June 9, 2003
Approval: 6/16/03

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 03/30

10:00 a.m. March 28, 2003

Contents

Executive Board Attendance

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

Executive Directors	**Alternate Executive Directors**
S. Al-Turki	A. Alazzaz
	A. Al Nassar, Temporary
	M. Kruger, Temporary
	F. Vermaeten, Temporary
K. Bischofberger	R. von Kleist
	H. Fabig, Temporary
M. Callaghan	
P. Duquesne	O. Basdevant, Temporary
V. Egilsson	B. Andersen
	B. Gulbrandsen, Temporary
S. Indrawati	C. Duriyaprapan, Temporary
N. Jacklin	M. Lundsager
	A. Baukol, Temporary
	P. Dohlman, Temporary
W. Kiekens	J. Prader
	Y. Yakusha
	A. Zoccali
	C. Pereyra, Temporary
	D. Vogel, Temporary
A. Mirakhor	J. Kwakye, Temporary
A. Mozhin	L. Palei, Temporary
	Y. Lissovolik, Temporary
D. Ondo Mañe	K. Kpetigo, Temporary
	O. Garner, Temporary
	P. Moreno, Temporary
P. Padoan	H. Vittas
	A. Lanza, Temporary
	A. Tombini, Temporary
Y. Reddy	K. Kanagasabapathy, Temporary
	E. Prasad, Temporary
	M. Brooke
	J. Droop, Temporary
A.S. Shaalan	G. Shbikat, Temporary
I. Usman	P. Ngumbullu
	J. Kanu, Temporary
Wei B.	
K. Yagi	N. Watanabe, Temporary

F. Zurbrügg W. Szczuka
S. Antic, Temporary

S.J. Anjaria, Secretary
B.Esdar, Acting Secretary
A.S. Linde, Acting Secretary
Y. Chia, Assistant
H. Mooney, Assistant
O. Vongthieres, Assistant

Also Present
IBRD: A. Bhattacharya, Senior Advisor; B. Mierau-Klein, Principal Econmist; M. Edwards, Principal Financial Advisor. African Department: N. Kirimani. Asia and Pacific Department: W. Tseng, Deputy Director; D. Citrin, E. Parrado, S. Schwartz, A. Richter, A. Wolfson . European I Department: A. Leipold, Deputy Director; R. Moalla-Fetini. European II Department: B. Burgess. External Relations Department: T. Dawson, Director; A. Gaviria, W. Murray, P. Reynolds . Fiscal Affairs Department: P. Heller, Deputy Director; A. Baldini, T. Daban. Independent Evaluation Office: D. Goldsbrough, Deputy Director. International Capital Markets Department: A. Bertuch-Samuels. Legal Department: F. Gianviti, General Counsel; K. Christopherson, S. Hagan, C. Ogada, R. Weeks-Brown. Middle Eastern Department: A. Bennett . Policy Development and Review Department: T. Geithner, Director; A. Arvanitis, M. Fetherston, M. Fisher, R. Kincaid, M. Hadjimichael, A. MacArthur, H. Tadesse. Research Department: R. Ramcharan, J. Zettelmeyer. Secretary's Department: P. Gotur, L. Hubloue, P. Ramlogan . Treasurer's Department: I. Goodwin Western Hemisphere Department: F. Frantischek, P. de Masi, M. Rodlauer, M. Rodriguez, A. Wolfe. Office of the Managing Director: V. Read, Special Assistant; J. Boorman, Special Asvisor; A. Mazarei, R. Nord. Office of Budget and Planning: H. Young. Monetary and Exchange Affairs Department: S. Craig, E. Frydl, M. Taylor, S. Wajid. Advisors to Executive Directors: D. Farelius, P. Gitton, C. Sia, F. Haupt. Assistants to Executive Directors: T. Segara, C. Harzer, N. Epstein, J. Salleh, N. Davidson, I. Kupca, K. Oo, J. Ralyea, M. Jamaluddin, B. Reichenstein, C. Gust.

1. STATUTORY SOVEREIGN DEBT RESTRUCTURING MECHANISM—DRAFT REPORT OF MANAGING DIRECTOR TO INTERNATIONAL MONETARY AND FINANCIAL COMMITTEE

Document: Statutory Sovereign Debt Restructuring Mechanism—Draft Report of the Managing Director to International Monetary and Financial Committee (SM/03/101, 3/25/03)

Staff: Fisher, PDR; Hagan, LEG

Length: 40 minutes

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

We once again take the opportunity to thank the staff and management for their efforts throughout the discussions on the SDRM to incorporate into the original proposals some of the several concerns expressed by emerging market borrowers and their creditors. Notwithstanding these efforts, we remained unconvinced of the necessity of such a mechanism for the reasons we have expressed during our various discussions on this topic, in particular, during our last meeting on March 5, 2003. Second, it became clear in our previous meeting that the idea of establishing a SDRM has not garnered the 85 percent majority support required to make an amendment to the Articles of Agreement.

However, we acknowledge and share the view expressed in the draft report that a lot has been accomplished from the discussions on the SDRM with respect to increasing awareness of market participants about their responsibilities for collective action problems.

As we suggested in the previous meeting, we would prefer that, in order to respond to the request of the International Monetary and Financial Committee (IMFC), the Managing Director's report should take stock of the intense discussions that have taken place on the various issues related to the SDRM, explicitly recognizing the lack of required support for moving forward. While thanking the Managing Director for acknowledging such a reality, we disagree with the presentation of the Attachment as the response to the IMFC's request. In our view, in addition to lacking the required support, the proposed features of the SDRM comprised in the Attachment contain differences on substance, not simply on technical issues.

We will offer comments and suggestions concerning the attachment in case the Managing Director decides to present it as part of his report to the IMFC. We will present our suggestions in the form of proposed alterations to the text of the Attachment.

First, two general comments: in several passages of the text, including obviously in Section 13, there is reference to the Dispute Resolution Forum. Although we will not make any specific comments every instance that such a reference occurs, we will like to see language, perhaps in the introduction of the Attachment, reflecting the fact that a few Directors have opposed the establishment of such Forum. Along the same lines, it should be made clear in the Attachment that a few Directors remain unconvinced that there is a legal basis for amending the Articles of Agreement for the intended purpose (Section 14).

The following are specific comments (proposed insertions are underlined, while proposed deletions are struck through):

Section 2. Principles: first bullet, first sentence - "The mechanism should only be used to restructure debt that is judged to be unsustainable by the debtor."

Ninth bullet - "Since the framework is intended to fill a gap within the existing financial architecture, it …" Replace by: "The framework should not displace existing statutory frameworks."

Tenth bullet - "The integrity of the decision making process under the mechanism should be safeguarded ~~by an efficient and impartial dispute resolution process~~."

Eleventh bullet - "The ~~formal~~ role of the Fund under the SDRM should be limited."

Section 3. Scope of Claims: item (a) second sentence "…, whether all or some of these claims would be restructured in a particular case would depend on a decision of the debtor and on the negotiations between the debtor and its creditors."

Item (b): "For purposes of the mechanism, and subject to (c) below, eligible claims would be limited to rights to receive payments from the sovereign ~~specified~~ debtor (as defined in the mechanism): (i) that arise from a contract relating to commercial activities of the specified debtor and (ii) that are not ~~neither~~ governed by the laws of the member activating the SDRM, and are ~~nor~~ subject to the exclusive jurisdiction of a tribunal ~~not~~ located within the territory of that member. Eligible claims would also include claims for payment of judgments resulting from a right to receive payments under a contract that meets criterion (i) above, if the enforcement of such judgment is sought outside of the territory of the member activating the SDRM."

Item (c): "For purposes of the mechanism, a specified debtor would comprise the central government of the member activating the mechanism

and, subject to consent of the debtor in question, could also include ~~(i)~~ the central bank or similar monetary authority of the member ~~and (ii) any local governments or public entities within the territory of the activating member that are not subject to a domestic statutory debt restructuring framework~~."

Item (d), sub-item (i): "Claims that benefit from a statutory, judicial or contractual privilege, to the extent of the value of such a privilege unless ~~such a privilege: (i) was created after activation and (ii) arises from legal enforcement proceedings against a specified debtor~~;"

Item (d), sub-item (v): "Claims held by international organizations that are specified in the amendment. (The amendment would authorize the Board of Governors, by a seventy ~~eighty-five~~ percent majority of the total voting power, to amend the initial list of such organizations and claims); and"

Item (d) - Insert a new sub-item: " (vii) Claims arising from trade credits".

Section 4. Activation: "Consistent with the principle of sovereignty, the mechanism could only be activated at the initiative of the sovereign debtor in question ~~a member~~. When activating the mechanism, the member would represent that the debt to be restructured was unsustainable. For purposes of the legal effectiveness of activation, this representation would not be subject to challenge."

Section 5. Provision of information: "Upon activation, a procedure would unfold that would require the activating member to provide to its creditors all information regarding its indebtedness that is being restructured and the indebtedness of all specified debtors (including debt that could but will not be restructured under the SDRM) to the Dispute Resolution Forum (DRF). The activating member would be expected to present the following information: "

Item (iii): "a list of claims which could be restructured under the SDRM but for which no restructuring is sought."

Section 7. Limits on Creditor Enforcement: "(a) When, after the date of activation but prior to the finalization ~~certification~~ of a restructuring agreement,..."

Section 8. Creditor Committees: "As a means of encouraging active and early creditor participation in the restructuring process, a representative creditors' committee, if formed, would be given a role under the SDRM to address ~~both~~ debtor-creditor issues and ~~inter-creditor issues~~ the registration of claims."

Section 11. Restructuring Agreement: "[(c) ~~Mandatory~~ Optional classification of official bilateral claims, if such claims are included under the SDRM]".

Mr. Oyarzábal and Mr. Calderón-Colin submitted the following statement:

First, I would like to commend the Managing Director for carrying out a difficult task by summarizing what has been a very extensive and constructive debate regarding the proposal of the SDRM in order to present it to the IMFC. I would also like to thank him for sharing his insights with us and taking into consideration our opinions.

At the outset, I would like to say, that in our opinion, the draft report has the merit of being at the same time comprehensive—by covering a wide range of issues—and sufficiently concise, giving testimony to the different features that have accompanied this vigorous debate. I would like to focus on just a few points.

We welcome the inclusion in the draft report of the contribution that this debate has generated by promoting collective action clauses (CACs) in sovereign bonds, a voluntary Code of Conduct, as well as the dialogue with the private sector, workout professionals, members of the judiciary, academics, representatives of civil society, and the official community.

However, the draft report states that further progress on the development of the proposal would require the resolution of a number of technical issues. We suggest that the term "technical" be removed because there are not only technical issues, but also issues of substance, including the nature of the mechanism.

Management acknowledges that "notwithstanding the substantial convergence of views within the Board on the key features, differences remain among Executive Directors on a number of issues". We would suggest to add the word "substantive", so the sentence would read "...differences remain among Executive Directors on a number of substantive issues". We believe that mention should be made not only to differences on issues, but also on the rational or design of the SDRM.

We request that the word "yet" be deleted from the sentence: "At this stage, there does not yet appear to be requisite support among the Fund membership to establish the SDRM through the amendment of the Fund's Articles" as the report is trying to inform the IMFC with respect to the current status of support or lack of support for a change of the Articles. By omitting this word the report would be more factual.

> We agree with management that the discussions on the SDRM have highlighted a range of issues of relevance to any crisis resolution framework that warrant continued work. We certainly support this idea, as long as it is carried outside of the context of the SDRM.

Extending his remarks, Mr. Tombini supported Mr. Oyarzábal and Mr. Calderón-Colin's request to delete the word "yet" from the draft report. That deletion would make the report a bit more factual and bring it more in line with the state of discussions.

Ms. Jacklin agreed with the comments as well with the suggestions of Mr. Oyarzábal as they reflected a more accurate description of the state of the discussion.

Mr. Reddy made the following statement:

> This has been a subject on which on the one hand we have made impressive gains in terms of understanding the subject and the complexities, as well as in sensitizing financial markets, the private sector, and public policy individuals with regard to this important subject. This is very important.
>
> In addition, though there have been contentious discussions, they have been comprehensive. Summarizing is not an easy task. Therefore, perhaps one way of looking at it is: what are we seeking from the IMFC? I believe that what we are seeking from IMFC is guidance on how to proceed, perhaps not on whether to proceed. If we are fairly clear on that, that we are seeking guidance on how to proceed and not whether to proceed, then we have to give as comprehensive a picture as possible of the problems, the dilemmas, and the differences to the IMFC.
>
> To that extent, again, I believe that the draft report is reflective of the discussions and the broad consensus in the Board. However, we do notice that there are some concerns that have been indicated in the statements. In this regard, there are two possible approaches. One approach is to capture the differences and try to project the consensus with possible modifications to the draft report as it is. The other way may be to consider adding another annex that tries to indicate what are the items of difference where there are serious differences and what do they imply. Thus, in that sense the Ministers may be able to get a sense of the many areas where there is agreement and on some issues where there is difference. Thus, that is a possibility, and I would like to place that before you and before my colleagues here to consider, because if we try to identify a common denominator in going to the Ministers on a complex subject, whether it will help the Ministers give us the guidance we need. This is one point I want to make.
>
> More generally, on the draft report as such, I have only two small comments to make. First, in terms of the general approach, it is possible that--or perhaps we have to recognize the fact—that there has been significant

progress with CACs and the Code of Conduct. These are related, complementary, and parallel measures, and perhaps not substitutes. Thus, there may be an advantage in having a paragraph as a backdrop on the totality of the crisis prevention measures that we have taken, and that all this work has to go on simultaneously in order to maintain a balance. That is one suggestion that could come as a backdrop.

Second, purely from an editorial point of view, I would like to submit that in paragraph 4 there is a sentence that reads, "not all Executive Directors agree on the desirability of the statutory sovereign debt restructuring mechanism". In the third paragraph, the draft report reads, "the Board discussions indicate that most Directors broadly support staff proposals on the key features of a statutory mechanism". Therefore, perhaps one way to bring this together is if we simply do not address the statutory part in paragraph 3. It can then be said that "all Directors" and we can then remove "most", "broadly support staff proposals on the key features of a mechanism that could enhance the operation...". That way we are able to find a common ground, and then elaborate in the next paragraph that some Directors did not agree with the statutory mechanism. Some people could see some contradiction here, but I have no serious feelings on that. I just thought I should bring this to your attention.

Mr. Mirakhor made the following statement:

We thank and commend management and the staff for their outstanding work and for their outreach and consultation efforts made toward designing a mechanism to help a sovereign and its creditors to collaborate toward an orderly resolution of unsustainable debt, thus filling a gap in the present architecture of crisis prevention and resolution. Once operational, the mechanism will bring stability to the international financial system. We also thank the staff for taking into consideration the specific comments we presented on the draft Proposed Features of a Sovereign Debt Restructuring Mechanism (SDRM).

Mr. Callaghan made the following statement:

We think the draft report is very suitable under the circumstances. It notes that considerable progress has been achieved, our understanding of the issues has improved, there has been a vigorous debate on the SDRM, a solid but not complete proposal for the SDRM has been fleshed out, there is not agreement on all the details of the proposal, and importantly, there is not agreement on the need for a SDRM. These are the facts.

All this should be presented to the IMFC, and that is what your draft report does. It does present the facts. It presents a state of play. There is no point today debating the concept of the SDRM or the details of the proposal.

The Attachment in your report should be presented to the IMFC. The IMFC has asked for a concrete proposal, and we have to respond. However, we should not report that more has been achieved than has actually been the case, and your report does not do this.

There has not been agreement on the details of a concrete proposal, even among those who support a SDRM, and there is not even agreement on the concept. No one is signing off on the details in the Attachment. It is a fleshed out proposal, but it is not set in concrete. Further refinement would be required if it were to go ahead.

We can pass on to the staff, probably best on a bilateral basis, suggestions to improve the consistency of the Attachment. However, we should not be too concerned about the detail, because it is not being presented to the IMFC as an agreed proposal. There is not agreement on all the details, and the square-bracketed paragraphs in the Attachment should be acknowledged as areas where agreement still needs to be forthcoming. I hope that they are not square brackets in the sense that they may be deleted.

To avoid drafting debates on the attachment outline that outlines the proposal, it should be made clear at the top of the Attachment that this is what has been developed to date, but that there has not been agreement on all the details. We are asking the IMFC for direction, and for whatever it is worth, your report does give a guide as to what we should probably expect to come out of the IMFC, namely, that we should note that there has been considerable progress in understanding the issues and there has been progress on improving arrangements for sovereign debt restructuring. It should note that we have had a vigorous debate on the SDRM, which has been constructive, but that we do not have agreement on all the details, nor do we have agreement on whether there is a need for a SDRM. However, we also need to conclude that we need to continue to improve the arrangements to handle situations where sovereign debts are unsustainable, including in particular through collective action clauses and a voluntary Code of Conduct.

Mr. Zurbrügg made the following statement:

Let me thank the staff and management for the outstanding job that they have done in coming forth with a comprehensive and concrete proposal for a SDRM. Best efforts have been made to take into account the many reactions from market participants and professionals, and a great deal has been achieved in a short time. Overall, we made reasonable compromises to address the concerns expressed by borrowers and creditors, without losing sight of the proposal's objectives.

The draft report gives an accurate picture of the Board's view at this point in time. It explicitly notes that the text on proposed features reflects the

views of most Directors. It also addresses Mr. Portugal's concerns by stating that "not all Executive Directors agree on the desirability of a statutory sovereign debt restructuring mechanism." It correctly states that "differences remain among Executive Directors on a number of issues," without qualifying the nature of these differences. In my view, the remaining issues are small compared to the achievements, and there is ample room for compromise.

I believe that your draft report and the attached features of a SDRM are an excellent response to the IMFC's request for a concrete proposal for a statutory sovereign debt restructuring mechanism, and it should be submitted as such to the IMFC.

Mr. Vittas made the following statement:

I would like to thank management and the staff for the draft report to the IMFC on the SDRM and the opportunity to comment on it.

I find the report to be not only brief and to the point, but also very candid, as of course it should be. It acknowledges the very significant progress that we have made in designing the mechanism, within a remarkably short period of time I would say, and the very strong support that the concept of a SDRM enjoys among the membership. At the same time, the report recognizes in a very fair and candid way that this support falls short of the majority required for proposing an amendment of the Articles of Agreement, and that on some key issues differences of view persist. Whether we call these issues technical or substantive is of secondary importance in my view. What is clear is that we need further guidance from the IMFC on how to proceed.

Another aspect of the draft report that I very much appreciate is that it acknowledges the major benefits that we have all derived in this effort from the extensive dialogue with outside experts and nonofficial parties. The only criticism of the report that I would make is that it is perhaps too modest in highlighting the very substantial role that the staff and the management team have played so far in moving forward the work on the SDRM, and more broadly in advancing the quest for a well-functioning debt resolution framework. If there is going to be any amendment to the draft, I think this point deserves to be given more emphasis.

All in all, we are strongly in favor of submitting the report to the IMFC in essentially its present form. We could accept some purely drafting suggestions, however we do not think that it would be useful at this late stage to reopen the debate on substantive issues.

Mr. Kruger made the following statement:

I would like to join my colleagues in thanking the staff for its excellent work in preparing a concrete proposal for a sovereign debt restructuring mechanism for the IMFC's consideration. The staff has taken a wide variety of perspectives into account in drafting these proposed features, and yet has still been able to construct something that is consistent and has both economic and legal appeal. I would also like to thank the Managing Director for all his hard work in ferrying this task to its completion.

I recognize that Executive Directors are divided on the SDRM. Some are not convinced of the need for a statutory approach to sovereign debt restructuring, while others believe that a non-statutory approach is unable to deal effectively with collective action problems and rogue creditors. Who is right? I think it is very difficult to tell. If this were an econometric problem, I would say our sample size is too small for us to have significant confidence in our conclusions. We simply do not have enough instances of sovereign debt restructurings to be able to abstract from country-specific factors and assess how well the current system works. Of course, this is a good thing. Moreover, the market is in constant evolution. Mexico might have set a new trend with its recent bond issue, and the use of collective action clauses could become quite widespread. In this case, our old observations will have been rendered obsolete by this regime change. While it is very difficult to be scientific in attempting to distill lessons from the past, it is even more of a challenge to extrapolate what sort of framework will best serve capital markets in the years to come.

Nonetheless, it is clear that there is not enough support to amend the Articles and establish the SDRM. However, the development of this concrete proposal has served a number of useful purposes. First, it gives the international community the ability to respond more quickly should it decide with the benefit of future experience that the non-statutory approach is not working. Second, as Mr. Reddy and Mr. Callaghan noted, it has been a vehicle for our education with respect to the economic and legal complexities of debt restructuring. As such, we are better prepared to interpret the implications of future restructurings. Third, by spurring the adoption of collective action clauses and fostering increased interest in a voluntary Code of Conduct, it has created positive externalities. Finally, it has pointed to the need to do more research on crisis resolution.

