibility, accelerated public sector reform, a more flexible exchange rate regime, and agreement on wage/productivity ratio for public and private sectors. These indicators should well complement the authorities' policy approach to maintaining low inflation, reducing high security costs, strengthening infrastructure, and other sector-specific growth-oriented policies. While we agree that sectoral wage agreements could help boost competitiveness, we caution the authorities that, in doing so, they should not overlook the necessary balance between productivity gains and fair wages.

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

Mr. Usman submitted the following statement:

Introduction

We thank the staff for a comprehensive set of papers and Mr. Bennett for his helpful statement providing us with recent economic developments in the country. The Jamaican economy remains fragile having posted weak performances in recent years resulting from harsh weather conditions and other external shocks. The country's economic performance remains threatened by deteriorating macroeconomic imbalances arising from disturbing incidence of crime, as well as perilous fiscal and current account difficulties. To return to a sustainable growth path, the authorities need to embark on wide-ranging structural reforms in this connection. We note the Jamaican authorities' efforts to introduce fiscal adjustment measures and urge them to strengthen the impetus.

Fiscal Developments

We are encouraged to read in Mr. Bennett's statement the authorities' commitment to a fiscal adjustment program that seeks to restore fiscal balance and boost economic growth. The budget deficit remains high and so is public sector debt which at 150 percent of GDP, leaves little room for the authorities to maneuver as shown in box 4 of the staff report. The incidence of high domestic interest rates makes it imperative for the authorities to make meaningful progress towards attaining debt sustainability.

We concur with the staff's recommendation for a civil service reform and expenditure review, whilst at the same time maintaining social-safety net expenditures. Furthermore, we urge the authorities to discontinue their deferred financing of capital projects and bring all off-budget expenditures into the national budget framework, as this will enhance public sector transparency and accountability. We support the authorities' commitment to introduce rigorous expenditure controls, put restraints on wages and urge them to go on with their efforts in requesting for a fiscal transparency Review Of Standards and Codes (ROSC).

Monetary and Exchange Rate Developments

Prudent monetary and exchange rate policies remain crucial for providing the enabling environment for promoting competitiveness thus, leading to economic growth and development. Currently, the Jamaican economy is experiencing an unhealthy crowding out of the private sector by the public sector, stifling private sector led economic revival. The sector is still recovering from the 1996 financial crisis and faces further pressures from the unfolding deteriorating domestic debt situation. While the local currency has depreciated against the US dollar in the last year, there has been no significant gains to result in improved competitiveness. The depreciation in currency has instead, resulted in increased debt-service costs. The authorities' efforts to protect the exchange rate have only resulted in upward correction of the interest rates, and therefore further undermining credit expansion to the private sector. The authorities are encouraged to review their exchange rate policy to enable the rate to be a more flexible and market determined.

Structural Reforms

The country faces daunting challenges requiring structural reforms that will address productivity growth and enhance exchange rate and labor market flexibility to boost competitiveness. It is our view that fiscal consolidation should form an integral part of a wider set of reform efforts, which should address other issues like crime and the high interest rates. On privatization, although the country has gone somewhat full-circle in its privatization efforts, the continuing work in the telecommunication sector should be accelerated.

Notwithstanding the daunting challenges facing the authorities, we wish them success in their future endeavors.

Extending his remarks, Mr. Bennett made the following statement:

I would like to thank the staff for their hard work. It has been my privilege to accompany them twice on their mission to Jamaica. I have always been impressed by their dedication and professionalism. In particular, I would like to thank Mr. Boote in his last mission to Jamaica. I want to report that the authorities have always valued his contributions and the frank and candid way in which he reports on issues that he has uncovered during the course of the mission. Next, I would like to thank Directors who have prepared statements for today's discussion. They are thoughtful and thought-provoking.

As those who have read the staff report will realize, these are difficult times for Jamaica. The staff report is unusually but appropriately frank in its discussion of the challenges facing Jamaica. For that, I commend the staff, and so do the authorities. They appreciate the candid way in which the problems of the country are set out and discussed.

Jamaica has published the staff report since 1999. The Jamaican authorities believe in transparency and the contribution that it can make to a full and active discussion of economic and financial issues. They intend to carry on that tradition and publish the staff report before us today. There are a number of sensitive information contained in the staff report; the Jamaican authorities will like to go over the report carefully and identify those parts which are market-sensitive, such as the reference to discussions on debt restructuring. But, having said that, they hope to be able to publish the staff report.

Mr. Francis made the following statement:

Jamaica's macroeconomic position is clearly worrying, with an extremely high debt ratio, a large public sector deficit, and interest rates, exchange rates, and unit labor costs at levels that are dampening private sector growth. Jamaica is facing a crisis.

The staff report documents what appears to have been a useful exchange with the authorities. It is encouraging to read in Mr. Bennett's helpful statement that the authorities appreciate the advice and constructive feedback from the staff. However, the adjustment task facing the Jamaican authorities is immense. There is still a substantial difference between what the authorities plan to do and what the staff recommend they should do to address their severe economic difficulties. It is to be hoped that the Fund will maintain a close, ongoing dialogue with Jamaica.

While the authorities' efforts to keep inflation and the debt-servicing burden low through the use of tight monetary policy is understandable, such an approach is best only as a stop-gap while more sustainable policies can be brought to bear. It appears that serious imbalances in other policies are drawing Jamaica to rely on excessively high interest rates for too long. Unfortunately, the excessive debt burden and associated interest payments appear to be crowding out both productive budgetary expenditure and also private investment.

We note that the authorities have indicated concerns about the inflationary effects of the exchange rate policy. While the authorities should be commended on taking an anti-inflationary stance, a floating exchange rate with some price pass-through normally helps small open economies adjust more easily to external shocks. Staff may wish to comment on whether Jamaica would be better targeting core inflation or a suitable measure that extrapolated from first-round effects of exchange rate movements induced by endogenous shocks.

If Jamaica is to avoid a debt trap, significant changes to the policy mix will be required. Fiscal policies must aim to substantially improve both the overall fiscal position and the quality of fiscal expenditures, while structural reforms must provide an environment conducive to balanced economic growth. Such a comprehensive reform program is yet to be formulated, let alone implemented. The magnitude of the reforms necessary will be politically difficult and contentious. Strong leadership is required. As part of building support for reforms, the authorities should clearly articulate to the people of Jamaica what is required and why it is required.

We welcome the authorities' objective to achieve a central government deficit of 5-6 percent of GDP in FY 2003/04, equivalent to a primary surplus of over 12 percent of GDP, and a balanced budget by 2005/06. Large surpluses will clearly be required if the public debt ratio is to be reduced to more sustainable levels. Mr. Bennett notes that Jamaica will need to continue to run primary surpluses in excess of 10 percent—in fact, probably closer to 12 percent—for many years, but the country's track record shows that it has the capacity to sustain results of that order. However, in the last five years, the primary surplus has only exceeded 10 percent of GDP twice. As the staff report notes, there is no room for slippage, for this will just increase the fiscal effort required.

While overall fiscal adjustment is one necessary policy element, serious efforts should also be focused on the quality of fiscal expenditures. In Jamaica's difficult environment, it is especially important that government spending be as productive as possible. It is therefore worrying to see that Jamaica's government wage bill, at 12 percent of GDP, is higher than most Caribbean and Latin American countries. It is also disappointing that large wage increases were paid to senior public servants and politicians. While there might have been a case for improving pay rates, although this is not clear, it is hardly timely, given the fiscal and wage restraint that is going to be called for. One wonders what example this will set and how it will go to help building a public consensus for the major economic reform that is required.

Remaining on the issue of efficiency of public spending, we share the staff's concerns that fiscal adjustment relies exclusively on revenue measures, and we urge the authorities to look to reduce unproductive expenditures where possible, while protecting the social safety net. The medium-term scenarios make sober reading. The baseline scenario, which would still leave public debt at above 140 percent of GDP, appears optimistic. It is unlikely that the authorities could continue to finance deficits of the order envisaged without increased upward pressure on interest rates and initiating further falls in the exchange rate. Debt restructuring may be unavoidable.

Ultimately, growth will be the key to reducing poverty and relieving Jamaica's debt burden. While suitable macroeconomic policies are a necessary precondition, it appears that much of the work also needs to be done on the structural side. While this is never quick or easy to do, and must be managed carefully, it is nevertheless unavoidable. We would strongly urge the authorities to tackle law and order issues, particularly as Jamaica is seeking to sustain and grow its tourism sector in a difficult tourist environment. The report notes that the direct costs of controlling crime and losses to business are estimated to be at least equal to 4 percent of GDP. We suspect that when all the indirect costs are taken into account, losses may be well above that amount.