I think the issues enumerated in the Managing Director's report are very relevant and worthy of our careful consideration. I am proud of what the staff has achieved. While we all may have certain reservations, the paper we have before us characterizes well the state of play with respect to a sovereign debt restructuring mechanism and therefore, as Mr. Mirakhor, I believe it fully fulfills our mandate with respect to the request from the IMFC.

Mr. Bischofberger made the following statement:

I welcome your report on the SDRM. As previous speakers, I would also like to use this opportunity to thank you and the First Deputy Managing Director as well as the staff team for your genuine commitment to the SDRM and for your hard work in bringing this project forward. As has been noted on many occasions, the present crisis resolution framework has significant shortcomings in terms of dealing with collective action and creditor coordination issues. We continue to believe that a SDRM is very much needed in order to tackle these problems in a more effective way.

Clearly, some features of the mechanism remain to be worked out. Moreover, as you noted in the report, there does not yet appear to be the requisite support among the Fund membership to establish the SDRM through an amendment of the Fund's Articles of Agreement. However, we have come a very long way in developing a concrete proposal, as was our mandate. Moreover, our work on the SDRM has laid the basis for important progress on some other fronts, including CACs and the proposed Code of Good Conduct, which we regard as valuable complements to the SDRM. This momentum should be kept up.

Your report describes this progress as well as the degree of convergence in a fair and accurate manner. The Attachment to the report also broadly reflects the state of our discussion on the specific features of the SDRM. Clearly, in our view, not all nuances of the last Board discussion have been fully captured in the Attachment. Indeed, in our statement issued ahead of the last Board discussion, we had a somewhat different view on some features of the SDRM. In this regard, the text in square brackets in sections 7 and 8 is useful in order to give a more balanced picture of the discussion and to indicate possible avenues of future work. Therefore, I would like to propose to delete the brackets while keeping the text in these two sections.

Mr. Brooke made the following statement:

I very much echo the sentiments being expressed by many Executive Directors so far, in particular by Mr. Mirakhor and Mr. Zurbrügg. As we have stressed in previous meetings, we believe that the staff has done an excellent job in putting together a concrete proposal on the SDRM, which we believe is workable and which a majority of Directors supports. Management and the staff should be strongly commended for keeping Directors well informed and for consulting extensively throughout this process.

We agree with the Managing Director that the work on the SDRM has substantially advanced our understanding of the issues that need to be addressed to bring about more orderly resolution of crises, and has also contributed positively to a more extensive debate and progress on collective

action clauses and the Code of Conduct, as others have just noted. The Managing Director's report accurately and fairly reports on the extent of our progress on the SDRM, and we have no hesitation in supporting the report that the Managing Director proposes without making any changes to it.

While there is not sufficient support for the SDRM at this time, the aggregation problems, the issue of inter-creditor equity, and the issue of alleviating the severe costs of economic dislocation that result from debt default will need to be addressed at some point. Consequently, a great deal remains to be done to improve upon our methods to prevent and resolve crises.

Mr. Yakusha made the following statement:

The statutory SDRM approach commends considerable support and is generally sound. While acknowledging that we do not yet have the required majority for going forward with the SDRM at this stage, it is important that the proposal, including its proposed features, remain on the table for future consideration. In the meantime, I agree that we should work in parallel on complementary approaches, such as collective action clauses and the Code of Good Conduct.

We continue to support the statutory approach for creating a mechanism for more orderly sovereign debt restructuring, as the proposed mechanism could help enhance our crisis resolution efforts. We have discussed the SDRM in a number of meetings, Board meetings, informal seminars, as well as outreach meetings, and slowly but surely during this process our views have converged to some extent, and as a result there now seems broad-based support for the proposed features. This in and of itself is quite a remarkable achievement. We should commend the staff and the management team for the excellent and hard work in this regard.

I broadly support the proposed features, noting that these shape the general framework while many technical details still have to be filled in. I also agree with the proposed cover letter to the IMFC, and as other Executive Directors, I think that this letter provides a quite honest reflection of the status of our discussion.

Mr. Duquesne made the following statement:

Let me, as others, commend management and the staff for their sustained work and efforts. As has been said by many colleagues, the present draft report is probably the first presentation of the state of the debate that could be made to the IMFC for the upcoming spring meetings. The brevity of the report is to be praised.

Obviously, I would have preferred that a consensus could have allowed the Executive Board to transmit on its behalf a proposal to the IMFC. Nevertheless, I would be ready to enter into a drafting session if it were our report, but assuming it is your report, as Mr. Vittas, with whom I am in broad agreement, I would resist doing so. However, let me say in passing, and if needed, that I do not support the amendments suggested by Mr. Oyarzábal. In addition, as Mr. Bischofberger, I would like to keep the text that is in brackets in paragraphs 7 and 8.

There is no need to recall that the SDRM proposal has made great strides since the end of 2001, and has clearly increased the knowledge and awareness of the international community—official as well as private—on the critical question of crisis prevention and resolution. It has been, in many ways, constructively thought provoking. That is why I regret that early on—one could even say prematurely—extremely regressive positions were expressed and sent a negative signal to the international community. Nevertheless, as stated clearly in your draft report and confirmed by all colleagues, our discussions have provided a new momentum to initiatives that aim at dealing with any debt crisis. Unfortunately, crises still occur and will be relatively frequent, even though not all on a scale to be a matter of concern of the SDRM. Thus, we are sure the question of a SDRM will return.

This Board has definitely benefited from the wide range of discussion that we have had. The debate has brought some positive side effects as regards the awareness of the benefit of CACs and of the usefulness of a voluntary Code of Good Conduct. This underlines the need to pursue work on all fronts on the crisis resolution framework. We just received a staff document on CACs and we would be interested in receiving another report on the Code of Conduct. We think that the Code is even more important because the role of the Fund in any kind of Code of Conduct would be more important than with regard to consigning CACs.

All in all, we must go on, and this is the consensual message I would like you to convey to our political authorities.

Mr. Wei made the following statement:

This draft report is a well-balanced one that faithfully reflects the Board discussion. While there is a lack of sufficient support from the Fund membership to establish a SDRM through amendment of the Fund's Articles, our discussion surrounding the SDRM has yielded positive results. The global perspective on crisis resolution through debt restructuring has been strengthened, as reflected by intensified discussion over the mechanism of sovereign debt restructuring not only within the Fund, but also between the Fund and the private sector as well as the academic world, and has promoted the use of collective action clauses. While the SDRM will probably not be put

on the immediate agenda of the Fund in the near future, we support continuing the research on the issues relevant to out crisis prevention and resolution framework that have been raised during our discussions on a SDRM.

In sum, we would like to pay tribute to the management and the staff for their constructive work on this issue. The significance of the work on a SDRM has been witnessed and acknowledged by the international financial community.

Mr. Yagi made the following statement:

As previous speakers, I would like to thank the staff for its continued efforts since November 20, 2001. The Fund is now in a position to make a concrete proposal on the main framework of a statutory SDRM to the IMFC. There are still some issues on which there is not yet full agreement and the report itself says that differences remain among Executive Directors on a number of issues, although there is a substantial convergence of views, and I do not need to reiterate these points.

I am willing to support this draft report of the Managing Director to the IMFC. I share the Managing Director's views that during the upcoming IMFC meeting ministerial guidance should be sought on the framework of a SDRM and how to move forward on these points. As this report will be discussed together with collective action clauses and the Code of Good Conduct, the discussion should be broad and comprehensive from the standpoint of achieving orderly sovereign debt restructuring and strengthening policies for crisis resolution. In this connection, we are looking forward to receiving a background paper on the Code of Good Conduct.

The developments in the Fund's discussion about the statutory approach to sovereign debt restructuring have undoubtedly contributed to raising awareness about this issue in both the official and private sectors and have catalyzed such favorable developments as the introduction of collective action clauses and the proposals on the Code of Good Conduct. In this regard, we reiterate our appreciation of the efforts made by the First Deputy Managing Director and the staff that has worked on this challenging issue.

Mr. Ngumbullu made the following statement:

On our part, we also consider the Managing Director's draft report to the IMFC on progress made with the design of a SDRM as a balanced summary of the discussions that have taken place on the issue.

There are still many issues both of substance and of a technical nature that need to be resolved to the satisfaction of both debtors and creditors, for whom the framework is intended. It is also clear that the support that is needed to establish the framework has not yet been firmed. As such, the progress made in designing the framework should continue for the time being to remain a "work-in-progress".

Finally, we agree that further guidance should be sought from the IMFC during the forthcoming meeting on the way forward.

Mr. Egilsson made the following statement:

As others, let me start by thanking the staff and management for their efforts to live up to the request from the IMFC on a proposal for the SDRM. In my view, the whole exercise has been worthwhile and it has carried us forward in this field. I look at the report as a report by the Managing Director and I choose not to contribute to editing it. Nevertheless, I want to express my general support for the report. It is now up to the IMFC to decide on the future course of action.

Let me also say that we have all along been a strong supporter of the SDRM venture. I hope that it is not dead, but that it will live on in some form.

Ms. Jacklin made the following statement:

I wanted to join in the praise that others have given to the work done, in particular by the First Deputy Managing Director, the staff representative from the Policy Development and Review Department, and the Deputy General Counsel as well as their colleagues, in working hard and diligently with a lot of creativity and flexibility in trying to bring forward a proposal, and most importantly to educate the official and the private sector communities on the risks in sovereign debt restructuring and ways in which that process might be improved.

I also want to thank you personally for your constructive efforts with regard to how we now try to take this forward to the IMFC for its decision on our work program in the future, and we regard your report as a very positive step in that direction.

Mr. Al-Turki made the following statement:

I thank management and the staff for their dedication and hard work on developing the modalities of a Sovereign Debt Restructuring Mechanism (SDRM). The Managing Director's draft report to the IMFC on this issue appropriately reflects the discussions that have taken place in the Board and is

candid in detailing the progress made as well as the differences that remain. In this connection, I agree that the last sentence in paragraph 7, regarding cessation of payments and a temporary automatic stay, and the last sentence in paragraph 8, on the cost of creditors' committee, should remain in the text. These sentences give a better flavor of the differences in views among Directors. It is also clear from the report that there is not yet the requisite support to establish the SDRM through an amendment of the Fund's Articles.

That said, I share the view that, the debate on the SDRM has "provided fresh impetus to efforts to promote the adoption of collective action clauses in sovereign bonds, as well as proposals for a voluntary Code of Good Conduct." These welcome developments should facilitate more orderly crisis resolution.

Ms. Indrawati made the following statement:

First, I would like to congratulate management and the staff for their excellent work on the SDRM. We believe that this has made an important contribution to the improvement of the comprehensive framework for crisis resolution and the international financial architecture. This has also stimulated in particular the development of market mechanisms for the restructuring of debt, including the development of CACs.

We support the view that the draft report is well balanced and captures both the extent of disagreement as well as the progress in this area. We also support the intention of management to seek the guidance from the IMFC.

Mr. Kiekens made the following statement:

If there is a negative correlation between the amount of praise for the staff and you and the degree of conviction of the Director, the substance of my statement is limited to one sentence. Your report is a good one, and you can submit it as such.

Mr. Calderón-Colin remarked that the draft report was thorough but also concise. The report accurately noted that the Board had not reached a consensus view with regard to a SDRM. The suggestions that had been made to revise it had been offered simply to make the report as factual as possible.

Mr. Tombini made the following additional statement:

I agree with others that this is your report, and that you have the last word in that regard. However, I would like to respond to Mr. Zurbrügg who said that we should not be too concerned about the Attachment and also to others who said that the Board should not engage in a drafting session, which I agree with. However, I do not agree with the notion that what is expressed in

the Attachment represents the views of most Directors, specifically in two areas where I saw many Directors in other discussions having different views.

Those two areas are the scope of claims, and this has to do with the inclusion or the suggestion to include local governments and public entities as well as the view, which many Directors expressed in the discussions, regarding the desire to exclude trade credits. The other area regards the provision of information, and we have seen alternative views in this regard, and I believe many Directors were of the view that the claims list should be limited to those claims that are covered under the SDRM. However, the text in the Attachment suggests that we should go further than that, and that information on even those claims that are not subjected to the SDRM—those that are explicitly excluded from its scope—should also be provided.

I will limit my comments to these two areas where I think there have been many Directors that expressed different views. Perhaps this could be introduced in the report in bracketed form or a mention in this regard could be made in the report.

The Chairman made the following statement:

What I sense from you and this discussion is that you very much appreciated the initiative taken by the Fund, particularly the First Deputy Managing Director, and the extremely good work done by the staff and the First Deputy Managing Director. We all appreciate it. I think it is a work product that represents the Fund at its best, as I see it, and whatever the outcome is, no one should be ashamed about this process. On the contrary, the opposite is true. The work on a SDRM has been very good and has demonstrated that this institution is at the top not only of this discussion, but also with regard to its mandate related to developments in the global international financial system, and we, as Mr. Kruger said, are proud of what the staff and the First Deputy Managing Director have achieved. I think we can all join this kind of expression.

Second, I do think that we all agree—or at least I sense an overwhelming majority—that the report should remain as the Managing Director's report. To me this means that overall you feel that the draft report is balanced, but as always—and this is fair—the Managing Director should take into account your comments at this meeting, and I will do so. If I decide not to make a particular change based on your suggestions, you can be assured that the minutes of this discussion will record all your specific comments in this context.

Third, I do think that we also agree that a SDRM should also be seen in the context of the CACs discussion outcome and the Code of Conduct, so

that we have three elements of a possible concept to carry forward, and I think this by itself is also a huge step forward.

We all agree, I assume, that we hope and look forward to some guidance from Ministers and Governors at the IMFC meeting.

Mr. Mirakhor agreed with Mr. Vittas that the Board's recognition of the efforts by the First Deputy Managing Director and the staff should be acknowledged. However, rather than acknowledge that in the report to the IMFC, it would be more appropriate to alert the IMFC Chairman of that fact and request that it be reflected in the IMFC Communiqué.

The Chairman observed that Executive Directors supported the proposal to publish the report, after any necessary revisions, on the Fund's external Web site after it had been sent to the IMFC.

2. ENHANCING EFFECTIVENESS OF SURVEILLANCE—OPERATIONAL RESPONSES, AGENDA AHEAD, AND NEXT STEPS

Document: Enhancing the Effectiveness of Surveillance—Operational Responses, the Agenda Ahead, and Next Steps (SM/03/96, 3/14/03)

Staff: Geithner, PDR; Schulze-Ghattas, PDR

Length: 1 hour, 40 minutes

Mr. Shaalan and Ms. Farid submitted the following statement:

The paper before us provides a comprehensive overview of the range of initiatives to strengthen Fund surveillance undertaken in response to a number of successive internal and external reviews of surveillance. These initiatives have expanded the coverage of surveillance beyond the traditional Fund purview of fiscal, monetary, and exchange rate policies to a broader set of issues including external vulnerability assessments, debt sustainability analyses, financial sector vulnerabilities, and structural and institutional policies that have an impact on macroeconomic conditions. We are in broad agreement with staff's conclusion that the present architecture of surveillance, as shaped by these initiatives, remains a viable framework. Further efforts to strengthen surveillance should be directed at deepening our analyses of the aforementioned issues, which are rightly receiving increased attention in response to the most recent crises. At the same time it is essential that we make sure that bilateral surveillance remains focused on the issues of relevance to the particular country in question.

While expressing broad satisfaction with the present framework of surveillance, staff, nevertheless, present us with a preliminary discussion of some areas where they believe improvements could be considered. We shall comment on a number of the proposals presented in the staff paper.

Calibration of Policy Measures to Reduce Vulnerability. We are in agreement that we should benefit from experience to calibrate Fund advice on policy measures aimed at reducing vulnerability. This is already taking place, as is evident in the evolution of Fund advice on exchange rate regimes, debt sustainability, the sequencing of financial sector and capital account liberalization, among other things. However, we are less comfortable with the proposal that staff "make a more systematic effort to analyze the political factors influencing the ability to establish and maintain shock absorbers." First, it is not clear what exactly is meant by this proposal. This proposal blurs the distinction between giving advice on economic policies, wherein lies the strength and specialization of Fund staff, and the passing of judgment on the authorities' "capacity to mobilize political consensus in favor of needed adjustment measures." We can well see this leading to mission creep into areas that lie outside both the Fund's core mandate and its expertise. A move in this direction would (a) overburden staff with a task they are not qualified to undertake, and/or (b) result in superficial analyses that have little value added and which may even be counterproductive. It will also be difficult to make sure that such issues of political economy are explored in an even-handed manner across all the membership. We, therefore, strongly caution the Fund against going that route without at least clearly defining and delineating the specifics of such an endeavor.

The next proposal staff puts forward under the heading of improving the calibration of policy measures is to make use of the revised eligibility criteria proposed in the CCL paper as a framework for more objective and transparent assessments of members' vulnerabilities and policies. Looking back at the criteria proposed in Annex III of the CCL paper, we would note that the obvious element that differentiates that proposal from the framework of Article IV consultation assessments lies in the setting of substantive standards and indicative thresholds against which eligibility would be assessed. Otherwise, the coverage is similar to current Article IV consultation assessments. We believe that it would be a mistake to impose on the Article IV process the standards and thresholds that were proposed to provide an increased element of automaticity to CCL qualification. In our view, this would again raise concerns that the Fund would be taking a "one size fits all" approach to surveillance rather than making considered assessments that pay due regard to the complexity of the policy and economic circumstances of members. We should also avoid the perception of consultations becoming a rating exercise.

Consideration of Cross-Country Experiences. The benefits of utilizing cross-country experiences in surveillance are clear. However, we must also guard against the risk of transposing the experience of one or more countries to others without taking sufficient account of differing circumstances. This may be an obvious point, but it is worth emphasizing.

External Effects of Policies in Systemically or Regionally Important Countries. We agree that greater attention needs to be paid to the systemic impact of large countries' policies. While some progress has been made in the identification of the economic and financial spillover effects of the policies of the advanced countries, we still note a reluctance in staff reports to propose policies to address them. While we agree that part of the problem lies in the fact that those countries are less receptive to Fund advice than other members, the Fund itself needs to more consistently and systematically address spillover effects of policies of larger countries. Perhaps, a specific section of Article IV staff reports of these countries should be devoted to spillover effects and recommendations to address them. Staff should also address these broader issues in the context of the brief assessment of the authorities' response to previous Fund advice that is now included in Article IV staff reports.

Surveillance in Program Countries. The paper notes that a number of procedural changes are being put in place to facilitate a fresh perspective in Article IV consultations in program countries. We believe it is too early to assess the new procedures at this stage. Nevertheless, we would like to repeat the concerns we expressed in earlier discussions with regard to creating an artificial separation between the surveillance exercise and the program framework. Regardless of the procedures, staff should always be encouraged to reassess the program framework, even in the context of program reviews. A fresh perspective does not necessarily require having a totally different team conduct the Article IV consultations. We trust that management will use its discretion to avoid an unnecessary duplication of work and to make sure that the advice given to the member countries is consistent and not contradictory.

Candor and Transparency. This chair continues to accord a high priority to maintaining the candor of staff discussions with authorities in order to preserve and strengthen the effectiveness of surveillance. The tension between the candor and clarity of Fund assessments and policy prescriptions on the one hand, and the transparency objective on the other, has been well recognized by both staff and the Board. We believe that a careful balance has been struck through the policy of voluntary publication of staff reports. We strongly believe that publication should remain voluntary in every sense of the word. Staff can explain to the authorities the importance of publication, but going beyond that would risk endangering ownership and candor. We would caution against any change in the policy and also against the application of pressure on members to publish staff reports.

Incentives for Sound Policies. The paper covers the issues that were thoroughly discussed in the recent Board discussion on the CCL. We shall not go over them again. Suffice it to say that, while the idea of providing incentives for sound policies may be attractive in theory, our experience with the CCL has shown that it is difficult to construct an effective incentive

framework in practice. We remain of the view that we should not pursue this avenue any further.

Assessing the Effectiveness of Surveillance. We should continue to assess the effectiveness of Fund surveillance through regular internal reviews, while external reviews should also be conducted at wider intervals. The experience with the brief assessments of the authorities' response to past advice should be reviewed in the context of the next biennial surveillance review.

To conclude, in our understandable zeal to strengthen our surveillance in an increasingly complex world fraught with economic uncertainties, we must avoid stretching our surveillance to areas beyond the Fund's mandate and expertise. We should accept the fact that the Fund cannot provide the answers or the expertise to address all the diverse problems facing the global economy. Our focus must remain on the tasks we are mandated and equipped to perform.

Mr. Callaghan submitted the following statement:

Key Points

- The Fund's effectiveness in providing policy advice will be enhanced if it is regarded as an "insider" in a member's policymaking process and not an independent commentator. We do not support moves that would see the Fund publicly rating countries.