Business competitiveness could be improved through more flexible working arrangements to promote wage outcomes by strong productivity. Improving the quality and efficiency of infrastructure services is also desirable, both from the point of view of the costs to government and the private sector.

Finally, we share the Jamaican authorities' concerns about the adverse impacts which are occurring in many countries due to the continued agricultural support policies of the U.S. and European governments.

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

Mr. Sipko made the following statement:

The Jamaican authorities have not been able to implement all of the measures included in their staff-monitored program (SMP) during 2002 and 2003. The most important slippages affected the measures aimed at strengthening the fiscal position, keeping inflation low, and creating favorable conditions for faster and sustainable economic growth. Mostly due to the fiscal slippages and the failure to complete the growth-oriented structural reforms, the economy is now faced with twin deficits, a very high level of public debt, and low growth. Other factors include a deterioration of the terms of trade, labor market rigidity, and a high crime rate. The most important challenges now facing the authorities are to restore Jamaica's macroeconomic credibility, rationalize expenditures and improve the collection of revenues, and adopt an appropriate exchange rate regime. To make Jamaica more attractive to foreign investors they should also increase the flexibility of the labor market and reestablish law and order.

The authorities have committed themselves to implement all measures needed to put their economy on a sustainable path. The most important are to restore macroeconomic balance, increase productivity and competitiveness, eliminate crime, and create favorable conditions for capital inflows. Box 3 of the staff paper clearly sets forth the requirements for attaining sustainable growth. It also indicates clearly that in spite of the slowing of growth, the percentage of people living below the poverty line fell from 30 percent to 17 percent. The so-called informal sector accounts for around 40 percent of GDP. We would like to know more about how the authorities plan to reduce this sector's role in the economy.

Revenue measures and expenditure measures must be become consistent with one another. It will not be possible to achieve a condition of fiscal balance in 2005/06 without implementing appropriate expenditure measures. Based on Jamaica's overall track record, and especially the experience with the SMP's fiscal targets for 2002/03, the goal of reaching a balanced budget by 2005/06 seems more ambitious than realistic, despite the authorities' commitment to implementing all of the necessary revenue and expenditure measures.

This brings me to the issue of the unsustainable public debt, which is still increasing. Two-thirds of the increase stemmed from the depreciation of the Jamaican dollar against the US dollar during 2002/03, but the rest was due to the fiscal deficit and higher interest rates. This debt, only half of which is at variable interest rates, has been financed mostly by borrowing domestic residents. Since Standard and Poor's has downgraded Jamaica's outlook from stable to negative, international placements may become even more expensive. Could the staff tell us how the authorities intend to finance the public debt in the near future?

Another cause of concern about the Jamaican economy is the increasing current account deficit. Even though the trade regime has become less restrictive, the authorities are encouraged to continue reforming the present tariff regime within the CARICOM framework.

It is also crucial to speed up the reform of the labor market. We welcome the authorities' efforts to establish a framework for assessing national productivity, and hope that the draft law permitting flexible work arrangements can soon be resubmitted to the parliament. Real compensation per worker grew between 1995 and 2001 by a total of 7 percent, although output per worker grew by only 0.5 percent. This was not right. We would like to emphasize that wage growth should always be consistent with productivity growth.

It is unfortunate that the Bank of Jamaica still hesitates to make the exchange rate more flexible. Despite the divergence of views between the staff and the authorities, we would encourage the authorities to seek the more appropriate floating rate regime. Concerning the current level of interest rates, which average 17.4 percent for the year as a whole, we would like to point out that this will strongly increase interest costs to as much as 2.5 percent of GDP. Lowering the interest rate could benefit the economy as a whole.

Finally, the regulatory framework of the financial system needs to be strengthened. Box 2 clearly shows that Jamaica's present system of security brokers is not consistent with international practices and norms. We join the staff in urging the authorities to more closely regulate the activities of securities brokers.

Mr. Basdevant made the following statement:

We would first like to thank the staff for their well written report, as well as Mr. Bennett for his statement.

We are particularly concerned about the deterioration of the economic situation. This situation is largely due to a loose fiscal policy that has induced financial stability and eventually brought the country closer to a payment crisis. Now the budget deficit has widened to 8 percent for 2002/2003, which is far from the target set in the SMP.