- The objective of Fund surveillance is to help members adopt appropriate policies, not simply to expose their policy shortcomings. The "client" when it comes to surveillance is the country, not the market.

- The initiatives to strengthen surveillance have been identified, the main challenge ahead is to ensure that these measures are effectively implemented in a uniform fashion. Management and the Board have an ongoing responsibility to assess the effectiveness of surveillance, and identify what is working and what is not working.

- Often, the easy part is identifying what policy measures a country should adopt. The real challenge is obtaining the necessary public/parliamentary support to implement the measures. For Fund surveillance to be effective, the Fund has to assist authorities build consensus in support for reform.

- The Board should undertake a review of its role in the surveillance process.

The paper provides a good summary of past reviews on surveillance and a stock take of the range of initiatives aimed at strengthening surveillance.

What is the Objective of Surveillance?

The paper asks what can Fund surveillance be expected to achieve, referring to the statement from the 1997 biennial review that Fund surveillance is only one influence, and generally not the predominant one, on members' policies and performance. Members will, of course, ultimately be responsible for their policies and economic performance, but the Fund can, and should help. What is missing is a more explicit recognition that the basic objective of Fund surveillance is to help its members achieve financial stability and sustained growth.

The mere term "surveillance" conjures up rather sinister and clandestine impressions. Hence, it is perhaps worth emphasizing that the surveillance "obligation" that each member of the Fund undertakes is designed to assist them and not to expose or berate their policy shortcomings. With this in mind, it may also be timely to emphasize that the "client" in terms of the Fund's surveillance is the member concerned, and not the management, the Board or the markets.

The means by which the Fund can assist a member is through the provision of policy advice. If surveillance was truly effective, the Fund would be an "insider" in a member's policymaking process and not an independent commentator. Unfortunately, there seems to be a growing tendency to undermine the Fund's role as a policy adviser in favor of being an external assessor.

Ingredients of the Surveillance Process

The key ingredients of the surveillance process are outlined in the paper—timely, accurate and comprehensive data; high-quality analysis; being open to different perspectives; and effective communication with the authorities and the public.

We think it is important to particularly highlight the need for good communication in the surveillance process. If we want Fund advice to be followed, there has to be a good deal of trust between the member and the Fund. In particular, missions have to build a relationship with the authorities, to establish their respect and win their confidence. The nature of the communication with the authorities is critical and may be underplayed, compared with the preparation of the staff report. In this regard, we believe

there is a need to provide mission chiefs with the necessary training to enhance their "political" and communication skills (as noted in paragraph 37).

It is hard to assess the positive effectiveness of surveillance but we know when it is ineffective and Fund policy advice is not being followed. We should ask why. It is important to consider the reasons. It may be because the authorities disagree with the advice. Alternatively, the authorities may agree with the thrust of the Fund's policy recommendations, but the problem is obtaining the necessary public/parliamentary support for the measures to be implemented.

The nature of the Fund's efforts to improve the effectiveness of its surveillance will vary depending on the circumstances. If the authorities do not agree with the Fund's advice, then the challenge for the Fund is to convince the authorities of the merits of its advice. If it is a case that the authorities largely agree with the recommendation but the problem is in winning necessary support for these policies to be implemented, then what is required is for the Fund to help the authorities build the necessary support to implement the reforms. The Fund can do this through greater dialogue with parliamentarians and by providing clear and persuasive analysis accessible to a broad audience.

The Agenda Ahead

Many initiatives to strengthen surveillance have been undertaken—such as enhancing data provision, providing more focused financial sector assessments, encouraging the adoption of standards and codes, and improved debt sustainability and vulnerability assessments. The key challenge ahead is to ensure that these measures are effectively implemented in a uniform fashion.

In many respects, the easy part is specifying what can be done to strengthen surveillance. The hard part is putting these policies into practice. This should be our ongoing focus.

More Systematic Analysis of Political Factors

The paper refers to the need for more systematic analysis of, and reporting on, political factors. This comes from the recognition that in a number of recent crises, the ability to implement policies that reduce vulnerabilities depends on the robustness of domestic political institutions and the capacity to mobilize political consensus in favor of needed policy adjustments. This applies not only to developing countries and emerging markets, but also to developed economies.

As noted previously, the challenge for Fund surveillance is to help the authorities mobilize the necessary political consensus in support for reform. Of course the Fund should not become involved in the political process, but by helping to articulate and communicate the benefits gained from adjustment measures, it can help build public support for such measures. However, the paper does not give much guidance as to the steps to be taken in order to strengthen the Fund's political information and knowledge. This issue was also left hanging somewhat in the response by the Task Force to the IEO's report on prolonged use.

Cross-Country Experience

The benefits of using the wealth of the Fund's cross-country experience have been highlighted in numerous reviews of surveillance. Drawing on cross-country experience not only helps with the analysis of a country's economic conditions and policies, particularly in terms of raising questions that need to be pursued, it can also be very influential in helping to enhance the persuasiveness of the Fund's advice. It is sometimes powerful to be able to point to successes where a country has adopted needed policy steps, as well as what happens if a country fails to take the appropriate policy measures.

The extent to which consultations during the course of an Article IV consultation mission focus on cross-country comparisons appears to be heavily influenced by the experience of mission members. As such, we would strongly endorse a more rigorous and systematic process to draw as much value as possible from cross-country experiences. This should be a focus at the early stages of the planning for a country's Article IV consultation and should be reflected in the consultations with the authorities. It should be second nature within the Fund to look around for useful cross-country experiences.

External Effects of Policies in Systemically Important Countries

There is clearly a need to focus on the policy externalities of large countries and this should be a particular focus of the WEO exercise. As the paper acknowledges, however, large countries might be less receptive to Fund policy advice since they are unlikely to seek financing. But the policy challenges in the large countries are no less pressing, in fact more so given the externalities involved, and the Fund has an important role to play in helping to build domestic consensus in support of needed policy measures. The challenge is for the Fund to bring something "new" to the policy debate in economies with deep bureaucratic structures and extensive domestic research capabilities. The Fund has to work hard to get its "voice" heard. It will have to work even harder on building effective relationships with policymakers and demonstrating that it does bring something new to the table. It has to ensure

that its material is particularly well-researched and it has to put an even higher premium on effectively communicating its views to the authorities, opinion makers, and the public.

Surveillance in Program Countries

The procedural changes designed to ensure that surveillance does introduce a "fresh perspective" in program countries and does not get enmeshed in the detail of program negotiations and reviews are outlined in the paper. The priority now is to ensure that these procedures are followed in practice. This is the challenge for management and the Board.

Candor and Transparency

The tension between the Fund being a confidential adviser to countries or an "independent assessor" of their performance is exposed in pursuit of the objective of publishing all staff papers in the name of "transparency". The main focus of the Article IV consultations should not be the preparation and publication of a staff report. Rather, the objective is to establish a close engagement with the authorities, undertake candid discussions, provide policy advice and, ultimately, influence policy decisions. We are supporters of transparency, but the aim is to encourage countries to be more transparent in terms of data, their economic conditions, policy decisions and policy intentions, so that the market can make its own risk assessments and act on them accordingly, not simply to respond to staff assessments.

The publication of staff reports and selected issues can nevertheless be very influential in helping to build public support for policy action. However, as we have emphasized in the last review of transparency, it is important to take into account the circumstances facing each country. Ensuring a climate of candor between the Fund and country authorities is vital if the Fund is to maintain its comparative advantage when it comes to surveillance, and this should not be lost in the interest of "transparency". We need to recognize that the influence of the Fund may well be greater if some discussions are held in confidence. This is an issue we need to come back to when we review transparency later this year.

Incentives for Sound Policies

Linking the extent to which a country pursues Fund advice to access Fund resources is unlikely to provide an incentive for a country to adopt sound policies, and is also likely to be impractical. The biggest incentive to pursue sound policies will be the benefits that come from sustained growth and greater resilience to external shocks As noted previously, we are very much opposed to the Fund providing explicit ratings of countries.

Assessing the Effectiveness of Surveillance

Assessing the effectiveness of Fund surveillance is difficult. However, as noted previously, it is relatively easy to identify when a country is not following Fund advice. Again, as also noted above, the biggest challenge in terms of strengthening surveillance is not to come up with new policies, but to consistently apply the existing policies. This calls for an ongoing review of how the Fund's surveillance function is performing day by day. It is not something that can be left for review every two years. Management and the Board have an obligation to assess the effectiveness of surveillance during the course of every Article IV consultation. We should be identifying what is working and what is not working. This goes beyond a brief "box" in the Article IV staff report summarizing the authorities' response to previous Article IV consultation assessments.

There is, nevertheless, a need to take stock from time to time and make an overall assessment of the effectiveness of Article IV consultations. We would suggest that in addition to the biennial surveillance review, there be more frequent occasions when the Board, management and department heads review the functioning of the surveillance process.

The Role of the Board

We would strongly endorse the Board undertaking a review of its role in Fund surveillance. Perhaps this could begin with a targeted, external assessment of the Board's role.

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

We appreciate the opportunity of discussing the next steps for strengthening surveillance, in light of the importance this Chair attaches to the topic. Consistently with what was stated in the recent discussion on the Conclusion of the Task Force on Prolonged Use of Fund Resources, we assume that today's paper reflects the staff's reaction to the issues on surveillance raised in the IEO's report. On those grounds, while the paper offers a very helpful synoptic coverage of the innovations to surveillance to date and the agenda items lying ahead, it falls short of developing concrete proposals on how to move forward. As a result, the political inputs from the IMFC and many of the indications provided by Directors since the last review of surveillance have not been given operational content yet.

Over the last few years, the Fund has made significant strides in strengthening its surveillance framework. The adopted strategy has aimed to improve the institution's diagnostic capabilities, to design and disseminate standards of "good behavior" across membership, and to make surveillance an increasingly transparent process. Important new instruments of surveillance

have been developed and implemented that have made surveillance more effective.

A number of steps need to be taken to enhance surveillance further. Such steps can be practicable only if the ultimate objectives to be pursued are realistic. In fact, while it is not realistic—as the paper recognizes—to expect that policy recommendations under Fund surveillance be the prime driver of policies in member countries, it is reasonable to assume that the Fund's deep and timely analysis of a country's risks and vulnerabilities—especially those posing systemic concerns—would generate enough pressure (including from peers) to induce the country to undertake the necessary corrective measures. In other words, the more accurate, credible, and known to the public the analysis carried out by the Fund is, the more compelling its recommendations would likely be under surveillance.

The Ingredients to Effective Surveillance

In light of the above, we agree with the key ingredients to effective surveillance being—as indicated by the staff—the quality and timing of information, the focus and breadth of coverage, the open-mindedness underlying the analysis, and the Fund communication with the authorities and the public. Strengthening each of these ingredients by working on the agenda ahead proposed by the staff would do much to improve the quality of surveillance and, hence, its effectiveness.

Timely transmission of reliable information to the Fund lies at the core of sound surveillance. While considerable progress has been achieved since 1995, when the whole issue of data provision was subjected to a comprehensive re-examination, there is still much to do. It is regrettable that still one-third of the Article IV staff reports indicate data inadequacies. More needs to be done to fill in the gaps and the shortcomings indicated in the staff paper, and we look forward to discussing the next reviews of data provision and standards scheduled for this year.

As regards the focus and breadth of coverage, important advancements have been made through the improvement of surveillance of the financial sector issues, the analysis of capital flows, and the assessment of crisis vulnerabilities. New tools have been designed and implemented, and others are being developed, which broaden and deepen coverage significantly, as the recent FSAP review has indicated. There is still room to refine those tools further, however, and on the occasion of the FSAP review we made a number of technical recommendations. We will not repeat them here but we ask staff to look into them.

Where more can and should be done to improve the qualitative nature of surveillance is—as recognized by the staff—in taking into account the

political realities of member countries as influencing their ability to establish and maintain policies to reduce vulnerabilities. This is fully consistent with recent research findings indicating that the primary factors determining the implementation of IMF-supported programs lie in the domestic political economy of borrowing countries, even more than in program design.

It is now well understood that issues such as the role of special interests, governance, political cohesion, institutional failures, attitude to reforms, political timing of reforms, and political interference in the financial sector affect a country's policy environment in ways that cannot be ignored by surveillance if surveillance is to be relevant. We therefore support the idea of introducing this analytical dimension into the surveillance exercise. Yet this raises the question of the Fund having enough in-house human resources with the needed political-economy orientation and background. An important role in this context could be played by the resident representative offices. We would like to have staff's feedback on this issue.

Concerning the open-mindedness of the analysis underlying the surveillance exercise, the staff point to the need for a more systematic consideration of perspectives gained through alternative and complementary channels, such as cross-country experiences, multilateral surveillance, the views of market participants and of outside experts. We strongly encourage the use of all these channels. In this regard, we are concerned that human resources may be somewhat over-used in number-crunching tasks, at the expense of more judgmental and strategic thinking. We wonder if there is room exploitable for resource re-allocations in this respect. We also wonder if bilateral surveillance activity in area departments benefits adequately from inputs of non-area departments. Finally, we wonder how best individual country experiences of international relevance can be transmitted across departments. Again, we would welcome staff comments on these issues.

On the fourth ingredient—communication with the authorities and the public—we agree that the Board should preserve its role of provider of peer pressure, guarding against the temptation of providing peer protection instead. Also, in the context of bilateral surveillance, the members of the Board should act less as defenders of their constituent countries and more as facilitators, where necessary, of the dialogue between the Fund, the national authorities, and the public of their countries, helping to publicize and to explain to their countries' public opinion the Fund's policy recommendations under surveillance.

On publication, we recommend that surveillance reports be published with amendments confined exclusively to highly market-sensitive statements and factual matters. Furthermore, we are concerned by the modest progress in the number of members that voluntarily publish Article IV consultations and UFR documents. We look forward to the next report on transparency and

stand ready to consider all needed measures, including a shift to a policy of presumption of publication, to encourage progress in this area.

As part of the agenda ahead, the staff also indicates the need to develop a well-defined set of criteria for sound policies that would provide a framework for more objective and transparent assessments of members' vulnerabilities. Would these criteria be different than the standards and codes currently in use?

A "Fresh Perspective"

In the case of program countries, we agree that surveillance should cover a much broader territory than just the review of programs, and we support the idea of approaching the analysis of a country's economic situation and policies from a fresh perspective. We would like to see concrete proposals on how to arrive at such a fresh perspective. In the past, we suggested the option of having separate teams—one for program review and the other for conducting surveillance—as a way to add different perspective angles on program countries as well as to provide a more independent appraisal of their economic circumstances and policies. While we understand that this would raise possibly significant resource constraints, we would like to see the option being evaluated by the staff.

Other approaches can be imagined. One is that the same team could serve both functions but under different chiefs. Also, consistent with the spirit of early Board involvement in the event of exceptional access, the Board could be involved early in the surveillance process when cases emerge of major divergences of interdepartmental views on country issues. We do need to have a serious consideration of the possible alternative options, their relative pros and cons, and their organizational impact.

Regional Surveillance

As we noted in the last biennial review of surveillance, macroeconomic stability often hinges on economic developments in neighboring countries. On that occasion we welcomed that the staff's guidelines took this dimension into account. Yet, we have not seen any concrete proposals for operationalizing the conduct of regional surveillance. In fact, ways should be considered for getting staff and country authorities in a region to evaluate mutual spillover effects in those cases where inter-country trade and financial linkages are strong. To this end, like for some EU countries, the schedule of regionally-relevant Article IV consultations could be adapted so as to take place next and close to each other.

Regional surveillance would be relevant not only to assess the possible transmission of shocks and risks across a region but also when a country

embarks on a critical program of adjustment and structural reform that might have repercussions on other economies in the region. In this regard, IMF surveillance could become instrumental in supporting regional cooperation where this is suboptimal, initially even by simply providing an institutional and systematic locus for the sharing of information and views among government authorities, and for the elaboration of scenarios and outlooks.

Assessing and Enhancing Surveillance

We agree that assessments of the effectiveness of surveillance will have to continue to rely on the various approaches used in past reviews. An effort needs to be made to evaluate as accurately as feasible the impact of surveillance on policy decisions both in program and non-program member countries, although this is hard to do. In this context we would welcome contributions from the Research Department. Also, we do see role for the IEO.

We definitely see value in considering more substantial treatment of the effectiveness of surveillance in individual Article IV staff reports, building on the steps adopted at the conclusion of the 2002 biennial review.

Finally, where other international surveillance bodies play a role in monitoring country policy decisions, it might be useful to assess the degree of convergence of the Fund's advice with that of the other surveillance bodies and check whether country responses to external advice changes with the degree of convergence. Evidence in support of such correlation would suggest the existence of surveillance spillover and cross-fertilization effects that would be worth exploring.

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

Surveillance of member countries and of the global economy are core functions of the Fund, and enhancing the effectiveness of surveillance needs to be a permanent concern of the institution.

Since the Asian crisis there has been a major strengthening of Fund's surveillance of emerging market countries. This has produced many positive results, helping these countries to strengthen their policy frameworks and significantly reduce vulnerabilities. We support the continuation of these efforts. We are, however, disappointed that the Fund did not place a similar emphasis and focus on the surveillance of industrial countries, specially those that are systemically and regionally important. Similarly, while the creation of the Capital Markets Department and the establishment of the Capital Markets Consultative Group represented important initial efforts, the Fund has not yet paid sufficient attention to the volatility of international private capital flows.

We believe these are major shortcoming of Fund's bilateral and multilateral surveillance that needs now to be corrected.

Externalities of Policies of Systemically or Regionally Important Countries

Fund's surveillance efforts should give particular attention to systemically and regionally important countries. The higher the likelihood that a member's economic situation might affect global growth and financial stability, the larger the returns to the entire membership of in-depth surveillance.

Effectiveness of surveillance in these countries is at question. Despite repeated calls and policy advice presented by the Fund, deflation and anemic growth persist for several years now in the world's second largest economy. Growth remains sluggish and constrained in the Euro area, while important structural reforms in the labor and product markets repeatedly suggested in Fund surveillance are yet to be fully implemented. Corporate governance issues and asset bubbles in the main industrial economies are other examples of recent problems that generated significant negative externalities to the world economy.

As staff points out, the likelihood of Fund advice to influence policy is low in countries that are unlikely to ever request its financing assistance. This is a matter of concern. By ignoring Fund advice, industrial countries might fail to correct imbalances and distortions, which while less frequent, when they emerge generally have significant effect on the entire membership. Ineffectiveness of Fund surveillance in influencing developed countries' policies may also strengthen the general public perception of the Fund's role as that of policing developing countries.

Unfortunately, we do not see signs of these problems been addressed. In fact, worrying signs in the opposite direction have recently emerged. In recent discussions of the Global Financial Stability Report—a main vehicle of multilateral surveillance—the suggestion was presented by some Directors that the GFSR should focus on emerging markets, given that developed countries are routinely analyzed by institutions other than the Fund, with such reports available at no cost through the Internet. We strongly disagree and believe that the Fund should routinely provide its own assessment of financial developments and prospects in mature countries, regardless of the frequency with which such analyses are undertaken outside of the Fund. Furthermore, Fund staff is in a unique position to better elaborate on the effects of these developments on emerging and transition economies. Recently, staff proposed re-focusing ROSCs and FSAP reviews, in order to re-allocate resources away from the surveillance of developed countries. Fortunately that approach was not approved by the Board.

The paper dedicates only two paragraphs to the role of the Fund in surveilling the impact of policies in systemically and regionally important countries in the rest of the world. Moreover, these paragraphs simply pay lip services to the issue, without presenting any suggestions to increase the effectiveness of surveillance in this case. We ask the staff to consider this issue in greater detail and present concrete ideas in future papers.

Calibration of Policy Measures to Reduce Vulnerability

While we broadly agree with most issues mentioned in paragraph 20 as important to increase resilience against external shocks, we are unclear about what the staff means with budgets that leave room for maneuver. We also wish to emphasize that there is not much that public policy can do with respect to private sector obligations other than prudential regulations for the financial sector. Hence, any balance sheet approach to financial crises should be limited to the public sector balance sheet.

We also believe that it is unwarranted to use the experiences of Argentina and Uruguay to draw conclusions about prudent debt levels for non-dollarized economies, as it seems to be the underlying idea in paragraph 21.

We agree that robust domestic political institutions that can effectively mobilize consensus are important to increase resilience. However, it is unlikely, given the Fund's mission and expertise, that these issues can be productively covered in surveillance, or be a topic for consideration by the IEO.

Revising the CCL eligibility criteria to use them separately in surveillance is likely to be a difficult exercise. It would be preferable to improve the design of the CCL itself or, at least, to avoid extinguishing it altogether. Obviously, any revised criteria would have to apply to all countries that have significant integration in world financial markets.