Although we commend the authorities for having contained interest payments, we are concerned with the sharp increase in other expenditures. Given the general unfavorable climate and the very high debt-to-GDP ratio, the only possibility to finance the current account deficit was to use international reserves, which the central bank did. It is thus commendable that in this context a payment crisis has been avoided so far. Nevertheless, debt won't be stabilized in the short run, and the objective of reducing the debt from 150 percent to 100 percent within three years seems to be very optimistic. Moreover, given the fact that a large part of the debt is denominated in US dollars, there is little room for maneuver, and the Jamaican dollar must be kept as stable as possible. We thus call for great prudence in the adoption of a more flexible exchange rate system.

We would like to stress the great fragility of the economic situation, and we feel that the measures proposed to tighten fiscal policy might not be sufficient. In particularly we recommend that the authorities move forward with restructuring the public sector and further containing public expenditures. The objective of a balanced budget for 2005/2006 seems to be particularly optimistic as well.

We feel that the forecast increase in revenues is also optimistic, in light of past experiences and the necessity to improve tax collection further. We also share staff's concern that the adjustment seems to rely too heavily on tax revenues, and not enough on expenditures.

More generally we urge the authorities to move forward with deep structural reforms, and to develop a comprehensive economic program in order to restore the confidence of private investors and to retrieve a sustained growth path. This requires, as we mentioned, reforming the public sector, but also diversifying the tourism activity, and opening further the economy to international trade.

Given the fragility of the economic situation, we also strongly recommend that the authorities make every effort to build a broad political and social consensus on reforms.

We these comments, we wish the authorities all the best.

Mr. Yu made the following statement:

We thank the staff for the well-written report, and Mr. Bennett for his helpful statement. The authorities faced daunting challenges last year due to sluggish economic growth and damage caused by natural disasters. As pointed out by the report, the fiscal position deteriorated and the currency depreciated sharply, giving rise to inflationary pressures. Against this background, the authorities have proposed an ambitious policy package to stabilize the economy. We generally agree with the thrust of the staff report, and encourage the authorities to put in place policies aimed at stabilizing the fiscal position, controlling the growth of public debt, and curbing inflation. That said, we have the following brief comments.

On the fiscal front, given the high level of public debt-to-GDP ratio, fiscal consolidation was the focus of macroeconomic adjustment. However, low economic growth, natural disasters, and a pick-up of expenditures caused slippages of the staff-monitored program in this area. Meanwhile, the sharp currency depreciation and high real interest rates further weakened the fiscal position. In this context, we welcome the ambitious program announced by the authorities.

Determined and rigorous implementation of the ambitious budget over the medium term is key to putting the economy out of its current difficult situation. On the revenue side, concrete measures should be adopted to simplify the tax system and further strengthen tax collection and administration. On the expenditure side, we encourage the authorities to put forward reforms in such areas as public expenditure and civil service, and have expenditure policies play a more important role in fiscal consolidation.

On the monetary front, the authorities should be commended for keeping the inflation rate low. However, the recent sharp depreciation of the currency raises new challenges to the authorities. In this context, we share the view that intervention should be minimized.

On the financial system, we are pleased to learn the relatively sound situation in commercial banks. However, supervision on nonbank financial institutions clearly needs to be strengthened in an urgent way.

Over the medium term, slow economic growth remains a soft point in the administrative capacity of economic adjustment. Growth prosperity remains uncertain, given the weak external environment and the structural impediments. We encourage the authorities to conduct structural reform as soon as possible to improve the labor market. In the trade area, we note the openness of the economy and understand the policies aimed at protecting its agriculture under the current circumstances.

In conclusion, we encourage the authorities to take substantial efforts to stabilize the macro economy and resolve the debt problem. We wish them every success in meeting their challenges.

Mr. Joicey made the following statement:

We share other Directors' concerns about the seriousness of the economic situation in Jamaica. The authorities are clearly in a difficult position and have limited room for maneuver. We thought that this report set out the positions well and frankly. It carefully sets the medium-term outlook, demonstrates the need for strong policy actions, but at the same time is candid about the difficulties associated with all the possible solutions. It is a good Article IV report at a critical time. We hope it will provide the basis for further collaboration between the staff and the authorities in the period ahead. We are pleased that the authorities have decided to publish the report.

The difficulties facing Jamaica are not new. The authorities have long emphasized the need to address the debt burden and overcome the constraints to growth, particularly crime and violence. Mr. Portugal and Mr. De Silva pointed out in their statement that they have achieved substantial primary surpluses and delivered macroeconomic stability under difficult circumstances in the past. However, the missing of the fiscal targets in the SMP last year was disappointing.

The debt dynamics, always extremely finely balanced, have worsened significantly. The position is very vulnerable, and action to restore sustainability and confidence are urgently needed. As Mr. Francis suggested, there is a need to look at the overall policy mix. We agree with the staff's emphasis and recommendations, and most of the comments made by Directors so far. I just have five brief comments.

First, like others, we welcome the authorities' commitment to strengthening fiscal policy, but we share the concerns of staff, Mr. Sipko, and other Directors at the emphasis on the revenue measures, and that the assumptions are optimistic. We support the measures set out in paragraph 27 of the staff report to strengthen the fiscal framework and the quality of expenditures, including also a fiscal transparency ROSC. Like Mr. Ondo Mañe, Mr. Francis, and other Directors, we are concerned of the scale of the wage bill and the recent wage increases.

Second, even with full implementation of the budget and substantial fiscal adjustment, the medium-term scenario and debt sustainability analysis in the report, which we thought, by the way, were useful and helpful, show that public sector debt would remain high. Like Mr. Mozhin and Mr. Palei, we welcome the candid discussion of a possible debt restructuring. We also welcome the staff and the authorities' intention to work further on possible options to address the debt burden and the related vulnerabilities associated with the high proportion of domestic debt and the fact that this is held by the financial sector.

Third, on monetary policy, while the authorities' strategy has kept inflation at low levels, the costs have been high. We support the staff's recommendation that monetary policy should focus more explicitly on inflation and allow the recent flexibility in the exchange rate to continue. Nevertheless, the issues raised in the staff report and the statements underscore the importance of looking more at the appropriate policies for small open economies, and perhaps this is something that can be addressed in the forthcoming discussion on exchange rate policy. This subject has come up in a number of discussions recently.

Fourth, in terms of boosting growth, we fully agree with Mr. Bennett on the critical importance of measures to tackle crime and violence, improve labor market productivity, and strengthen productivity in the public and private sectors. Like Mr. Sipko, we would also welcome any further comments on measures to address the large informal economy which is mentioned in Box 3 of the report. We welcome the ongoing work by the World Bank and the IDB on the constraints to growth. Are there any plans to use this work to build a consensus for reform and develop a comprehensive national strategy, perhaps something equivalent to a PRSP-type process? As the report makes clear, and Mr. Francis emphasized, this is a crucial complement to fiscal consolidation and it may be a way of building support behind the reform agenda. We would welcome staff's comments on that. We also agree with the comments that Mr. Francis made on trade liberalization, particularly in agriculture.

Fifth, and finally, on the financial sector, we welcome the steps that have been taken to strengthen supervision, and agree on the importance of working closely with the Fund on a regulation governing security dealers. We welcome the authorities' participation in the GDDS this year, and encourage them to agree on a timetable for SDDS participation to build on that achievement. The position in the financial sector is fragile, given the large exposure to public debt. A number of Directors raised the possibility of an FSAP review, and I would be interested in staff's thoughts on the appropriate timing of this. Although a full FSAP review may not be appropriate at this time, there is scope for a limited FSAP review or technical assistance. Again, we would welcome staff comments on that. Clearly, the important thing is that the staff and the authorities remain in close contact, and this report seems to provide the basis for doing that.

Ms. Lundsager made the following statement:

We thank the staff for its candid assessment. The main positive element in what has otherwise been mostly negative developments in recent months is the broad consensus among the authorities, the Fund staff, and members of this Board on the seriousness of the situation and on the need for immediate and deep fiscal and structural reforms. This is only a first step in what will need to be a sustained, and difficult, effort to restore long-term fiscal health and reinvigorate private-sector led growth.

Fiscal

The staff report states that public debt is approaching unsustainable levels (see DSA), driven in part by past fiscal deficits. There is general agreement that an increase in the primary surplus to unprecedented levels is necessary to help restore sustainability – and that this should be done within a medium-term planning framework. The authorities, however, are pushing primarily higher revenue measures, citing political difficulties in cutting expenditures. But with tax revenues already over 31 percent of GDP and overall expenditures nearly 40 percent of GDP (in this year's budget), we share Mr. Portugal's view that the authorities should focus on controlling and reducing expenditures. As the staff points out, the public sector wage bill is among the highest in the region, adding to fiscal costs and setting trends in wage settlements that permeate through the rest of the economy, harming competitiveness. We would also be interested in the staff's views on how to bring the informal economy more effectively into the formal sector.