Cross-Country Experiences and Surveillance

The staff argues that there is scope for more systematic integration of cross-country experiences in surveillance. The first condition for such undertaking is a complete coverage of best performers in surveillance exercises so that other countries can learn from their experience. While useful, cross-country experience has always to be checked against country-specific circumstances, before being presented as relevant by the Fund.

Surveillance in Program Countries

We are not convinced that surveillance in program countries raises significant concerns about effectiveness. In fact, surveillance in program countries tends to be more effective in terms of being translated into concrete policy actions when compared to non-program countries, especially industrial countries. While it is true that the objectives of surveillance and Fund-supported programs are not necessary the same, both activities share many common broad goals such as the restoration or maintenance of macroeconomic stability and external viability.

While in specific cases it may be useful to have a fresh look into the overall economic strategy, as reflected in the operational guidance following the 2002 biennial survey, we have to guard against a general separation between surveillance and program activities. Such separation would lead to significant efficiency losses, create problems of coordination, and substantially increase staff numbers. We suggest that the recent changes being implemented in surveillance of program countries be allow time to work and have their effects evaluated before embarking into additional steps (as suggested in paragraph 28). We are not sympathetic to the idea of using outside experts, except in the case of voluntary exercises.

Tensions between Candor and Transparency

Staff correctly points to the fact that there is a potential tension between the candidness of policy dialogue and the extent to which the results of that dialogue can be made public. This makes it all the more important that the decision on publication of Article IV consultations and UFR staff reports be a truly voluntary prerogative of the country involved.

While the staff recognizes the trade-off between publication and candor, it does not offer any concrete suggestion to minimize the problem. One such alternative would be a more liberal deletions policy, which we suggest the staff to consider.

Another point we would like to make is that transparency should not be mechanically equated to publication of Fund papers.

Incentives for Sound Policies

Staff comments on two proposals that could conceivably provide greater incentives for countries to adopt sound policies. We strongly oppose the approach of formally and explicitly rating or evaluating countries' policies in relation to a pre-defined standard or a comparator group, which would transform the Fund into a rating agency. The second proposal, which argues for a better link between the country's policies and access to Fund resources,

seems to hold more promise. Certainly, the Fund's general resources have to continue to be available to all members under the current Stand-By Arrangement facility and criteria. However, the existence of a special facility for stronger performers with more demanding pre-qualifying criteria could motivate countries to strengthen their policy framework in order to qualify, emulating good policies, and stimulating an approach to the Fund in anticipation of problems. These are the objectives of the CCL and we believe that the Board should reflect more on the decision of allowing this facility to expire.

Assessing the Effectiveness of Surveillance

In order for Fund advice to effectively influence member countries policies some key conditions have to be met. Policy advice should be of a high quality. A constructive relationship of thrust and respect needs to exist between the mission and the authorities. While the quality and appropriateness of advice should not be compromised by extraneous considerations, the probability of advice been actually implemented is enhanced if political and implementation constraints are recognized and given attention.

Assessing the effectiveness of surveillance is an integral part of the surveillance process. While sporadic and selective in-depth case studies by the IEO and surveys of country officials can and should play an important role, the aim ought to be to develop a more general and systematic approach to evaluate the effectiveness of surveillance. Since the 2002 surveillance review, Article IV staff reports are expected to include a brief assessment of the authorities' response to key challenges addressed in previous Article IV consultations. This procedure ought to involve more than listing policy recommendations of previous consultations, and indicating those that were implemented and those that were not. It is critical to understand the reasons why policy recommendations were not adopted, and to identify if the effects of those that were implemented were in line with the staff's expectations. We acknowledge that this is a major undertaking, but it can make a meaningful contribution.

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

Key Points

- The surveillance framework has improved significantly in recent years. Looking ahead, the emphasis should be on taking advantage of its unexploited potential by strengthening its implementation. The decelerated speed of the implementation of some of the initiatives and the uneven progress across countries and regions is of concern. We therefore need to focus on boosting this implementation within the current framework.

- Further emphasis on cross-country experiences, as suggested in the staff paper, could be useful. In this respect, more focus could be placed on a proactive pre-mission planning in order to make the Article IV consultations even more attractive and relevant to member countries. A brief note summarizing relevant lessons and experiences could be submitted to the authorities in advance, perhaps together with the standard questionnaire. Such an appetizer would also provide a fresh perspective.

- We should continue to strive for enhancing the effectiveness of surveillance and a culture of a Fund that "listens and learns". Fund surveillance can still benefit from more candor in communicating policy concerns and advice.

- The best incentive for sound policies lies in the experience that they pay off in terms of high quality growth.

- We support the envisaged work program and continued priority to crisis prevention efforts as effective prevention is always preferable to cure.

We would like to thank the staff for an interesting paper, giving a fair and good overview of how the Fund's surveillance has adapted in recent years to a changing international environment. The Fund's surveillance has generally been of good quality and very valuable for member countries. We believe that the diagnosis of the key ingredients of effective surveillance in paragraph 6 is valid and we are very pleased with the many initiatives that have been undertaken in the field of Fund surveillance since the mid-1990s.

The objectives for Fund surveillance should remain ambitious and realistic. We agree that it would be unrealistic to expect policy recommendations under Fund surveillance to be the primus motor of policies in member countries. In this respect, it is important to realize the limits of the real influence of the surveillance process. As is stated in the staff paper, "Fund surveillance is only one influence, and generally not the predominant one, on members' policies and performance." In countries where external evaluation and analysis is not readily available from other sources, surveillance is probably more influential.

We concur with staff that the present architecture of Fund surveillance represents a viable framework and that the focus should be on taking advantage of its unexploited potential, including the various initiatives agreed upon in recent years. While we agree that further efforts to strengthen surveillance should focus on the issues listed in paragraph 19, we offer some additional remarks on these and related issues.

Improvements should be made within the current surveillance framework trough boosting the implementation of existing initiatives

While many new valuable initiatives have been added to the surveillance framework in recent years, the speed to which these initiatives are being implemented has recently decelerated. This is a concern that deserves attention. For example, the number of countries subscribing to the SDDS only increased from 50 to 51 during 2002, and data inadequacies are still too frequently an issue raised in staff reports. Timely, comprehensive and reliable information is crucial for the effectiveness of surveillance.

Furthermore, while it is clear that what has been achieved in the area of transparency during recent years is impressive, big differences still remain between regions, and it appears that the progress has leveled off. It would have been useful for our discussion today if the statement on transparency which Fund management plans to provide at the upcoming IMFC meeting had been available, recording the progress made and providing information on publication rates by country and region. We were somewhat concerned about the decreasing speed of progress in the previous report. We hope that this is only a temporary phenomenon since it has become progressively clear that transparency is in the interest of the countries themselves. As a recent IMF Working Paper concludes, investors tend to a greater extent flee countries that are less transparent during a crisis and transparency can be an important contributor to making portfolio investors ride out market downturns instead of rushing for the exit. Moreover, a study by Fitch Ratings found that, following publication of a ROSC, a country was more likely to receive an upgrade in its sovereign credit rating than to receive a downgrade. Thus, not least the incentives for transparency deserve emphasis. We look forward to resuming our discussion on presumptive publication of Article IV consultations and UFR documents in June.

As the paper rightly points out, full candor in the presentation of staff assessments of diagnoses and prescriptions to the Board is a sine qua non for effective surveillance. Throughout the surveillance process, it is important to guard against the risk that collegial or other considerations turn valuable peer pressure into potential harmful peer protection.

A fresh perspective in program countries without major revisions to the surveillance framework

We agree that surveillance in program countries needs to become more independent from program considerations in order to facilitate a fresh perspective, but that this can be done in a pragmatic way, without any major revisions of the current institutional framework for surveillance. Developing well functioning procedures for strengthening surveillance in program countries, as well as on improving assessments of political feasibility of

programs are of key importance. We believe that the procedural steps listed in paragraph 28 provide a valuable complement to the measures adopted at the conclusion of the 2002 biennial surveillance review.

More emphasis on pro-active pre-mission planning could be considered in order to make Article IV consultations even more attractive

The "public good" the Fund is offering through its surveillance is unique, given the institution's global membership. At the same time, for many countries, especially non-program countries, the Article IV consultation process competes with the surveillance mechanisms of other international organizations and private entities. For the Article IV consultation process to become even more useful for the authorities, more focused and pro-active pre-mission planning, aiming at providing the authorities with experiences from other countries/regions in a similar situation could make the surveillance even more valid.

Therefore, deepened efforts to make more effective use of cross-country analyses should be considered. As the staff paper points out, "there is significant scope for integrating insights from cross-country experiences more systematically into surveillance exercises". Many valuable lessons are learned and should be disseminated. We would use this opportunity to remind about the very valuable study in the recent WEO on institutions, showing that there is empirical evidence pointing to a clear correlation between the quality of institutions and economic growth. We would think that a brief written note, summarizing relevant cross-country experiences and lessons learned at the Fund on key policy issues in the country concerned could provide a fresh perspective to the consultation. As an appetizer, such a note should be send to the authorities well in advance of the staff visit, perhaps together with the usual questionnaire.

Debt Sustainability and Vulnerability Assessments

We have come a long way in enhancing the understanding of debt sustainability issues and we are looking forward to the forthcoming review on this topic. We should continue having a special emphasis on strengthening analyses and assessments of vulnerabilities. We see merit in the suggestion made by Mr. Bischofberger in our recent discussion on access policy on developing a debt sustainability database.

Incentives

We fully support the next steps laid out in Section V. However, regarding the Fund's role in surveillance as a source of encouragement for adoption of sound policies by member countries, we would like to emphasize that we do not support the suggestion (in paragraph 32) of changing the role of

Fund surveillance to a more explicit rating of country's policies. The best incentive for sound policies is, of course, the experience that they pay off in terms of sustainable high-quality growth. In this respect, it is worth emphasizing the importance of self-responsibility and ownership.

Effectiveness of Surveillance

It is our view that assessments of the effectiveness of Fund surveillance will have to continue to rely primarily on the various approaches used in the past reviews, i.e. review of policy initiatives, case studies and surveys. More substantial treatment of the effectiveness of surveillance in individual Article IV staff reports, which would build on the steps adopted at the conclusion of the 2002 biennial surveillance review, would be useful. In addition, we would like to underline the need for monitoring implementation of policy recommendations in previous Article IV consultations. Moreover, it will be important for the effectiveness of our efforts if we continue to promote a culture of a Fund that "listens and learns". In this regard, we should continue to make the best use of the very rich experience and expertise available, both inside and outside the Fund. Furthermore, we believe that increased attention should be paid to potential systemic effects of regionally important countries.

The Agenda Ahead

We support continued priority to crisis prevention efforts, as prevention remains preferable to cure. We are in full agreement with the proposed next steps in the planned work program. In this respect, would like to emphasize the importance of moving forward on the existing initiatives, not least on transparency and vulnerability assessments.

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

In response to the request by the IMFC, the staff have prepared a concise yet comprehensive overview of the substantial ongoing work to improve surveillance at the Fund. We generally agree with the evaluation of the constraints of surveillance and of the main prerequisites to ensure its quality. We also agree with the core premise of the report that the present architecture of surveillance is fundamentally healthy and that the key initiatives introduced in the aftermath of the high-profile capital account crises guide adequate adjustments in surveillance. Therefore, at this stage, we do not see a compelling case for introduction of any systemic changes in the existing surveillance architecture. While trying to avoid repeating our comments made at the time of the previous discussions, we offer a few remarks on some of the issues for discussion.

We find the proposal to pay more attention to cross-country experiences to be non-controversial. This theme could be found in most of the

prior documents devoted to improvements in surveillance. In recent staff reports, we often find useful insights when a particular country is compared to a group of its peers. Hence, we are generally satisfied with the progress in this area and encourage the staff to follow the best practices.

Similarly, there is little doubt with respect to the benefits of analysis of potential effects of the policies in systemically or regionally important countries. Frequently, the main challenge for the staff is to find an appropriate format for such an analysis. Sometimes we find references to the potential contagion effects in Article IV consultation reports, on other occasions such an analysis becomes a part of multilateral or regional surveillance reports. Moreover, we are aware of the efforts to increase focus on regional surveillance within the area departments. In our view, at some point, the staff should take stock of the variety of formats and try to come up with a more systematic guidance on their relative benefits.

While in the beginning of the Fund's drive towards more candor and transparency many authorities remained wary of the innovations, today the focus in the discussion has shifted to the search for an appropriate degree of transparency so that it does not harm the quality of the policy dialogue between the staff and the authorities. We consider the pace of changes in the area of transparency as broadly adequate and, at this stage, we would be hesitant to go along with any proposals to force publication decisions on the members of the Fund.

In our view, it would be a mistake to assess the effectiveness of surveillance without taking into account the consequences of transparency policy for the Fund's work. Timely publication of the program documents and Article IV consultation reports allows a very broad group of observers to form an opinion on the content of the Fund's advice and on the effectiveness of surveillance. Among these observers are NGOs and other representatives of civil society, investors, rating agencies, consultancies and various research organizations. In addition, the creation of the IEO was a boost to a comprehensive ex-post evaluation of surveillance, such as the upcoming report on the Fund's role in Brazil, Indonesia and Korea. All of the above opportunities provide additional checks to the internal assessments of the effectiveness of surveillance. Notably, as the staff have specifically pointed in their paper, in recent years, the internal review process was also subject to serious refinements. Finally, according to the operational guidelines, each Article IV consultation report should include a description of the prior Fund's advice and the authorities' reaction to policy recommendations. To sum up, currently, the staff and the Fund in general are much more accountable for their advice. We agree with the staff that the results of the above changes in the process of surveillance should be allowed to work their way through and, at the time of the next surveillance review, the staff and the Board should put a stronger emphasis on efficiency aspects of surveillance.

While at the time of the most recent CCL discussion most Directors favored termination of the facility, they also called for incorporation of the focus on crisis prevention into a broader surveillance framework. To be fair, one should admit that the initiatives on transparency, data provision, FSAP reviews, and standards and codes already go a long way towards achieving this goal. However, in the staff paper, we did not find any comprehensive operational alternative to the CCL approach and philosophy. Without a functioning CCL, it would be difficult to come up with well-defined criteria to be used as benchmarks of high quality policies, since the abstract definitions lacking applications to specific cases would not impose the needed degree of discipline on the analysis of policies by the staff and the Board. Furthermore, without having an explicit arrangement with the Fund, any dialogue between the Fund and the authorities of an emerging market economy is bound to suffer from the deficiencies similar to those currently present in relations with the Fund's largest members, as described in paragraph 26. The proposal to introduce publicized or confidential ratings of the Fund members has known drawbacks, including the entrance and exit issues. As we have already stated previously, we do not favor such ratings made by the Fund, and, in the absence of the meaningful criteria, would find them even more difficult to accept.

Finally, we view favorably a review of the role of the Board in Fund's surveillance, since without such a review, any analysis of the current process of surveillance would remain incomplete.

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

This chair continues to believe that strengthening the Fund's surveillance should be the cornerstone of the Fund's efforts to ensure the stability of the international financial system and prevent crises. We therefore highly value the various initiatives and responses by the staff to strengthen the Fund's surveillance since the mid-1990s, particularly in light of the experience of the Asian crisis.

As was pointed out at a previous biennial review, we should be realistic about the effectiveness of the Fund's surveillance, since the Fund's recommendations cannot have decisive influence over the policy-making of members' authorities. This does not mean, however, that any improvement in surveillance is in vain. For instance, because of its unique mandate to undertake surveillance activities across the membership, the Fund can provide high-quality analysis of the impact of a member's economic policies on the economies of other members, on the regional economy, and on the world economy, as well as in-depth comparative analysis across countries. In light of the Fund's responsibilities to the international community, it is important for the Fund to make its policy advice based on such analysis more effective and to make efforts to have its recommendations more widely accepted by the

authorities. Even if some members do not adopt the policies recommended by the Fund in the short term, over time the Fund's policy advice should be perceived as effective and thereby contribute to building consensus on a desirable broad policy framework.

We think that the key ingredients for effective surveillance, as identified in successive reviews, continue to be appropriate, namely, timely, comprehensive, and accurate information; clear focus and adequate breadth of coverage, and high-quality analysis; the need to avoid "tunnel vision" and to bring "a fresh pair of eyes"; and effective communication with the authorities and the public. In particular, the idea of maintaining focus on critical issues including external sustainability and vulnerabilities, while broadening the coverage of surveillance beyond the traditional areas of fiscal, monetary, and exchange rate policies, continues to be valid. We look forward to further progress in this direction.

Section III of the staff paper summarizes fairly the operational responses in recent years aimed at strengthening surveillance. This chair sees the current surveillance as a viable framework and also agrees with the staff that there are a number of areas where further work is needed. While we will not repeat what we said at other Board meetings concerning our position on some of the issues raised in Section IV, we would like to make several comments for emphasis.

The staff paper suggests that the staff should make a more systematic effort to analyze countries' domestic political institutions and their capacity to mobilize political consensus in favor of needed adjustment. We think that it would certainly be useful for the staff not only to recommend adjustment policies that are theoretically desirable but also to examine the feasibility of such policies and ways to implement the needed adjustment; and we expect mission chiefs and particularly resident representatives to play an important role in discussing with the authorities appropriate policies and their implementation. However, management and the Board should recognize that the effectiveness of the staff's political analysis is inevitably limited because it does not have an extensive knowledge of members' political situation or the expertise to analyze political developments in depth. Moreover, the Fund must avoid compromising its policy advice because of too much consideration of political aspects.

We welcome the strengthened analysis on the externalities of the policies of systemically or regionally important countries in view of the Fund's objective of contributing to the health of the global economy and financial stability. That said, in light of past discussions, we understand that large economies and advanced countries are not the only members that are categorized as systemically or regionally important. Whether a country is systemically or regionally important or not should be judged according to

such factors as the extent of neighboring economies' dependence on its economy and the importance of its financial system internationally.

On the issue of surveillance in program countries, it is necessary to examine carefully what measures would be both practical and effective in bringing a fresh perspective to the Fund's assessment of the country's economic condition and the appropriateness of its policies. In this regard, we continue to believe that a fresh perspective is necessary not only at the time of Article IV consultations but also during program reviews. To this end, we expect the management and staff to examine the effectiveness of, and room for improvement in, existing measures such as internal review by PDR, altering the composition of staff missions by the management, and external review by the IEO. We also suggest that the management and staff should consider carefully the costs and benefits of possible measures that could involve organizational changes, including separate review procedures or reporting lines for surveillance and lending activities and enhanced independence of the surveillance function of the Fund. In this connection, we highly value the staff's swift and adequate response to the Board's discussion on prolonged use of Fund resources, and we look forward to a review of the effectiveness of the proposed ex post assessment.

We share the staff's view that candor and transparency are essential elements of effective surveillance since clear diagnosis and prescription by the staff and appropriate dissemination of information to the public encourage members to adopt sound policies and strengthen the functioning of markets. However, we also concur with the staff that there is inevitably a degree of tension between these two principles. It is important for the Fund to explore ways to reconcile the two principles to maximize the benefits from its activities in improving the efficiency of the economy, ensuring financial stability and strengthening the international financial architecture. From this standpoint, this chair believes that the Fund should review its transparency policy comprehensively with due regard to the need for flexibility in deleting and correcting descriptions in its documents. We expect that the Executive Board will take up this issue in June as programmed.

In the paper, the staff expresses its intention to explore the scope for providing strong incentives for better policies through surveillance and greater selectivity in the Fund's lending policies. This is an ambitious initiative, and we look forward to a Board discussion on this issue within a short period of time. As the staff admits, this issue poses difficult questions, and we therefore suggest that the discussion take place soon in an informal seminar, rather than in a formal Board meeting.

Finally, while we welcome strengthened financial sector surveillance in view of the experience of the Asian crisis, we would reiterate the importance of synthesizing more systematically the staff's financial sector

analysis with the surveillance of the fiscal, monetary, external, and real sectors. What is expected of the Fund is not fragmented policy advice for each economic sector; rather, the Fund should present to the authorities a comprehensive, coherent, and well-sequenced package of economic policies. To this end, a fundamental and theoretical review of the Fund's surveillance framework is necessary, not just operational responses on individual parts of surveillance activities.

Mr. Bennett submitted the following statement:

Key Points

- The Fund has made impressive progress in adapting its surveillance tools and activities to the rapidly changing global economy.

- It is still early days for many of the new surveillance initiatives. To get maximum value out of FSAP reviews and ROSCs, a compliance "road map" should be incorporated into Article IV consultations to help guide and monitor progress. This procedure would provide a clear link between FSAPs/ROSCs and surveillance.

- Surveillance in program countries needs to become more independent from program considerations. An in-depth examination that fully explains existing procedures, and carefully examines the pros and cons and resource implications of further changes to strengthen independent surveillance in program countries, could be helpful. It may be useful to begin this examination with a series of informal workshops to facilitate an exchange of ideas between the staff and Board members.

- Candor and transparency are essential for effective surveillance. Much progress has been made on this front.

- On the issue of publication—which will be discussed in detail at future meetings—we hope to establish the presumption of publication for Article IV staff reports and PINs of relevant Board discussions. Publication of all documents for countries with Fund programs, especially for exceptional access cases, is particularly important—this goes beyond transparency, it is an issue of accountability.

I join other Directors in thanking the staff for preparing this thoughtful paper. By accurately taking stock of the findings of past reviews, describing the various responses, and setting out the existing planned and potential

initiatives on surveillance, it provides a good platform from which Directors can give guidance to the staff on the direction of future work.

Operational Responses

The Fund has made impressive progress in adapting its surveillance tools and activities to the rapidly changing global economy, and these are well summarized in Section III: Operational Issues. It is still early days for many of these initiatives, and the challenge now is to try to put into practice the new policies—it will be the quality of the follow-through that will, to a large extent, determine the success of these innovations.

One specific area where good follow-through can be particularly fruitful is in the area of standards and codes. To get maximum value out of FSAP reviews and ROSCs, it will be vital that these reports have clear conclusions and explicitly prioritized recommendations. Indeed, we suggest that the staff work with the authorities to establish a compliance "road map" as part of each FSAP review and ROSC. This road map would be a summary table of the FSAP reviews' and ROSC's main findings that listed, in order of priority, the principal initiatives needed to address the main vulnerabilities. It would be the reference point for periodically assessing progress on compliance, a process which should be carried out as part of the annual Article IV consultation exercise. This procedure would provide a clear link between FSAPs/ROSCs and surveillance.

The Agenda Ahead

We very much agree with the staff that the present architecture of surveillance remains viable. That being said, surveillance needs to be sharpened and better tailored to individual country circumstances. It also needs to be more focused and frank about a country's key vulnerabilities (in part, through increased use of stress tests) and more forcefully highlight the importance of prudent debt levels and proper debt management.

More generally, there are areas where further work is needed. Unfortunately, there is no "silver bullet" to improve surveillance—the Fund will have to work on multiple fronts, experiment with different approaches, and stay flexible. What we can achieve with surveillance in each country, and overall, will depend to a large degree on specific country circumstances and each country's willingness to co-operate with the Fund. In this respect, we have to be cognizant that "one size does not fit all", and be prepared to use different approaches for different countries, regions, and circumstances.

The staff offers a preliminary discussion of some areas where a further evolution in the Fund's approach to surveillance would be desirable. We

broadly agree with the agenda, and we will limit our remarks to two areas: (1) Surveillance in Program Countries, and (2) Candor and Transparency.

Surveillance in Program Countries

One of the main findings of the IEO's Report on Prolonged Use of Fund Resources was that surveillance in program countries needs to become more independent from program considerations. Consistent with the IEO recommendations, a number of procedural changes are now being put in place to facilitate a "fresh pair of eyes", including a more systematic use of ex post assessments and an augmentation of resources for Article IV consultation when needed to facilitate comprehensive assessment. To further improve surveillance in program countries, do we need to go further? That is, do we need to adopt additional procedural/managerial policies and safeguards, or perhaps introduce more fundamental changes?

Further work by the staff on this issue would be very useful. My initial views are that while a major overhaul is not needed, more can and should be done. For example:

- *To help ensure that surveillance is objective*, it may be useful to put in place additional and transparent safeguards and triggers to bring a fresh perspective when a country shows any signs of going off-track.

- *To improve the quality of the surveillance*, and to ensure that sufficient staff resources are devoted to the task, staff incentives and procedures for allocating resources may have to be re-examined, and the use of standalone Article IV consultations increased. At present, it may be that the review process is seen as being more valuable than the surveillance function (I know this is just anecdotal, but the staff frequently exchanges congratulatory handshakes after a review, but not after a surveillance discussion).

- *To enhance candor* and reduce the extent to which political consideration dilutes the objectivity of the surveillance process, the Fund could, for example, include more detailed comparisons of forecasts from the private sector and other institutions (where available) in its analysis.

An in-depth examination that fully explains existing procedures, and carefully examines the pros and cons and resource implications of further changes could be useful. In order to get to the final product in the most efficient way, it may be useful to begin the process with a series of informal workshops to facilitate an exchange of ideas between the staff and Board members.

Candor and Transparency

Candor and transparency are essential for effective surveillance. Much progress has been made on this front. A case-in-point is the evolution of surveillance in Argentina. In the past, surveillance was not very candid and the reports were not published. The most recent report, however, was quite candid—it very clearly pointed out the considerable risks of the program and left it up to the Executive Directors to make an informed decision on whether or not they were prepared to take those risks. The authorities also plan to publish the report.

As the staff points out, full candor in the staff's presentation of its diagnoses and prescriptions to the Board is a sine qua non for effective surveillance. Increasing the number of informal sessions is one vehicle to facilitate this. For its part, management needs to ensure that the incentive structure for the staff clearly encourages candor above all.

For our part, the Board must improve its feedback—we must acknowledge when the staff is doing a good job, remind them when they are not, and staunchly defend them when they are being unjustly criticized for doing their job. Moreover, Executive Directors must be more candid to ensure that peer pressure for the adoption of sound policies does not turn into peer protection of existing policies.

On the issue of publication—which will be discussed in detail at the next meeting on transparency—we hope to establish the presumption of publication for Article IV staff reports and PINs of relevant Board discussions. Publication of all documents for countries with Fund programs, especially for exceptional access cases, is particularly important—this goes beyond transparency, it is an issue of accountability.

Mr. Al-Turki submitted the following statement:

I thank the staff for a comprehensive and well written report for today's discussion. The report clearly lays out the important steps taken by the Fund to enhance the effectiveness of surveillance and details a number of areas where additional work is needed. I broadly agree with many of the points raised in the report and support the conclusion that the present architecture of Fund surveillance remains a viable framework. Here, I will make a few comments.

It is important to remember that while the Fund may not have been fully effective in addressing every crisis or solving every macroeconomic imbalance, it has likely prevented many crises from taking place and contributed substantially to improving members' policies. Unfortunately, those successes cannot be accurately measured. I mention this to emphasize

that while there is always room for improvement, Fund surveillance is basically on track. The key is to retain the focus on adapting Fund surveillance practices to changing circumstances. We also should not have the illusion that improvements in Fund surveillance would prevent all crises or enable us to detect and solve every problem early on.

Effectiveness of Fund surveillance ultimately depends on the countries' willingness to cooperate and implement the Fund's advice and recommendations. To ensure such cooperation, the Fund must be viewed as a discreet and trusted advisor that provides even-handed treatment to its members. In this connection, the Fund's policy advice must be tailored to take into account each country's specific circumstances and implementation constraints. The Fund also needs to strike the right balance between candor and transparency. In this regard, publication of the staff reports should remain voluntary.

It is important to recognize that no one has a monopoly on the right policies. Specifically, one should keep in mind that the Fund's analysis and advice, while excellent, are not infallible. Reasonable people could differ, and it is in the nature of economics that economists have differing views. Therefore, in assessing a country's responsiveness to Fund policy advice, due attention should be given to not only the complexities and time needed to implement the staff's advice, but also the authorities' views regarding the appropriateness of this advice.

On calibration of policy measures to reduce vulnerability, I believe the Fund has always used the lessons from post experiences to strengthen its analysis and improve its policy advice. The increased focus on the capital account, on debt sustainability, and on financial sector soundness are evidence of the adaptability of Fund surveillance. The staff should also have a general knowledge of a country's social and political situation when providing policy advice. However, a systemic effort in this regard could be impractical for the reasons mentioned in Mr. Shaalan's and Ms. Farid's statement.

I have reservations regarding the use of the eligibility criteria proposed in the paper on the review of the CCL as a benchmark for Article IV consultations. This could undermine the benefits of a tailored approach that takes into account each country's particular circumstances and implementation capacity. It could also risk the Fund being viewed as a rating agency.

I endorse strengthening the regional and international dimensions of Fund surveillance. In particular, greater coverage of the implications of policies in the largest economies on others would be most useful. I also agree that it is important to integrate insights from cross-country experiences more systematically into the surveillance exercise. However, when transferring the

experiences of other members, it is essential to take the differing circumstances, capacities, and stages of development among countries fully into consideration.

I remain of the view that surveillance appears to be effective in program countries in view of the frequent reviews, the continuous follow-up by the residents' representatives, and the implementation of the agreed Fund policy advice. Indeed, the reviews by PDR and other functional departments as well as Management and the Board should allay any concerns regarding the coverage and/or appropriateness of policy advice.

Finally, I am in broad agreement with the staff's proposals for assessing the effectiveness of surveillance.

Mr. Mirakhor submitted the following statement:

We thank staff for an interesting paper that documents an impressive list of initiatives taken in recent years to address weaknesses in Fund surveillance and that explains the strategy underpinning them. While we agree that the present architecture of Fund surveillance remains the appropriate one, more could be achieved through the effective operationalization of the framework, including through giving greater attention to evenhandedness—the key to promoting a genuine and lasting cooperative spirit among Fund members.

Staff proposes a number of issues where further work is needed beyond those which are subject to periodic review. Our comments on each of the issues are as follows:

Calibration of Policy Measures to Reduce Vulnerability. Vulnerabilities should not be assessed against a 'checklist' for all countries without adequate differentiation. It is clear that the areas of potential vulnerabilities, described in paragraph 20, are relevant for emerging market countries with a strong presence in the international capital markets and an open capital account, but not necessarily to other countries. Moreover, there may be trade-offs between exchange rate flexibility and foreign reserve needs.

In regards to the recommendation in paragraph 22, we support an evolutionary approach to sensitizing Fund staff to political economy issues—in line with the recommendations of the IEO's report on prolonged use—and more systematic analysis and reporting of these issues. Resident Representatives can play an especially useful role in this process. In the meantime, however, use could be made in the interim of analyses conducted by the private sector, for example, the Economic Intelligence Unit, Oxford Analytica, IIF, etc.

We have reservations with regard to the recommendations in paragraph 23 relating to the assessment of members policies against a "well-defined set of criteria for sound policies" and wonder, like Mr. Padoan and Mr. Bossone, where standards and codes fit in this picture. In any case, this seems to be an ambitious undertaking and one that is fraught with risks even if due regard is taken of country-specific circumstances. Such an approach would also seem to run counter to the need in program countries for strengthening country ownership through, inter alia, the articulation of alternative policy choices.

Consideration of Cross-Country Experiences. We support better integration of cross-country studies and experiences into surveillance exercises. Indeed, this is an area where the Fund enjoys a unique advantage, given the wealth of its data and experience in dealing with an almost universal membership. While some progress has been made recently in this area, more needs to be done—including using the inter-departmental review process as an input into individual surveillance exercises—to ensure systematic inclusion of these experiences in staff reports.

External Effects of Policies in Systemically or Regionally Important Countries. We agree with the need for greater attention to the systemic impact of large countries' policies—an area where progress has been slow. We are attracted by the idea proposed by Mr. Shaalan and Ms. Farid that, perhaps, a specific section of Article IV staff reports of these countries be devoted to spillover effects and recommendations to address them. This may be a good way of raising the "profile of the externalities of large countries' policies" in the surveillance process.

Surveillance in Program Countries. We support the thrust of the recommendations embodied in the context of the Board's discussion of the report on the Task Force on Prolonged Use of Fund resources in this area, including, in particular, the more systematic use of ex post assessments of the use of Fund resources and strategic planning.

Candor and Transparency. We continue to see a need to strike the right balance between candor and transparency. While there will always be some tension between candor in the Fund's policy assessment and the objective of greater transparency, this will be an ongoing challenge as we move towards greater rates of publication of staff reports.

Incentives for Sound Policies. We are not comfortable with the variety of proposals advanced within the Fund and by external observers to give Fund surveillance more "traction" (paragraph 32), and share staff's misgivings on the practicality of the proposals. We join Mr. Callaghan in expressing strong objections to the Fund providing ratings of country policies. Moreover, linking access to Fund resources to policy quality raises important issues.

Countries with good policies are not likely to seek Fund resources, except in case of contagion. Moreover, good policies and strong institutions are most likely to protect countries from the effects of contagion. If this criterion is applied, access to Fund resources—one of the main privileges of the membership—would be clouded in uncertainty.

As Mr. Anderson and Mr. Farelius indicate, the best incentive for sound policies lies in the dissemination of the experience that they pay off in terms of high quality growth and poverty reduction. This could be done in many ways, including using our external communication strategy more effectively and fostering a greater dialogue with a broader audience in member counties on the benefits of sound policies with clear and persuasive analysis backed up by country experiences.

Assessing the Effectiveness of Surveillance. While staff acknowledge the difficulty of this task, assessing effectiveness should remain at the heart of our efforts to strengthen surveillance. We see merit in continuing with the approaches employed in past internal and external reviews and look forward to a review of the experience with assessment of authorities' response to the key policy challenges identified during Article IV consultations. However, it is important to assess how these challenges have been addressed, rather than simply determining whether the member has followed the specific advice of the Fund, or not.

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

Staff has provided a useful overview of the Fund's current surveillance framework. The paper highlights the significant changes that have taken place since the mid-1990s. Based on the importance this chair attributes to effective surveillance, particularly as an instrument of crisis prevention, we have consistently supported changes that could contribute to strengthening surveillance activities. In our view, the institution has responded appropriately to the challenges posed by the changing global environment and the quality of Fund surveillance has further improved.

Consolidating Progress

At this point in time, we see no need for a major overhaul of the framework. Rather, following the launch and main-streaming of so many initiatives over the past years, the focus should now be on consolidating the progress through steadfast implementation and ensuring effective links between the many new instruments and policies.

Many observers have noted that the recent failures in anticipating and swiftly addressing economic and full-blown financial crises demonstrate the persisting weaknesses of Fund surveillance. We must take this criticism

seriously and not be complacent. However, we should also make clear that even the best surveillance framework will not eliminate policy mistakes and crises. Economic policy making in member countries is guided by a myriad of factors and Fund advice, offered in the context of its surveillance activities, is hopefully an important one. As stressed by staff, the key ingredients of effective surveillance are well-known. We should build on this know-how in order to make surveillance more relevant for individual member countries and for the membership as a whole. The work program outlined by staff provides a good basis for this task even if we are fully aware that many of the issues pose difficult questions of balance and judgment. We would also see merit in conducting a review of the Board's role in Fund surveillance as part of the next biennial review.

The Suggested Agenda

As noted above, we agree with staff that even under a strengthened framework, Fund policy advice will not usually be the prime driver of policies in member countries. This should also not be our goal. Policy processes are foremost driven by factors that are deeply rooted in historical, cultural, and political characteristics of the member. The value-added of the Fund is high-quality analysis, sound expertise, and impartial policy recommendations that go over a time period beyond the electoral cycles. In order to do this, surveillance needs to remain focused on key issues of macro-relevance, in line with the Fund's mandate. This requires setting clear priorities and being selective among the wide range of issues that would potentially deserve the staff's attention.

Given the significant broadening of surveillance instruments, particular attention must be given to adequately linking the various outputs. Administrative capacities of many members—especially low-income countries—are severely tested by the increasing burden of the various surveillance exercises and it is important to demonstrate that all the pieces fit together and result in more effective advice. In this context, it will also be crucial to implement the recently decided prioritization of standards and codes assessments. By better tailoring the assessments to country needs and by improving the integration of assessments into Fund surveillance, the impact of these instruments can be significantly improved.

The calibration of policy advice is arguably the area with the biggest potential for improving Fund surveillance. However, it is also the area in which there are not clear-cut solutions. While we have made important progress in defining the areas that are important to reduce vulnerabilities, we still lack operational frameworks for determining benchmarks or critical levels. As our experience with early warning systems shows, such frameworks are fraught with uncertainties and can have unintended consequences. While we can certainly further refine the analytical basis in these areas, we should

not expect too much. What is important is that all core issues (no taboos) are discussed in a frank manner. Also, cross-country comparisons with appropriate consideration of country specific circumstances can provide qualitative benchmarks. We encourage staff to continue their efforts to better integrate cross-country experience into the surveillance exercise.

Regarding the analysis of political factors, we agree in principle that a more systematic analysis of political factors could be helpful in improving the effectiveness of surveillance. However, we are not sure that the benefits would outweigh the costs. This will depend on the concrete implementation of this analysis. While a better understanding of the political economy could make the Fund's policy advice more realistic and, thereby, more relevant, the focus on economic matters has been one of the strengths of our institution and we do not have much in-house capacity to judge political developments. Moreover, taking into account political factors could lead to a weakening of our advice, making it less clear and more ambiguous.

Regarding systemically or regionally important countries, we fully agree with staff that they deserve relatively more attention and that respective policy issues should be mentioned more explicitly both in bilateral and multilateral surveillance. It is a fact of life that economic policies of large countries are of importance for their neighbors, their region or even the world. While no country likes to be singled-out as possibly affecting others in a negative way, our institution has an obligation to put particular scrutiny on systemically or regionally important countries and their policies.

As to surveillance in program countries, we agree with the thrust of the paper. Since the 2002 biennial surveillance review, a number of valuable changes are being implemented. Article IV consultations have become more independent from program reviews which has made surveillance more potent. We fully agree with staff that the surveillance process needs to be timed in a way that is most effective in terms of bringing a broader perspective to a program strategy. We understand that authorities in program countries are often reluctant to conduct stand-alone Article IV consultations because of the perceived stigma. This problem can best be addressed by unlinking Article IV consultations from program reviews even under normal circumstances and by making stand-alone Article IV consultations more common. We would be much more cautious, however, about the idea of having different mission chiefs or wholly different teams conducting surveillance and review missions. It is far from clear for us that the cost-benefit analysis of making these kind of institutional changes would be a favorable one.

As to assessing the effectiveness of surveillance, we agree with staff that we will have to largely rely on the approaches employed in the past. The intangible nature of surveillance makes it difficult to design concrete methodological approaches. We look forward, however, to more explicit

assessments in upcoming Article IV staff reports of the authorities' response to key policy challenges addressed in previous consultations.

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

Summary

We welcome the opportunity to follow up on the discussions we held last year in the context of the biennial review of surveillance and consider the steps needed to improve its quality and effectiveness. Indeed, the evolution of surveillance is fundamental to the ongoing work to strengthen the international financial system – in particular, crisis prevention. We think that the staff paper might have stated what IMF surveillance should aim to achieve. Surveillance should at a minimum assure that the authorities have considered the risks and alternatives associated with their policy course as well as implications of their policies for the international financial system. If the IMF advice and track record are good, then, over time, the surveillance process will build credibility and have a greater impact.

Enhancing the Surveillance Agenda

We strongly believe that the surveillance agenda ought to result in a product that is as objective and clear as possible, and that can usefully inform the public and command the attention of senior policy makers. We would prioritize four points in this effort:

- *Data*: Country authorities need accurate, timely, and comprehensive data in order to formulate and implement their macroeconomic policies effectively. Fund statistical technical assistance is of course invaluable to those members who need assistance in improving their data collection.

- *Objectivity*: More objective and comparative measurement standards, like the debt sustainability model are needed, to reduce the potential for political pressure. This does not imply that the Fund will take a sort of "ratings agency" approach, but only that more objective assessments will be a regular part of the analysis where they are appropriate. Further, these objective standards need to be complemented with improved Fund access to national data. We urge early discussion of the long-overdue Board meeting on the issue of data provision to the Fund.

- *Transparency*: Increased transparency of data, standards and codes evaluations, and surveillance documents would enhance market responsiveness to economic fundamentals and help reduce contagion. We continue to encourage all members to adopt GDDS

and SDDS, as appropriate. As we noted previously, we believe that the Fund should move toward a presumption in favor of routine publication of surveillance-related documents. We look forward to the upcoming discussion on the review of the Fund's Transparency Policy.

- *Role of the Executive Board*: The Executive Board ought to demand high quality and unbiased surveillance that does not shy away from difficult policy options and provides a factual account of a member's response to prior surveillance findings. In addition, Executive Directors can urge their respective capitals to reinforce IMF surveillance assessments, when appropriate, in their bilateral relations, particularly with countries where serious vulnerabilities persist.

Improving the Analysis of Vulnerability Assessments

We agree with the staff that a well-defined set of criteria for sound policies can provide a framework for more objective and transparent vulnerability assessments. Current work at the Fund on building vulnerability assessments, which we strongly welcome, ought to be seen as a key element in the effort to promote more effective surveillance. In that regard, we support the ongoing efforts to review the Fund's vulnerability assessments. We look forward to further work on the debt sustainability framework (through the use of meaningful stress tests), financial soundness indicators, liquidity management, cross-border economic linkages, currency mismatches of both public and private sectors, and dollarization. We also believe that a Board discussion of "national balance sheet analysis" in vulnerability assessments would be useful, and that it would especially be helpful to improve our data and work on corporate balance sheets.