Structural

There are also some differences regarding the scope of structural reforms to generate growth. The authorities' focus on security and infrastructure are welcome, including the emphasis on anti-crime measures. But the authorities' efforts to support specific sectors would be better directed towards improving the general business climate for local entrepreneurs and foreign investors. A broader approach—as the Fund staff is advocating (and that reflects ongoing Inter-American Development Bank and World Bank research on possible sources of growth in Jamaica)—should include cutting red tape for entrepreneurs and liberalizing the labor and product markets so as to reduce costs. This could also help boost the service sector, which seems to have the natural advantage of geographical proximity and language compatibility with North America (as discussed at the last Article IV consultation).

The staff's suggestion to conduct a civil society dialogue could be helpful in generating political support for such structural and fiscal measures. In that regard, publishing this report with its sober assessment could help generate agreement that there is indeed a serious national problem that requires a united national effort to solve. We therefore welcome Mr. Bennett's indication that the authorities will publish. We would add in terms of dialogue, that the authorities should be talking with their external creditors and investors, laying a foundation of information sharing and dialogue so as facilitate a smooth relationship.

Monetary

On monetary policy, the authorities recently resorted to exceptional interventions and issuance of high-interest, dollar-linked debt to halt the slide in the exchange rate. We share the staff's desire to see a more flexible exchange rate to restore competitiveness. The authorities desire reduced volatility, but intervention will not generate that stability—strong policies and performance will. We support the adjustments proposed by the staff that would lessen the emphasis on the exchange rate trajectory, such as eliminating the export surrender requirement as planned, and that would increase reliance on shorter-term monetary instruments.

Financial Sector

We join the staff in urging supervisory reforms of the securities sector. Though the financial system indicators are fairly good, we agree with Mr. Mirakhor that the authorities should participate in the FSAP at the earliest possible time. This would strengthen the authorities' hand in taking any needed preventive actions and improve their ability to adjust rapidly to any emerging pressures.

We welcome Jamaica's active participation in the Caribbean Financial Action Task Force (CFATF) and its active stance in the fight against terrorist financing. We encourage steps to further strengthen the anti-money laundering regime and urge passage of the Prevention of Terrorism Act now before parliament.

The staff representative from the Western Hemisphere Department (Mr. Boote), in response to questions and comments by Directors, made the following statement:

A question was asked whether the staff report is understating the seriousness of the current situation. The staff tried to provide a balanced assessment and, in this regard, many Directors have commented on the frankness of the report. We have stressed the risks in the current situation in various places in the report, for example, particularly in paragraphs 51 and 58 of the staff appraisal section.

There were various questions in the fiscal area. On the scope for reducing the debt burden, given the high domestic debt, and in the absence of any formal restructuring, basically there is not much of an alternative to continued and sustained fiscal consolidation, as Directors have commented during the discussion today and also in the statements. A very high primary surplus is required over the medium term, as well as policies to promote growth—I will elaborate on these policies later—and a macroeconomic stance which encourages lower interest rates; these are key as far as the fiscal dynamics are concerned. I should note that the government has been receiving, on a rolling basis, debt forgiveness from some of its bilateral creditors.

On the source of fiscal adjustment and the scope for further expenditure cuts, which various Directors have asked the staff to comment on, three-quarters of expenditure pertain to interest and wages, with the latter accounting for over one-third of expenditure. These two items constitute nearly 100 percent of revenues. Wages, as a percent of GDP, have risen by around 2½ percentage points over the last two years, and various Directors have commented on the high level. The February increase in wages for senior civil servants and parliamentarians contained a large retroactive element of catch-up to private sector market comparators. However, as was widely commented in the Jamaican press at the time, the size of the wage increases clearly did not help in the overall context of wage restraint. Therefore, in effect, action to control expenditure has to involve containing wage growth, and the staff suggested bringing forward the civil service reform and a review of expenditure.