Surveillance in Program Countries

Surveillance is and should be distinct from program development and reviews, but we believe that it is important to ensure that surveillance in program countries is every bit as strong as in non-program countries. There obviously is a need to have the benefit of the most expert staff on a country to be part of the surveillance review. However, a broader perspective and independence of judgment are also needed. We look forward to reviewing the experience in implementing the "fresh pair of eyes" approach. In program countries, we support the staff's proposal to time surveillance reviews to maximize their value, and we support the proposal for more systematic ex-post assessment, differentiated review procedures for Article IV consultations and UFR documents, and the augmentation of resources for Article IV consultation reviews.

Making Surveillance More Effective

We agree with the suggestion of others that Management propose ways and means to make Fund surveillance more comprehensive and accountable within the existing framework. As part of the response, we would like to understand more clearly the current review procedures within departments and senior management of surveillance reports.

We welcome the development of the new staff guidance on surveillance (referred to in paragraph 41), and would recommend that the Board discuss these proposals before they are adopted by the management. Once finalized, we would support the publication of the guidance.

We agree with the proposal to enhance the inter-departmental review of surveillance reports, particularly to include ICM. We strongly agree that ICM expertise needs greater integration into surveillance (including debt sustainability and vulnerability analyses), and we believe that cross country comparability is critical to achieving greater objectivity and thus more effective surveillance output.

We also would like to know the concrete measures taken by the Management to demonstrate support for the staff who have succeeded in providing sound, clear and candid assessments and advice, in a professional and effective manner, in the course of surveillance reviews and surveillance reports. We believe the only way for surveillance to become a more effective policy tool is for high quality advice to be clearly conveyed so that a track record of IMF credibility is established, and advice given does have a policy impact.

Mr. Usman submitted the following statement:

We thank the staff for the document for today's discussion. Significant progress has been made in increasing the Fund's tools to enhance bilateral surveillance since the Mexican crisis, including the introduction of ROSCs and FSAP reviews. Progress has also been made with regional surveillance by extending it, inter alia to the European Monetary Union (EMU), and the West Africa Economic Monetary Union (WAEMU). As regards global developments, surveillance was enhanced with the semi-annual discussions of the Global Financial Stability Reports, in addition to the discussions on the World Economic Outlook (WEO) and World Economic and Market Developments (WEMD).

Expectations from Fund Surveillance

The Fund staff provide member countries with policy recommendations and advice following surveillance exercises. While

countries are in theory free to accept and implement or reject the recommendations, many of our member countries are in practice constrained to exercise this freedom due to their need to access Fund resources, and on their inability to formulate alternative policy measures due to capital capacity constraints. The notion highlighted in the staff document that Fund surveillance is only one, and not necessarily the predominant element in influencing a member's policy, is not correct in the context of HIPC and PRGF-supported countries, which are locked into concessional financing. While many of our program countries have benefited significantly from implementing staff's policy advice, others had difficulty in keeping their programs on track where the staff insisted that their policy recommendations be implemented against the authorities' own priorities or ability to implement them. We urge that Fund staff provide authorities with a menu of policy options in the context of surveillance, and allow them to exercise their preferred choices. This would be in line with the policy of establishing ownership by the authorities of both policies and programs when these are tailored to the country's specific circumstances.

Key Ingredients for Effective Surveillance

Key ingredients to Fund surveillance include according to the staff paper improved provisioning of data, greater transparency, and openness to other perspectives. We would include more policy choices in staff recommendations to the authorities.

Comprehensive, reliable and timely data are indeed essential for effective surveillance. Obtaining the appropriate level of standard may, however, be difficult for many of our member countries. While many have participated in the ROSC and the FSAP review exercises, or in the Fund's GDDS framework, resource constraints hinder them from achieving the requisite minimum standards. Technical assistance, to increase their capacity in this regard would be needed.

The scope of surveillance has increased significantly during the last decade and has enabled staff to better analyze and form better judgments of vulnerabilities facing member countries. However, the possibility that some countries might be experiencing surveillance overload should and could not be ignored. Surveillance overload could be avoided through better planning and sequencing of staff missions.

Fund surveillance would also be enhanced through greater openness to other perspectives. In this regard, opening up Fund's surveillance for assessment to external parties would be welcomed. We also welcome the proposed program of the Independent Evaluation Office to assess IMF's role in three recent capital account crisis cases (Brazil, Indonesia, and Korea),

which could also provide useful insights into the effectiveness of past surveillance exercises.

The Fund has made major strides over the last few years to increase transparency, in the context of surveillance. We are, however, of the view that the views of the authorities and the sensitivity of information should always be considered when the Fund communicates to the public on individual country matters, through Public Information Notices (PINs), News Releases and Press Briefings. The same should apply in the publication of their Article IV staff reports and other staff documents. Increased transparency should however be balanced with the candor by which the authorities would engage with the staff during Article IV consultations and other discussions. Moving away from voluntary publication to presumed publication, would in our view have a negative impact on the candor during discussions between the staff and the authorities.

When countries depend on Fund resources, particularly HIPC and PRGF-supported countries, they tend to have little scope, in challenging the staff's policy advice, whether in the context of Article IV surveillance or program reviews. Increasing the menu of policy options, and providing more scope for countries in determining the pace, timing, and implementation of the Fund recommendations would provide member countries with a greater opportunity to own those policies and/or programs.

Calibration of Policy Measures to Reduce Vulnerability

The Fund's policy advice to members concerning inter alia the flexibility of exchange rates and adjusting the composition and level of public sector debt, has contributed to their resilience to absorb economic shocks. Since political factors also play a role members' ability to implement shock absorbers, improved understanding by the staff of the political dynamics influencing members ability to implement the needed adjustments, would be valuable. We wonder however, whether the Fund staff has the needed expertise to undertake such political analysis or should they at all venture in such analyses. Instead, we would urge the Fund staff to seek advice from credible established institutions to obtain views of political factors, which might have an influence a member's ability to implement shock absorbers.

Fund Surveillance Architecture

Substantial progress has been made by the Fund in implementing various initiatives to enhance the effectiveness of surveillance, but there is still ample room for further improvement in such areas as debt sustainability analysis, the Fund's vulnerability assessment framework, separating program reviews from Article IV surveillance, as well as transparency issues. Also, given many African countries' constraints in complying with additional data

requirements due to lack of capacity, increased data requirements by the Fund would need to be matched by increased technical assistance.

The paper also mentions the possibility separating Article IV surveillance from program reviews, to allow for a fresh perspective on economic developments in the country. While a fresh perspective may from time to time warranted, we should be careful not to overburden member countries in dealing with successive mission teams. As regards increasing the participation of member countries in the Fund's ROSC and FSAP review exercises, these should be limited to those countries that have the institutional capacity to absorb them, and as well as those that are systemically important. To this end, more industrial countries should volunteer to participate in these exercises. We would also like to see increased focus on trade issues and its impact on developing countries during the Article IV surveillance of industrial countries.

Incentives for Sound Policies

The paper mentions two possible approaches to encourage members to implement sound policies, i.e. through a rating mechanism and through linking member's access to the implementation of sound policies. It is our view that the Fund should refrain from playing the role as rating agency. The issue of increased access through the implementation of sound policies has recently been addressed in the Board during the review of the CCL facility. We support the view that further improvements in the Fund's lending policies to promote greater selectivity is warranted, but have reservations as to whether this should take place through surveillance exercises.

Next Steps

The future program as regards surveillance would in our view benefit from a broadened scope to include issues pertaining to low income countries. This could inter alia include further analysis of the relation between the PRSP process and Article IV consultations in low income countries, the need to start to think about exit strategies for prolonged users of Fund resources, and continued surveillance of the impact of trade practices in mature economies on developing countries.

Ms. Indrawati submitted the following statement:

At the center of the Fund's mandate is the conduct of surveillance of member countries and the global economy at large. As part of the process, numerous reviews have been undertaken to enhance the effectiveness of surveillance. We welcome these efforts and today's discussion on this important topic of surveillance and thank staff for their well-written paper. We agree that generally the architecture of surveillance remains a viable

framework and support the appropriate focus of the Fund to take advantage of the unexploited potential of the present framework to contribute to better economic outcomes across the Fund's member countries. In addition, there are a number of areas where further work and explorations are needed given the changes in the global economic environment, including those presented by rapid evolution and growing integration of world financial markets.

Achieving the Objectives of Surveillance

The objectives of the Fund's surveillance include to improve its diagnosis of risks and vulnerabilities; develop standards and codes; data disclosure and transparency; and strengthen member countries economic policy framework and institutions. We welcome the effort including improving vulnerabilities assessments, expanding coverage of financial sector assessments, and enhancing surveillance of international capital markets. At the same time, efforts to broaden and deepen analyses of the state of the economy of the member countries are commendable. Nevertheless, what is of importance is that the aim of the surveillance should be focused on crisis prevention in the member countries.

Given the broad objectives of surveillance and the range of measures that can be implemented, it would be useful if staff could identify the areas that should addressed in the short, medium and long term objectives. Besides ensuring the effectiveness of the surveillance, this would also facilitate Fund and member countries in prioritizing their policy implementation. Surveillance, nevertheless, could only be achieved to a certain level, given that some areas are beyond the Fund's control such as issues relating to political, social and institutional setting.

It is worth to reflect the level of acceptability by the member countries of the Fund's advice in order to achieve the surveillance objectives. It was mentioned in the staff report that industrial countries have been less receptive to Fund advice as they are unlikely to seek financing from the Fund and are, therefore, less constrained to take account of the views of the international community in the formulation of their policies. At the same, some of the low income and emerging countries were also less receptive partly due to the trust and credibility of the past performance of Fund's advice. This situation calls for more efforts to improve the Fund's advice and its appropriateness based on the countries circumstances. While we agree on the issue of policy recommendations based on a case-by-case basis, clear focus and adequate breadth of coverage as well as high quality analysis are also important to ensure the effectiveness of the advice.

At the same time, efforts by the Fund to achieve these objectives should also take into account its capacity in terms of costs and resources. In order to prevent the Fund from diluting from its mandate and to prevent

duplication of efforts, collaboration with other international institutions and agencies should be intensified. The Fund can entrust certain aspects of surveillance to other relevant institutions or agencies, in order to ensure the constraints faced by Fund do not affect the effectiveness and appropriateness of the recommendations. This is particularly relevant when it comes to improving the institutional setting in the member countries where the policy advice could go beyond the Fund's mandate. With more collaboration, Fund could give more focus on the core areas under its responsibility.

Impact of Policy Advice

The 2002 review of data provision to the Fund for surveillance noted significant progress in the provision of data, even though about one third of the cases discussed in Article IV staff reports still indicate data inadequacies. While we recognize the importance of better and more timely data, we caution against making data standards an end in itself. There are costs for greater transparency and sometimes these costs outweigh the potential benefits. Efforts to improve and add on new requirements to the data provision must be tempered by the need to take into account the institutional capacity of member countries to gather the required data, especially when the countries are still grappling with the existing data inadequacies. There is a need to strike a fine balance between increasing transparency and the burden imposed on countries. At the same time, the request for comprehensive data or information also calls for improving the ability on the Fund part, to analyze and produce economic model, which are reliable and predictable. In this regard, additional staff might be needed and staff capability need to be strengthened further to improve the quality of Fund's advice to member countries. At the same time, the accuracy of the existing methodology should be further reviewed.

Agenda Ahead and Next Steps

We welcome staff's recognition that there are a number of areas where further work is needed, beyond those issues and initiatives that are subject to periodic review. We also agree with the focus on issues listed in paragraph 19 of the paper to further strengthen surveillance.

On surveillance in program countries, we concur that it needs to become more independent from program considerations. It is encouraging to note that a number of procedural changes are now being put in place to facilitate a fresh perspective in the Article IV consultation process. Our experience shows that some of the conditions and procedures were too stringent and have affected the implementation of the program. In ensuring its effectiveness, expert staff on certain policy areas should also be included in the missions together with staff who are already familiar with the country's situation to take full advantage of both experience and expertise. In addition,

we support the view that the staff report should also include the authorities' views and detail explanation of their policy stance. We encourage the Fund to reconcile the focus of surveillance activities to avoid dilution of policy recommendations. In this connection, we would like to stress that the Fund should focus its surveillance efforts on countries whose economic development and policies create potential systemic impact on the international financial system.

On transparency, the paper highlights that roughly 60 percent of Article IV consultations and 50 percent of UFR staff reports are presently published. However, a substantial number of Fund members have been reluctant to move to a policy of presumed publication of staff reports. One possible reason for this is the potential adverse affects from doing so. Financial markets are influenced significantly by sentiment and some of the issues highlighted in the Fund's report might give negative signals on the state of the economy. We are not convinced that the publication of staff reports would help investors to be more discriminate in their assessment of individual countries. Greater transparency provides little assurance that markets would be more discriminating when there is a crisis of confidence. Therefore, in enhancing transparency, we would encourage the staff to examine the ability of the market to utilize and interpret the increasing volume of information before imposing more onerous requirements on its members without clear benefits to the international community. At the same time, the publication of Article IV staff reports should continue to be voluntary as presumed publication might reduce the effectiveness of policy dialogue, as it will deter frank discussion between staff and authorities on sensitive issues.

On assessing the effectiveness of surveillance, we are of the view that an independent review of the Fund surveillance is also important to provide a balanced assessment. It is important to draw lessons not only on the appropriate policy stance in crisis management and resolution, but also on institutional arrangements for a more effective implementation of these policies. In addition, we believe that it may be impractical to assess countries policies either against one another or against an explicit set of standards as the dynamism of externalities and differing internal environment make it difficult, if not impossible to formulate benchmarks. We would also like to suggest that a survey be conducted on the effectiveness of the surveillance in the past to provide a general guideline and better understanding on how institution works and the role of the Fund.

In enhancing surveillance, attention should also be given to identifying and making critical analysis of new sources of growth for the country. By doing so, aside from efforts focused on improving the existing situation, attention should be directed by the country on new areas development that could help in strengthening the economy in the medium and long term. This would, we believe, greatly enhance the effectiveness of Fund surveillance.

One area worth considering is the promotion of regional surveillance. While actions to forestall a crisis have largely been undertaken at the national level, there remains a pressing need to explore regional solutions given the linkages between economies close to each other and the potential contagion effects of open markets. A regional surveillance could be more effective as the countries in the region would have the greatest stake in maintaining economic and financial stability and would presumably have the greatest incentive to avoid irresponsible policies. As such, regional surveillance would be a useful complement to the surveillance by the Fund.

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

We thank staff for this useful overview of Fund surveillance which allows us to take stock of the wide array of initiatives being implemented, or in the process of doing so, with the well justified purpose of increasing the effectiveness of surveillance. The Fund already has at its disposal many instruments and policies to make the most of its surveillance activity and indeed what is needed is to employ fully the potential embedded in the present architecture. The effectiveness of surveillance is, however, a difficult area to tackle since policies and outcomes cannot always be directly linked to Fund surveillance, as the staff report notes. We are less skeptical, however, regarding the impact of surveillance than paragraph 38 may suggest, particularly in the case of members that are in need of Fund financial support. This may be validated by the negative sentiment to the Fund's policy advice in many countries. In fact, governments generally take Fund policy advice seriously and go great lengths to accommodate it. How much is perfunctory and how much is shared raises the critical issue of ownership, which leads us to distinguish effectiveness from influence. Ownership is at the heart of effectiveness, but lack of it does not prevent surveillance from influencing policies. We, therefore, would like from the start to emphasize the importance of ownership, which is somewhat downplayed in the report, to make surveillance more effective. In the interaction between ownership and Fund policy advice, we consider that the Fund should be more conscious of its influence, while striving for improved effectiveness, and not minimize its significance through expressions such as "Fund surveillance is only one influence, and generally not the predominant one".

On the key factors for effective surveillance presented in paragraph 6, no explicit reference is made there to ownership, although the last bullet refers to "member countries' willingness, or unwillingness to act" as a defining factor for effective surveillance and thus could be considered an implicit reference to ownership. The problem remains, however, that this bullet implicitly refers to ownership as a given. It is either there or it is not. However, we view the Fund as having an active role in encouraging ownership through, among others, a frank dialogue on the different policy alternatives open to members consistent with their particular circumstances

and the risks involved in each policy option, while showing sensitivity to the political constraints that the authorities may be facing. Since the staff report is intended for publication, the reference to the political and social realities in member countries, in the fourth bullet, should more appropriately be part of the last bullet of paragraph 6, accompanied by a more explicit presentation of the concept of ownership. In addition, the second bullet referring to the need for clear focus and adequate breadth of coverage could benefit from an explicit cross-reference to the conditionality review and, in particular, to the objective of more streamlined conditionality. The latter brings to the fore another critical distinction that is not made explicit in the paper: that of surveillance for program countries as being different from that for non-program countries. Except for some specific paragraphs in the paper, it is difficult to distinguish when references pertain to one or the other case. Moreover, by stressing the weaknesses of surveillance in program countries, staff tends to downplay the Fund's leverage where it is most evident. The result is the attempt to address a more general shortcoming through an artificial construct that separates Fund supported programs from its surveillance activity.

Openness to fresh perspectives has two components: first, the fresh view that could come from within the Fund through cross-country experiences and multilateral surveillance and, second, the fresh view stemming from market participants or outside experts. The first assumes that there is someone in the Fund that has internalized this bilateral and multilateral experience and is able to apply it successfully to any individual country paying due consideration to its particular circumstances. This assumption, however, cannot be taken for granted, particularly at a time when so many experienced senior level staff are retiring. Thus, in order to make good use of cross-country experiences and multilateral surveillance, it is important to distinguish the experience contained in Fund documents from that assimilated by individual staff members. It is only the latter that, in our view, contributes to a more distilled and effective Fund surveillance. It goes without saying that from this point of view the "freshness" of the perspective does not depend on the department where a particular staff member works on but on his/her professional knowledge and tactfulness.

Section III provides a comprehensive summary of the Fund's operational response to address weaknesses detected in successive reviews of Fund surveillance. The noteworthy aspect in this section is the similar overall characterization of financial sector surveillance with that of standards and codes. In both of these cases, the conclusion presented is that a more focused use of available resources is called for. In the first instance, to make possible a more continuous financial sector surveillance in countries with material financial sector vulnerabilities or countries of systemic importance. In the second, relating to standards and codes, the purpose is to focus on countries and areas with the highest return to domestic and international stability as well

as to members' institutional capacity. To arrive at these obvious conclusions valuable time and scarce technical and financial resources were expended. This experience should serve to guard against future policy initiatives which involve mechanical responses and leave small margin for judgment .

On the completeness of the present architecture of Fund surveillance, it is clear that FSAP reviews, debt sustainability analysis and vulnerability assessments, along with procedures to increase transparency and observance of standards and codes to strengthen institutions in member countries conform a sound framework for effective surveillance. In addition sensible principles guide staff in their surveillance activity. These principles will soon be enhanced through new directives regarding surveillance in program countries and prolonged use of Fund resources. All in all, it appears as every aspect considered key to reducing both external and domestic vulnerabilities is being contemplated There is an area, however, of the architecture of Fund surveillance which, in our view, could be radically strengthened. The asymmetries in the international adjustment process and the obstacles to growth and sustainability inherent, inter alia, in trade and subsidization policies warrant at least a clearer definition of the Fund's role as a lender of last resort in the international financial system. This topic has, of course, wider implications not entirely separated from the discussions on the CCL and the definition of an objective set of criteria to facilitate decisions on contingent lending. All of this should be framed under the more general issue of creating incentives for sound policies. A thorough discussion of the lender of last resort role for the Fund could provide useful externalities for the general discussion on Fund surveillance and its effectiveness.

Regarding Section IV of the paper: "The Agenda Ahead", we find there diverse issues. While some have already been thoroughly discussed, as for example, regarding surveillance in program countries, others such as surveillance in systematically important countries have been merely noted rather than specifically addressed. This is critical if inroads are to be made for a more symmetric adjustment process. Taking better advantage of cross-country experiences is another area that may justify further discussion. Finally, we found some inconsistency in the title of the "Agenda Ahead" that gives the impression that the issues listed are about to be addressed when in fact the following section in the paper on "Next Steps" indicates clearly that only a few of the topics listed in the "Agenda Ahead" are included in the work program until the 2004 Spring Meetings.

As to the fresh perspective to Article IV consultations in program countries, paragraph 28 alludes to ex-post assessments in line with the conclusions of the Task Force on Prolonged Use of Fund Resources. We would like to note, however, that while the strategic planning approach has the potential to address a widespread need in the overall surveillance exercise of the Fund, the Task Force limits its application to Prolonged Use cases

exclusively. Further consideration should be given to progressively extending this approach to all Fund programs.

The assessment of the effectiveness of surveillance is not an easy task given the difficulty of separating its impact from that of other variables due to the lack of counterfactual evidence. Nonetheless, we consider that a greater reliance on interviews with staff and policy makers may bring a wealth of useful insights in this matter and therefore we recommend an increased use of this methodology.

Lastly, on the next steps we would add only that the suggestion to review the role of the Board in Fund surveillance, in particular as a source of encouragement for the adoption of sound policies by member countries, seems to us redundant. The reference in paragraph 5 of the paper to the collegial nature of Board discussions and the risk of turning peer pressure into peer protection of existing policies is clearly outdated and such a risk does not seem to flow from today's Board praxis.

Mr. Brooke submitted the following statement:

As we have noted before, we firmly believe that the Fund's surveillance work has an essential role to play in strengthening the international community's crisis prevention efforts and in promoting global stability and growth. It provides a unique means to assess national and global economic prospects, to detect vulnerabilities at an early stage, to provide policy advice, and more broadly to promote international cooperation.

Successive financial crises among the Fund's membership have prompted a series of reviews of our surveillance practices and initiatives to address the identified weaknesses. Together these measures have played a significant role in strengthening the Fund's surveillance tool kit and in helping member countries to address weaknesses in their policy frameworks. In this regard, the recent WEO highlighted evidence that the risk of contagion from financial crises has declined and that investors are beginning to discriminate more between countries. Furthermore, many emerging market economies are also adopting strategies to insure themselves against contagion, by for example building up reserves, or shifting to more flexible exchange rate arrangements.

These developments are very welcome and provide some evidence that the measures already put in place are starting to have a beneficial impact.

However, we fully agree with staff that there is scope to deliver additional improvements within the existing framework:

- More needs to be done to promote greater adoption of the GDDS and SDDS standards among the Fund's membership; we look forward to hearing about progress in this area in the data standards review later this year.

- On financial sector surveillance: we need to further prioritize our efforts; continue to increase the number of countries who have received comprehensive FSAP assessments; provide these countries with clearer recommendations that are better prioritized and firmly anchored in a risk-based, cost-benefit approach tied to the identified vulnerabilities; and develop stronger links to follow-up Technical Assistance that facilitates capacity building and the development of financial sector expertise in member countries.

- While progress with the standards and codes initiative has been excellent, there remain a number of areas for improvement. First, take-up of ROSCs has been uneven. We, therefore, need to find ways to give countries greater incentives and capacity to adopt these international best practices; increasing the resources available for technical assistance will be critical to achieve this. Second, we need to ensure that ROSCs provide advice that is acted upon. Third, further thought needs to be given to strengthening the coverage of areas outside the IMF's core expertise such as the non-financial corporate sector, corporate governance and accounting and auditing. And fourth, ROSCs should be published and we need to encourage the private sector to make greater use of them. We welcome the agreement reached last week on means to strengthen the ROSC initiative and look forward to their implementation.

- We also welcome the wide-scale use of the agreed debt sustainability framework in Article IV consultations and UFR documents. However, this usage has highlighted some differences in application of the new procedures by the different area departments and has also exposed some of the weaknesses of the approach. As we highlighted in the Board discussion back in June, there are a number of ways in which the current approach could be refined. We hope the upcoming review will fully discuss the many suggestions that were made at the previous Board discussion together with further consideration of what constitutes a prudent debt level given the currency composition of the debt, its maturity, whether it is indexed and who holds it. This work will, of course, also be relevant in debt rescheduling cases.

- On vulnerability assessments, recent crises have demonstrated that we still need to improve our understanding of banking sector vulnerabilities, the financial linkages between economies and the

transmission channels for crises. We support the intention to increase the frequency of FSAP review updates and to strengthen the focus on financial sector work in the Article IV consultations of countries that have not already undertaken an FSAP review. These changes will, no doubt, be beneficial. But we think more could be done to strengthen our regional surveillance of such transmission channels and apply this knowledge in our bilateral surveillance efforts.

- On transparency, we continue to believe there is a strong case for moving to a presumption in favor of publication of Article IV consultations, UFR documents and ROSCs. We look forward to the next discussion of this issue in June 2003.

We feel the best way for Fund surveillance to take fuller account of political economy considerations would be to expand the discussion in Article IV and UFR documents of the various policy options available to authorities. As such, the commitment to include a full discussion of policy trade-offs in the recently agreed conditionality guidelines could be extended to the staff guidelines for surveillance work. We would be wary of expanding the discussion in staff documents of political factors beyond this. If it is felt that further political economy information should be provided this could be in the form of an oral presentation by staff.

Progress in all of these areas will, no doubt, help to further improve the quality and effectiveness of Fund surveillance. Going beyond these measures, however, we continue to see a strong case in favor of a more fundamental strengthening of IMF surveillance, making it more independent, authoritative and accountable. While there is still debate on the best way forward, previous Board discussions of the Biennial Review of Surveillance and its follow-up have highlighted a good degree of support for staff to consider a broader array of options within the existing framework than is discussed in this staff paper.

For IMF surveillance to be seen as objective, it must operate within an organizational framework that provides a credible guarantee of rigor and candor. As we have noted on previous occasions, we feel the current structure has shortcomings in two key dimensions. First, in program countries, particularly prolonged users of Fund resources, the existence of a Fund program can diminish the priority assigned by Fund staff to surveillance or reduce the objectivity of its analysis. And, second, there is a risk that political considerations at the Board can counter the benefits of peer review and reduce the impact and objectivity of Fund advice.

We noted last year that the revised operational guidelines provide only minimal guidance to address the first of these issues. We do not consider,

therefore, that they represent a significant step toward a regime that emphasizes the independence of the surveillance exercise from the program framework, and the need for a fresh look at economic conditions and policies.

We, therefore, call on staff to propose ways and means to make Fund surveillance more comprehensive and accountable within the existing framework. These should consider carefully the pros and cons, including the implications for staffing, costs and information flow, of greater operational separation between program and surveillance activities, and the possibility of separate internal management lines, whilst preserving the responsibility of the Board. We would like staff to prepare a report before the 2003 Annual Meetings on the progress made in providing a fresh perspective in program countries.

As Directors agreed in the surveillance discussion in April, there are two aspects to effective surveillance: the first is the quality of the Fund's advice; the second is the extent to which member countries implement such advice. The staff's proposal (discussed in paragraph 36) to include a brief review of past policy advice in each Article IV consultation is welcome, but it addresses only the second aspect. It does not assess the quality of the Fund's advice. Moreover, it does not provide a means for assessing whether the Fund is providing objective, rigorous and consistent standards of surveillance across all member countries. Further work is needed, therefore, on measures to review the effectiveness of Fund surveillance.

In particular, we would welcome a review of the Board's role in Fund surveillance. The Board could take a more strategic view towards surveillance, setting a surveillance remit and reinforcing its guidance that surveillance in program countries should be as broadly focused as surveillance in non-program countries, with IMF staff and management reporting back on performance.

Mr. Reddy submitted the following statement:

We very much welcome the staff paper reviewing in a comprehensive manner, various methods of strengthening surveillance since mid 1990s, their main conclusions, operational responses and suggestions for next steps and agenda ahead. It is useful that such a discussion closely follows the reviews of FSAP and standards and codes and special access facilities of the Fund.

Methodology and Conclusions

The most important aspect of the changing surveillance procedures and methodologies in recent years has been their increased focus upon crisis prevention. This is sought to be achieved by making the surveillance process more and more proactive than reactive, besides the conventional focus of

strengthening macroeconomic and structural policies of member countries. Naturally, the range of issues covered has widened and the analytical contents have deepened with successive reviews of surveillance procedures. We commend in this regard, the continued watchfulness of management and staff and their resilience in responding to changing environment both in the areas of multilateral and bilateral surveillance.

In drawing conclusions about methodologies, staff analysis appears to be somewhat less than positive. We agree that ultimately, the effectiveness of surveillance needs to be judged by its impact on policy decisions and the development of sound economic institutions by members themselves, which are in turn influenced by a variety of factors; and hence, it is difficult to isolate the contribution of Fund surveillance. The member countries' responses to policy advice from the Fund will inter alia depend upon the quality, persuasiveness and timeliness as also political acceptability. There could be no doubt, scope for applying more rigorous tests of evaluating effectiveness of surveillance process; but, it is clearly evident from the experience that overall, the efforts towards strengthening of surveillance has brought about virtuous cycles both internally among the IFIs and externally among the member countries.

Internally, there is much better and higher frequency flow of data and information, better coordination among the IFIs in particular between the Bank and the Fund, focused and candid country matters discussions with up to date market intelligence, better communication and transparency in relationships with authorities—political leadership and officials, and better, selective and focused policy discussions during Article IV consultations. Externally, among the member countries, there is increased sense of awareness and management of risks, better understanding of markets and increased ownership and commitment to prudential practices based on medium term policy frameworks particularly in the critical areas of monetary, fiscal and exchange rate and reserves management. In this backdrop, we support the continued efforts of staff to review surveillance methods in search of making them more effective as tools of crises prevention. In this regard, we particularly welcome and appreciate the recognition of the need for sensitivity to political constraints and the benefits of elaborating alternative policy proposals that take into account the political and social realities in the member country. The bi-annual surveillance reviews help to build upon such pragmatic elements into the surveillance process. The earlier reviews of conditionality and access policies in capital account crises and contingency credit lines are closely related to this issue and the surveillance procedures should duly recognize the Directors' concerns in those areas. As a parallel effort, as we have emphasized in the past, there is the need to have a review of program design and related frameworks of macroeconomic and structural policies, in the light of experience gained so that policy implementation reviews as part of

surveillance gain the necessary flexibility, even while the scope and depth of surveillance get strengthened.

Operational Responses

We welcome the impressive initiatives undertaken since mid-1990s addressing the weaknesses in Fund surveillance and simultaneously making some efforts at strengthening the international financial architecture. From the surveillance angle, we recognize the need for improving Fund's diagnosis of risks and vulnerabilities and encourage various steps taken including FSAP reviews and standards assessments on a voluntary basis, focused Article IV consultation discussions, debt sustainability analysis, vulnerability assessments and improving transparency. Recently, we had opportunity to review aspects relating to FSAP reviews, ROSCs, and standards assessments and we extensively commented upon those exercises. On the other policy responses, we would like to offer a few comments:

- The debt sustainability analysis should duly consider the composition and nature of debt, ownership of debt, features of instruments like exchange rate or interest rate linked etc. It may be recalled that there is no single threshold level of debt which can be considered as a dangerous level.

- We share the view that the capital account developments and market perspectives captured through refined analyses from the International Capital Markets department have added significant value to multilateral surveillance.

- The vulnerability assessment models and empirical research studies on associated aspects like early warning systems are useful, but needs to be interpreted with caution when applying to new situations, taking duly into account, the changes in environment and additional information and current data available regarding a member country. These studies help in enhancing our understanding of micro-market structures and their behavioral patterns.

- We also encourage vulnerability assessments and associated sensitivity tests, but they must be based on realistic assumptions to carry credibility.

- In regard to surveillance of program countries, we find that it is very close, adequately frequent and comprehensive in details. Ownership and commitment to program are of course part of the negotiation process. We would only urge that while reviewing program and program compliance in terms of a package of

measures, there is enough flexibility in approach and the authorities' concerns about institutional processes and limitations are adequately recognized and there is enough leeway for both the authorities and the Fund to make necessary mid-course corrections, without losing sight of the overall thrust of the program in leading the member country achieving sustainable growth with adequate safety-nets.

- As regards transparency policy, the voluntary nature of publications should continue. We do not support the move from voluntary to presumed publication of staff reports.

- As regards CCL, we do not consider that it will provide incentives for the adoption of strong policies and strengthens in any manner, the Fund surveillance, though we have no objection to its being further reviewed.

The Agenda Ahead

The present architecture of surveillance, varied in scope and application, no doubt provides a viable framework. As regards the agenda ahead our views are:

- The calibration of policy measures to reduce vulnerabilities is no doubt significant. But, as we mentioned on several occasions, the causes of recent crises originated not necessarily from domestic factors, but triggered more by external shocks, unpredictable behavior of international capital markets and sudden alteration in the direction and volume of capital flows, notwithstanding the robustness of domestic institutions and political consensus and commitments. This is one area that needs to be addressed in the broader context of issues concerning the development of the new international financial architecture.

- Consideration of cross-country experiences particularly in market development, sequencing and pacing of reforms and evolving new policy frameworks in monetary, fiscal and external sectors would be very much welcome.

- Analysis of systemic impact of large countries' policies deserves greater attention in Fund surveillance. Being larger members, they share in fact the larger responsibility in maintaining the global financial stability and the integrity of the international payments systems.

- We welcome the approach towards candor and transparency to achieve credibility and objectivity. But, over caution and exaggerations on the basis of unrealistic assumptions should be avoided.

- Publicized ratings of countries, in our view is not within the scope of Fund's surveillance activity. Based on the nuances reflected in the Fund reports, and published information and data, it is for the markets to make their own assessments. Access to Fund resources also should not be linked to rating assessments across the board of all member countries.

- We encourage evolving survey methods, as in the case of recent discussion on Fund/Bank collaboration on public expenditure management policies, case studies and also assessment of specific initiatives.

Comments on Specific Issues

As regards what the Fund surveillance can do (paragraph-38), we do recognize that progress in several areas listed in section III of the paper are broadly on the right track. But, it is also necessary to emphasize the fact that while Fund surveillance is only one of the factors, it could be a major influencing factor, in so far as economies which are potentially vulnerable to instability. In this regard, the strengthened surveillance can help such countries in building up necessary institutional mechanisms in time, preventing crises situations or in minimizing the costs of crises.

In so far as the diagnosis of the key ingredients of effective surveillance, there is a need to distinguish between developmental aspects and surveillance aspects. We would like to reiterate that FSAP reviews, standards assessments and ROSCs should be viewed more as developmental efforts promoting sound financial markets and systems rather than as tools for rating or grading member countries. Furthermore, effectiveness of surveillance will also depend upon homogeneity of treatment of countries and while prioritizing vulnerable and systemically important countries, it is necessary that no bias is shown towards only developing and emerging market economies. The list of items covered in section III and the related progress must be viewed from this angle.

As regards the present architecture, the multilateral surveillance has progressed very well. In so far as bilateral surveillance is concerned, we would emphasize that the Article IV consultations which provide opportunities for a direct and effective dialogue with the authorities should be the prime channel of surveillance, in particular in non-program countries, compared to any other mode. Data provision, ROSC and standards and codes

assessments address developmental aspects rather than surveillance aspects as we emphasized earlier. FSAP reviews on a voluntary basis could combine the features of developmental and surveillance angles. Here again, the external factors have to be given due weight in the stress tests.

In terms of prioritizing the areas where further work is needed, we would emphasize systematic consideration of cross country experiences and added focus upon systemically important and regionally important countries, and learning from more effective assessments of surveillance experience.

In program countries, the surveillance is adequately comprehensive, but as we mentioned earlier, some more flexibility in program review and performance assessments may be needed.

We support the staff to work further on the basis of next steps indicated in section V.

The Director of the Policy Development and Review Department (Mr. Geithner), in response to questions and comments by Directors, made the following statement:

First, generally, the purpose of this paper is to take stock of the range of initiatives that are in the pipeline to strengthen surveillance, and to lay out a roadmap of priorities for the work ahead. We are not at the beginning of the process of strengthening surveillance, but we are also not at the point yet where we can be fully confident that we are doing everything possible and sensible to improve the quality, candor, and impact of surveillance. I am not sure we could ever say we are at that point, but we want to continue to work toward that goal.

Many of the initiatives that are relevant to this objective were initiated over the last 5–8 years. Some have a shorter history, and were initiated over the past 1½-2 years. Of these, some are at the preliminary stage of execution, implementation, and refinement. In other areas, we are still looking at ways to improve our internal standards. Policy initiatives and procedures in this area generally are important to the effort, but they cannot guarantee or substitute for the hard work of analysis, judgment, persuasion, and communication that are critical to the staff's efforts to deliver better surveillance and decisions in the program context.

There was a question about what is underway internally to improve the capacity of the staff to provide an assessment of political factors that are relevant to surveillance and an assessment of the risks to program implementation. The staff did not intend in this paper to lay out those initiatives. They consist of several strands, including: an internal training program for mission chiefs; the broader use of outside experts when needed to benefit from outside views; a range of efforts to ensure that mission chiefs in

the context of Article IV consultations reach out somewhat more broadly to relevant political actors and other elements of society. The staff is also looking at ways to improve the role of resident representatives in this area. We will discuss with management the ways in which we can provide a clearer sense of the internal efforts under way.

There was a question about whether the criteria for evaluating the sufficiency of cushions against volatility and vulnerability would be different from the framework of standards and codes. At the Board discussion on the review of the CCL, the staff laid out a framework of criteria for measuring vulnerability that could form a basis either for surveillance or for a reformed CCL. We are proposing to have a subsequent discussion about these criteria in the context of the forthcoming discussion on the CCL and its future, as well as the role of precautionary arrangements. We envision the criteria to be broader than the simple assessments that are part of the ROSC and FSAP review processes. The staff is aware of the limitations, complexities, and sensitivities associated with this exercise, but we will have a chance to discuss that more fully in the context of the forthcoming discussion on the CCL.

There was a question about whether there is room for reallocating internal resources from the "number crunching" task to more judgmental and strategic thinking. These skills are not necessarily fungible and you cannot have one without the other. The staff is trying develop ways of improving its capacity for analysis, judgment, and strategic thinking. The resources that are devoted to the fundamental task of quantitative analysis do not occur at the expense of judgmental and strategic thinking.

There were many related questions on the review process—how cross-country experiences are integrated into this process, how the perspectives of other departments are utilized by area departments, and, more specifically, what the review procedures are within area and PDR departments with respect to surveillance and program documents. The staff would need to consult with management or how we can brief the Board on the internal review process.

Mr. Yakusha made the following statement:

At the outset, I would like to welcome this discussion on surveillance, which provides valuable suggestions; it is important to follow-up on them. Having said that, I continue to believe that a radical overhaul of our surveillance activities is not really necessary. We can, however, improve our surveillance framework by strengthening some elements and putting more emphasis on others. First and foremost, we should ensure that our surveillance reports and our policy advice to member countries are firm, clear, and candid. Surveillance is a crucial component of our crisis prevention framework. For surveillance to play this role, it also needs to address vulnerabilities in good times to make countries improve policies and reduce vulnerabilities, so as to

make them less susceptible to shocks. In the context of public finances, for instance, this could mean that the Fund takes a firmer line regarding the working of the automatic stabilizers in times of high growth, so that in bad times, there will be less need for governments to recourse to drastic procyclical measures.

In addition, more can still be done to improve the clarity of Fund advice, especially in the core areas of Fund expertise. We can give a clear opinion about fiscal policy, monetary policy, exchange rate systems, and last, but not least, debt sustainability. Without ranking countries, the Fund can give a clear and honest opinion about the quality of countries' policies in those areas similar to the objectives of the eligibility criteria that were discussed and broadly supported in the context of the recent review of the CCL. In fact, we already give clear judgments in countries with access to Fund resources or precautionary programs where the decision to agree on a program is a kind of black and white decision. Even though I agree that our debt sustainability framework might require further improvements, the Fund should also not shy away from giving clear opinions about the prospects of debt sustainability, so as not to be accused of misinforming the markets that a crisis has occurred.

Another way to make surveillance more effective is by being more transparent to the public about the Fund's opinions on a member's economic and financial policies, and more regular voluntary publications of Article IV consultation missions' concluding remarks may be helpful. This not only increases the public accountability of the Fund as an institution, but also gives others an opportunity to challenge this opinion and to enter into discussion about the Fund's assessments. Accountability will also be increased by including references in every Article IV staff report to early advice, not only including the extent to which the authorities followed up on the advice, but also assessing whether the Fund's recommendations were adequate. In addition, the extent to which a country has followed up on the advice of the Fund in the context of surveillance in the past should have a weight in Fund program decisions. Especially in program countries, comprehensive surveillance is valuable and necessary, so as to provide a somewhat broader prospective of the economic situation and policies of program countries, but also to put the Fund program into a somewhat longer-term perspective.

Consultation cycles should, therefore, be flexible to allow for consultations to take place at a time when they are most valuable, not when the next program review will come. It was unfortunate, for instance, that the Article IV staff reports for Argentina and Uruguay were only ready after a new credit line was already at least informally agreed upon. Although we should not overburden the staff, as well as the national authorities, I still think it is useful to include some new perspective in the Article IV consultation mission team compared to the use of Fund resources team. Experience in my constituency is mixed, but suggests that adding an outside mission chief or

another team member to the use of Fund resources team to perform the Article IV consultation could provide a necessary fresh perspective, but only if this so-called outsider already has adequate knowledge of the situation and policies of the country under review. Furthermore, the outsider might be able to compare with other country experiences, and, in this respect, the Fund has kind of a unique position of accumulating a vast variety of good practices. I am not sure that we are doing a good job of disseminating knowledge about these good practices.