A question was asked on the financing of the public debt. The authorities, in the financing plan underlying the FY 2003/04 budget, assumed access to international capital markets in the second half of the year, with the remaining financing coming from domestic markets, as well as some international financial institutions. Whether access to international capital markets is regained on terms that are acceptable to the authorities, depends on developments from now, but there are no payments falling due on international bonds through the middle of next year, and therefore a period of non-access to capital markets could be met by a rundown of reserves. There is no immediate external financing problem at this point.

There was a question asking the staff to clarify its position on the exchange rate and its views on a free float. The Recent Economic Developments section of the staff report was written in the context of the authorities' exchange rate policy, which favors relative stability of the exchange rate. In practice, a large exchange rate depreciation occurred over the last year due to the declining confidence in the macroeconomic situation. By contrast, as various Directors have noted, the staff would favor a somewhat different exchange rate policy, which would build on recent gains of competitiveness to promote growth and reduce the current account deficit—in a sense, a more flexible policy. In this regard, given the debt dynamics, domestic measures to increase productivity and enhance competitiveness through structural reform are also important.

As far as a free float of the exchange rate is concerned, the staff would favor less intervention in the foreign exchange market and a deepening of that market by various steps described in the staff report. On the possibility of moving toward inflation targeting, fiscal dominance at the moment makes that extremely difficult. The consumer price index is based on a 1986 basket, which is out-of- date. Work would be required to update the basket for the consumer price index before it could be used as a key basis for policy formulation. The Bank of Jamaica monitors a core inflation concept, so there is already progress in that direction. However, there is more work that needs to be done on the inflation index.

On the financial sector, there was a question on the zero-weighting of the banks' holding of government debt in calculating the capital adequacy ratio. The current treatment of zero-weighting is consistent with the internationally-recognized Basel standard, which is zero risk-weighting of government debt. Any change in that could be destabilizing for markets. However, the staff sees a case for accompanying the internationally-accepted treatment by monitoring in parallel an unweighted capital adequacy ratio—called a leverage ratio—which would also reflect large exposure to government debt.

On the issue of undertaking an FSAP review, the authorities stated as reported in paragraph 37 of the staff report that there are reforms taking place in financial supervision and, therefore, they did not think the timing was right to request an FSAP review in the near future. However, the staff is certainly open to any requests that the authorities may wish to make on technical assistance, or for a more limited FSAP review, for reasons that various Directors have advanced during the discussion.

There were two other general issues raised. One was the question of how to bring the informal sector into the tax net and to integrate their activity in the economy. The government has been taking several steps to try and increase tax compliance through various measures, which the staff welcomes. There is scope for further attempts to broaden and simplify the tax base and, to the extent possible and consistent with the overall fiscal position, to reduce tax rates as a way of bringing the informal economy more within the tax net. There is also action that can be taken to curtail illegal activity and a whole series of other measures to reduce regulatory burdens for small enterprises. The government proposed, as part of the budget, a 4 percent import charge, which is tax deductible, and that was deliberately constructed as a way of encouraging enterprises to come within the tax net. Unfortunately, from the point of view of the staff at least, in response to the representations made by the private sector to those measures, the tax deductibility element was removed and the rate reduced, so that incentive effect was lost.

On the second issue of measures to promote growth and to build a wider societal consensus on those measures, we are advised by Bank staff that it is hoped that their proposals in the area of growth will generate a dialogue both with government and a wider section of the private sector. The staff also sees the case for such a wider dialogue to discuss important elements of structural reform, which the government is already doing. For example, on tackling violence, there is an agreement with the opposition on certain measures. There is also scope for further action with broader societal consensus in such areas of reform as labor mobility and flexibility, and on economy-wide agreements on productivity.

Mr. Bennett made the following concluding statement:

I thank Directors for their interventions and the staff for their responses. There is a consensus on the future challenges that Jamaica faces; the authorities understand that and are determined to address those challenges in their own way, but with an open dialogue with the international financial institutions, including the Fund. The advice of the Fund is very much valued by the Jamaican authorities. I will certainly undertake to convey to the Jamaican authorities the comments that have been made today, both orally and in the statements. It will be a delicate future for Jamaica, as it struggles to tackle these challenges. There are not many positive shocks on the horizon that one can point to, and Jamaica still faces a number of negative shocks, both exogenous and endogenous. However, the Jamaican authorities will try to cope with them as best as they can.

The Acting Chair made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They noted that inflation remains subdued, remittance inflows continue to be strong, and the progress made in the last decade in reducing poverty is largely intact. However, economic growth has slowed to below the rate of population growth, unemployment is high and rising, and crime and security considerations discourage private sector initiative. Directors expressed particular concern about the sharp deterioration in macroeconomic imbalances during FY 2002/03 and the significantly higher public debt to GDP ratio. The recent large fiscal and current account deficits are unsustainable and risk serious future financing difficulties. The risks are accentuated by Jamaica's high degree of vulnerability to exogenous and weather-related shocks. The authorities will need to move forcefully to contain the public debt, aiming at the same time to strengthen the social consensus in support of sustainable growth and poverty reduction policies.

Directors welcomed the authorities' commitment to effect a strong fiscal adjustment, as reflected in the FY 2003/04 budget and the objective of attaining fiscal balance by FY 2005/06. Reaching the planned substantial fiscal adjustment will be challenging, but is necessary to restore a sustainable fiscal position. It will require timely implementation of revenue-enhancing measures, but the emphasis ought to be on rigorous restraint of expenditures, particularly wages and unproductive outlays. In such an environment, measures to ensure the quality and efficiency of public spending will also be crucial. Directors encouraged the government to identify contingency measures, particularly on the expenditure side, in case the revenue projections and expected decline in interest rates do not materialize or other shocks emerge, and to incorporate medium-term fiscal consolidation targets into legislation.

Directors observed that monetary and exchange rate policy has sought to steer a difficult course between the balance of payments and inflation objectives. Using the exchange rate as an anchor for inflation expectations succeeded in keeping inflation low, but at the cost of a widening current account deficit and an overall decline in competitiveness since 1995. Directors considered that greater exchange rate flexibility would better safeguard competitiveness and respond to shocks. An acceleration of structural reforms would also help improve productivity and growth prospects. Directors noted that deepening the foreign exchange market could also improve its stability.

Directors encouraged the Bank of Jamaica to reorient monetary policy toward a greater focus on inflation, operating through shorter-term interest rates. Focusing on changes in shorter-term interest rates could help reduce the need for large movements in longer-term rates. Directors emphasized that a reduction in the public debt would be needed to reach a sustained lower level of interest rates.

Directors underscored the importance of complementing fiscal retrenchment with a more comprehensive program of structural reforms to generate faster growth, preferably based on a national consensus developed through dialogue with civil society. Such a program should include flexible working arrangements, and an economy-wide agreement to promote wage restraint and productivity growth, reduce regulatory barriers to small enterprises, and lower agricultural protection. At the same time, a few Directors noted that it would be helpful for Jamaica's poverty reduction efforts for industrial countries to increase access to their markets for Jamaican exports by, inter alia, reducing their subsidies, particularly in the agricultural sector. Directors viewed further anti-crime measures as necessary to strengthen security and the investment climate.

Directors noted with concern the large exposure of the financial system to public sector debt and the need to keep the situation under close review, given the macroeconomic situation. They welcomed the authorities' plan to strengthen the supervision of non-bank financial institutions, particularly of securities broker-dealers, who hold large amounts of government securities. Strengthened supervision should improve the effectiveness of monetary policy and reduce risks of market instability. At the same time, Directors considered that needed changes should be introduced carefully and with a view to maintaining stability in the government securities market. Directors also stressed the need to foster a level playing field between competing institutions and to avoid creating opportunities to engage in regulatory arbitrage. Directors encouraged the authorities to move forward with implementation of measures to combat money laundering and the financing of terrorism.

Directors expressed concern about the fragility of the current macroeconomic situation. Even with determined implementation of the strongest policies, the situation remains difficult, with the economy vulnerable to shocks. Directors underscored that the authorities have a limited margin for maneuver, given the high and rising public debt levels—which have been exacerbated by exchange rate depreciation—a financial system with large holdings of public domestic debt, the current loss of access to international capital markets, and the effect of sustained high interest rates on the debt burden. They encouraged the staff to collaborate closely with the authorities on these issues in the period ahead.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/03/53 (6/6/03) and EBM/03/54 (6/9/03).

4. 2003 ANNUAL MEETINGS—OBSERVERS

The Executive Board approves the draft letter to the Chairman of the Boards of Governors of the Bank and the Fund recommending for his consideration a list of organizations that would be invited to send Observers to the 2003 Annual Meetings, as set forth in EBD/03/47 (6/2/03)

Adopted June 6, 2003

APPROVAL: September 9, 2003

SHAILENDRA J. ANJARIA
Secretary