Furthermore, I would even suggest to go as far as to consider, when we can, to hold separate Article IV Board meetings from use of Fund resources meetings for program countries. I fully support staff's suggestion to assess more systematically, ex post, the use of Fund resources. Before embarking on a wide-ranging ex post review process, however, I would recommend to remain focused and to start, for example, with ex post assessments of a few cases with a macroeconomic outturn well below program assumptions, so as to draw lessons from these cases and implications for future Fund engagements.

I agree with staff that the international impact of policies pursued by systemically important countries deserves greater attention in Article IV consultations. I would like to add that we should not only discuss these issues when those systemically important countries are under review, but also in the context of countries affected by these policies; in other words, not only the source of contagion deserves special focus, but also the victims. It might be especially useful to discuss more systematically the impact of development and policies in large and neighboring countries when discussing Article IV consultations of smaller neighboring countries.

Mr. Bischofberger made the following statement:

The staff report comprehensively and appropriately summarizes the significant progress achieved in strengthening Fund surveillance in recent years. These achievements have clearly improved the Fund's capacity for crises prevention. Nevertheless, there is room for further improvements.

We broadly share staff's analyses and recommendations. However, as others have noted, including Mr. Padoan and Mr. Bossone, the paper falls a bit short of developing concrete proposals on how to move forward. That being said, we fully agree with the paper's main conclusion that the present architecture of Fund surveillance remains a viable framework. As noted by many other Directors, the focus of our future work in the area of surveillance should be on consolidation of the achievements within the existing framework rather than attempting fundamental changes in that framework. Or, as staff puts it, at this stage it is important to exploit the potential of the given architecture.

We are comfortable with the list of key ingredients of effective surveillance identified by staff. In this regard, we would like to stress our strong support for calls on member countries to improve data provision, to enhance transparency, including publication of Article IV consultations and Use of Fund Resources documents, and to intensify communication with the Fund.

We have three brief remarks concerning the operational responses to strengthen Fund surveillance: First, as already mentioned in the context of our discussion on access policy, we think that developing a debt sustainability database could significantly improve the effectiveness of surveillance, since it would allow the assessment of a country's vulnerability on a more continuous and, if need be, on a more speedy basis. Second, with a view of the intention to publish the staff paper, paragraph 17 which describes the main features of the CCL, should also reflect the fact that, at this time, there is no majority to extend the CCL beyond November 2003. Third, while we are aware of the huge amount of work needed to produce high quality surveillance documents, we think that these documents, including FSAP reviews and ROSCs, should be circulated to the Board as soon as possible after the conclusion of a mission. This being said, we would like to reiterate our full support for the ROSC-Initiative and the FSAP and for their strengthening along the lines agreed to during the recent review discussions.

Regarding staff's proposals to further strengthen incentives for sound policies, I would agree with Mr. Callaghan that the biggest incentive to pursue sound policies will be the benefits that come from sustained growth and greater resilience to external shocks. However, adoption of sound policies is, in any case, the main prerequisite for granting a member country access to Fund resources. In this context, we strongly believe that the publication of ratings of member' s policies would be faced with severe methodological problems. We are convinced that the final responsibility for risk assessments and investment decisions should be left with the markets. We see some merit in enhancing surveillance by more systematic efforts to analyze the political factors influencing a member's ability to establish and maintain shock absorbers since this may contribute to stronger selectivity in the Fund's lending policy. In any case, the Fund should further strengthen its focus on capacity building which, as the latest WEO has highlighted, is a key precondition for attaining sustainable growth.

We broadly welcome the procedural changes mentioned by staff which aim at facilitating a fresh perspective on Article IV consultations with program countries. Many interesting points have been brought up in the statements circulated for today's discussion and also in a previous intervention. In particular, calls for further improving the objectivity and independence of Fund surveillance within the existing framework are justified. However, we would like to note that there is also a need to

ensure—to the extent possible—the objectivity and political independence of decisions about the access to Fund resources. Furthermore, while there is certainly room for improvement regarding the timing of surveillance exercises, we have the impression that already current circumstances allow for mixed missions, consisting of country as well as functional department staff members. Therefore, this alternative could be used more extensively.

Finally, Mr. Chairman, we are in broad agreement with staff's proposals for assessing the effectiveness of surveillance and support the envisaged work program for the Executive Board.

Mr. Wei made the following statement:

At the outset, let me thank the staff for the well-written report. After reading the extensive statements, let me briefly indicate my position on the issues raised in the report.

I agree with others that, while the Fund has improved substantially its surveillance function, there is still a lot of room for improvement. I am of the same view that Fund surveillance may not be the predominant influence on a member's policies and performance, and that the best the Fund can realistically hope to do is contribute over time to building or maintaining a consensus on the broad policies that are mentioned in the staff report.

In order to enhance the effectiveness of surveillance, I believe that the views of the authorities should be fully reflected in the staff report. On many occasions, it is understandable that policy advice presented by the Fund may not be accepted by the authorities, not because the advice itself is not correct, but because the economic circumstances do not allow the authorities to do so. Another point is the equal treatment of all members, which should be emphasized in the Article IV consultation process. In this regard, I share Mr. Portugal's view in his statement that Fund surveillance in major industrial countries should be further strengthened due to their larger impact on the global economy.

On the two specific issues, namely, the coverage in the Global Financial Stability Report and the focusing of ROSCs, I also share the views of Mr. Portugal.

Another issue is the asymmetrical treatment of surveillance over the official and private sectors. While it is important to include both the public sector and the private sector into the coverage of surveillance, up to now, most of the efforts have been devoted to strengthen public sector surveillance. Surveillance of the private sector, especially on various institutional investors, such as the pension funds, mutual funds, and key financial centers, has not been strengthened to the extent that it is deemed sufficient. While we

understand the division of labor between the Fund and other IFIs, as well as the budgetary constraint on the Fund, we would like to encourage the staff to make extra efforts in conducting surveillance on the above areas. If an additional budget is needed, we would like to support increasing the budget for this purpose.

On the issue of financial sector surveillance, the progress made in carrying out FSAP reviews in selected countries on a voluntary basis is encouraging, and we think to continue this work on a voluntary basis is appropriate. Meanwhile, it is more cost-effective to strengthen the institutional capacity of members' central banks and financial supervisory institutions by enhancing their regulatory arrangements and unifying supervisory standards with international norms. In this connection, Fund technical assistance is of critical importance.

I also share the two points made by Mr. Shaalan in his statement on the capacity to mobilize political consensus in favor of needed adjustment measures and the issues of surveillance for program countries. I believe the Fund should confine itself to the key economic areas in line with its mandate and expertise. Program countries should be treated by the same policies and procedures in the surveillance process.

Lastly, I share the views of many others on the voluntary nature of the publication of Article IV staff reports and, for this issue, Ms. Indrawati made many useful comments, and I share her comments.

Mr. Duquesne made the following statement:

Let me thank the staff for this report on a crucial issue for the Fund. As stated by colleagues, strengthening and improving surveillance is a key aspect of this institution's mission to ensure the stability of the global system and to prevent crises. Like Mr. Yagi and Mr. Miyoshi, we believe that the key reasons for effective surveillance are those identified by the staff, which are: timely, comprehensive and accurate information; careful focus and adequate range of coverage; the need for a fresh perspective; and effective communication with the authorities. I would also, like others, include the need to take into account the political realities of member countries, and I will come back to this issue later.

The progress made over the past years on several issues, such as the evaluation of standards and codes, the development of FSAP reviews, and the increase in the number of published documents, has strengthened our surveillance framework. It has to be acknowledged that the institution has changed for the better, and has learned lessons from the past. This positive judgment should not lead us, however, to complacency, and there is still room for improvement due to the increased complexity of the global economic and

financial system, which constantly raises new challenges for surveillance. Let me turn briefly to some of these issues and challenges that we need to address.

First, I share the concern expressed by Mr. Padoan and Mr. Bossone on the timely transmission of reliable information. It is quite regrettable that one third of the Article IV staff reports still indicate data inadequacies, and we look forward to the discussion on the next review of data provision and standards.

Second, I fully agree with the staff that systemically and regionally important countries deserve more attention, and that the consequences of their policies on their neighbors should be mentioned explicitly in bilateral and multilateral surveillance. As this chair has argued regularly over the past years in favor of a regional perspective in our surveillance, let me underscore, like Mr. Yagi, that large or advanced countries are important, but are not the only ones that should be categorized as systemically or regionally important. In fact, so long as a country's policies have substantial effects on its neighbors, these effects warrant analysis under our surveillance work.

Third, I share the view that more frequent cross-country comparisons could facilitate making a judgment on the appropriate mix of domestic fiscal adjustment, debt restructuring, and multilateral financing. These cross-country comparisons will complement historical comparisons, notably on the concerned country's previous achievements with regard to fiscal consolidation.

Fourth, I share Mr. Padoan's and Mr. Bossone's excellent statement on the political economy. Taking into account the political realities and balance of progress is a key element of improving our surveillance. Assessing the political and social capacity of a government to implement the Fund's advice is part of the surveillance process. So, due attention should be paid to the timing of reforms, the proper sequencing of major changes in the legislative framework of a member country, the capacity of existing institutions to function properly and resist the pressures from vested interests, and so on. In assessing all these aspects, the role of the Fund's resident representative is central. I also think that cross expertise with the World Bank would be useful. More generally, allow me to refer to the paper I produced on this topic for our last retreat and to the excellent conclusion of our debates made by Ms. Indrawati.

All in all, this is a work in progress, and I recognize that staff reports are covering this issue more and more on a regular basis. However, we still need to go further and systematically introduce this analytical dimension in our surveillance work. As mentioned by Mr. Padoan, it raises the question of the Fund recruiting or training the staff with the appropriate political economic background. This being said, I acknowledge that we have to further

reflect on the concrete implementation that we can expect from the analysis of those political factors.

Fifth, like Mr. Mozhin and Mr. Palei, I regret that the report did not include any comprehensive alternative to the CCL approach and philosophy. Without the CCL, it would be difficult to provide member countries with the criteria to be used as benchmarks of high quality policies. I hope that this question will be addressed in the forthcoming Board discussion on the CCL.

Sixth, we are concerned, like others, by the slow increase in the number of countries that publish Article IV consultation and use of Fund resources documents. We are ready to consider ambitious measures for our forthcoming discussion on transparency, including a shift to a presumption of publication.

Finally, strengthening surveillance of program countries through a fresh pair of eyes was a key element of our last review on surveillance. Like Mr. Bischofberger, we would need more details on concrete ways to achieve such a fresh perspective. I understand that the recent internal changes in PDR were devised in part to address this issue. Maybe the staff or management would like to comment on that. Let me also say that I understand many Directors' concern that the priority now should be to ensure that the new procedures are implemented and followed in practice. We should, therefore, strike a balance between the need to inform the Board on the progress made and the need for staff to concentrate on the implementation of the guidelines.

To conclude, let me emphasize the central role of the Board in Fund surveillance. The implementation of a fresh pair of eyes is primarily designed for the Board's discussion and assessment, and to that extent, I would certainly welcome creative organizational changes within the Fund, but we would oppose any initiative that would bring institutional changes detrimental to the role of the Board.

Mr. Moreno made the following statement:

Prior to our comments we thank staff for its report; we have appreciated its synthetic approach in summarizing the progress on surveillance and suggesting potential lines of action. Our main general assessment on surveillance is done through the biennial reviews. Nevertheless, we value very positively today's discussion; we believe that having this type of assessments between biennial surveillance reviews is a very useful instrument, which allows us to better follow our progress in improving surveillance.

At his stage we agree with the staff that we should focus on better exploiting and enhancing the effectiveness of the present surveillance

architecture, which we consider to be strong. We still have to advance to a better implementation of the measures that we defined in last year's surveillance review, notwithstanding that we should always remain open to new initiatives.

Our efforts on surveillance should be aimed at increasing its effectiveness with the view of improving the quality of our advice and its impact on member countries' policy measures. Improving the quality of surveillance requires finding an equilibrium between a specialization in those areas of expertise and comparative advantage of the Fund, and sufficient breadth in the analysis in order to include all the relevant factors affecting macroeconomic policy. The surveillance principles of macroeconomic relevance and hierarchy of concerns based on an informed assessment of the issues of the expanded scope of surveillance, constitute the adequate guidelines to find that equilibrium. Within this framework, we would like to highlight certain aspects that this chair considers of particular importance.

First, this chair has advocated the need to consider country-specific circumstances and to develop a better understanding of the political economy and the social circumstances, in order to enhance the quality of surveillance and better asses this impact in terms of actual economic reforms of our advice. Here, while we agree with staff that defining a set of criteria for sound policies would help provide a more objective assessment, we would warn against the risks of introducing a fixed set, which might introduce rigidities to consider country-specific circumstances, and the risk of a potential indirect use of the set of criteria as an instrument for rating countries, which we do not think should be done by the Fund. Additionally, we have concerns with the use of the eligibility criteria of the CCL, which might be too demanding as they are today.

So far, we have seen little progress and the area of political economy that we believe would significantly improve surveillance. Its enhancement will require to develop adequate capacity and technical expertise in this institution, which we support. Additionally, we believe that it is important to stress the focus of Article IV consultation missions on the issues of particular relevance to the country and the ways to solve them in an effective way. As a step forward, our policy recommendations might be formulated with a clear prioritization and establishing a range of alternatives based on political feasibility.

Cross-country analysis would also help us understand within a broader perspective the economic conditions and policies of the country and the applicability of our advice in similar country circumstances. This type of analysis, probably better done through selected issues reports, would reinforce our Article IV consultation discussions.

Second, we would highlight the importance of taking into account regional and systemic effects. Given the strong externalities of economic policies, there is a need to enhance the analysis of spillover effects of economic policies of countries with systemic and regional impact, both in Article IV consultation discussions and multilateral surveillance exercises. Parallel to that, we believe that it would also be important to advance in regional analysis. Currently we focus our regional analysis on monetary unions, but there might be scope for undertaking analysis of large free trade areas or even regional analysis of areas with strong economic links and similarities, for which an ad hoc surveillance exercise similar to that of the Euro area, or the WAEMU might be warranted.

Third, we would also stress the need to enhance sector-specific instruments. Exercises like the FSAP review, the ROSCs, and technical assistance missions have proven to be very successful and we should strengthen the resources to undertake them. In this context, we believe that there are two areas that merit priority attention and where effort and resources should be concentrated: financial sector assessments and institutional building initiatives. Here we wonder whether a re-allocation of resources might be considered.

Fourth, as means of evaluating the impact of our advice, we support a more systematic and substantial assessment in Article IV consultations of the authorities' response to policy challenges outlined in previous reports. We would welcome staff's assessment on the effective application and potential improvements of this assessment on Article IV consultations for the next biennial review.

Finally, regarding incentives for sound policies, we should keep our work in finding contingent financing lines for the countries that have undertaken sound policies.

Mr. Ondo Mañe made the following statement:

I would like to thank the staff for preparing this set of papers aiming at strengthening the effectiveness of Fund surveillance. Like previous speakers, I agree with the core premise of the report that the present architecture of surveillance is fundamentally adequate to respond to the challenges of the changing global environment and that it has contributed to the improvement of the quality of economic policies of membership. As regards the points for discussion, I will make the following comments.

On calibration of policy measures to reduce vulnerabilities, I am in agreement that we should learn lessons from past experience to calibrate Fund advice and adapt the sequencing of reforms to the specific circumstances facing member countries. I also agree that the robustness of the domestic

political institutions is essential in helping effectively mobilize political consensus in favor of needed adjustment measures. However, I share the reservations expressed by Mr. Shaalan and Mr. Portugal regarding the extension of the Fund mission in the political arena which is outside both the Fund's mandate and expertise.

I also support a more systematic consideration of cross-country experiences as inputs into bilateral surveillance. As a prerequisite, I would like to draw attention on the need to identify best performers in the surveillance exercise, and avoid transposing the experience from one country to another without careful consideration of the specific circumstances of each of them.

Regarding external effects in systemically or regionally important countries, I agree that the Fund surveillance should pay greater attention to the systemic impact of large countries' policies, as these countries can generate both positive and negative externalities at the regional and global level. In this regard, I concur with Mr. Shaalan that we should perhaps devote a specific section of Article IV staff reports of advanced countries to spillover effects of their policies on other countries and make recommendations to address them. Thus, there is a need to give greater attention to the coverage of issues such as trade liberalization. Indeed, increasing market access to advanced countries will not only help foster growth in low income countries, but it will also ensure uniformity of treatment across the Fund's membership, as program countries are forced to open-up their markets.

As regards surveillance in program countries, I do not support the separation of programs and surveillance, as I do not believe that having two teams on a country will be helpful. In fact, it may lead to more problems. In the surveillance exercise, we should keep in mind that promoting economic growth is also part of the Fund's mandate. Thus, I am of the view that surveillance in low-income countries should move beyond the number game and provide a "fresh perspective" to the authorities on the reassessment of economic conditions, risks and vulnerabilities, as well as policy options to foster economic growth. I am convinced that helping these countries identify and assess the sources of growth is the only option to build stronger economic foundations and graduate from Fund resources.

As regards the tensions between the candidness of policy dialogue and the extent to which the results of that dialogue can be made public, I fully agree with the need for increased transparency, but I also believe that we can reconcile the two concerns by maintaining the policy of voluntary publication of staff reports.

Regarding incentives for sound policies, I can go along with the proposal to establish a stronger link between the quality of a country's policies

and access to Fund resources, so as to reward good performers, while preserving Fund resources. At the same time, such an approach should not lead to penalizing countries with the willingness to implement reforms but weakened by low institutional capacity. Concerning the second proposal, like previous speakers, I oppose the approach of formally and explicitly rating or evaluating countries' policies in relation to pre-defined standards, as we do not want the surveillance exercise to become a pass or fail exam. The surveillance exercise will only be effective when based on country ownership. I agree with Mr. Andersen that the best incentive for sound economic policies lies in the experience that they pay-off, in terms of high quality growth.

On assessing the effectiveness of surveillance, I believe that Fund advice can effectively influence member countries only if they are of high quality and based on a constructive relationship of trust and respect between the mission and the authorities. This is very important and I welcome the experience of having the authorities' feedback on how past advice have helped address key challenges.

To conclude, I am convinced that we have made some progress in strengthening surveillance. To be effective, surveillance should not be intrusive It should be based on country ownership, quality advice, trust and mutual respect and take into account both the need to concentrate on areas of great relevance for promoting economic growth. Finally, I think that it is also important to strengthen technical assistance to help countries to address the weaknesses identified in the surveillance process.

Mr. Kiekens made the following statement:

The staff concisely summarizes the Fund's many efforts since the Mexican crisis to adapt Fund surveillance to the growing freedom of capital movements, and to respond to the various reviews of Fund surveillance from the Whittome Report of 1995 to the last biennial review of surveillance in July 2002.

The success of efforts to improve data dissemination, sharpen financial sector surveillance, spot external vulnerabilities, promote best practices, assess the sustainability of public and external debt, make the Fund's policy advice more transparent, and strengthen the surveillance of program countries enhanced the effectiveness of the Fund's surveillance. Mr. Padoan, Mr. Duquesne, and others have rightly stressed the importance of providing reliable data to the Fund an a timely manner. In this area, more progress is needed. I also recall that the Board discussion on data provision by countries for surveillance purposes is now more than three years overdue. I am regularly disappointed by the absence from staff reports of critical statistical data needed for making an independent informed assessment of policies in the

country under surveillance. This seriously impairs Directors' conclusions, which all too often are merely paraphrases of the staff's conclusions.

There remain no obvious conceptual gaps to be filled, but there are some initiatives that should be more widely adopted by members, and some concepts that have yet to be translated into operational guidance.

Let me comment briefly on initiatives which should be implemented more widely.

Because of the voluntary nature of the FSAP review, participation has been somewhat uneven across countries and regions. You know my remedy: FSAP reviews should become mandatory because examination of the soundness of financial sectors is part and parcel of the Fund's surveillance mandate under Article IV.

ROSC coverage is also far from complete. ROSCs should focus not only on countries and areas with the highest return on domestic and international financial stability, but also on countries that are implementing best practices. This will not only help the Fund keep abreast of best practices, but will also avoid negative signaling. In assessing compliance with standards, we must keep in mind that they have been defined as "best practices" for use in sophisticated financial systems and economies. For that reason, in less advanced countries, ROSCs must focus only on norms that are relevant given the state of the economy and the country's progress toward compliance.

The policy of voluntary publication of country documents has brought about a sea change in the transparency of the Fund's activities in most parts of the world. There is increasing evidence that capital avoids the least transparent countries, especially during periods of high risk aversion. Next June we will examine whether this differential market behavior has led more countries to publish their Article IV consultation and Use of Fund Resources staff reports.

There are also some new initiatives to be developed further and expressed in operational terms for surveillance purposes.

Some time ago, I suggested that the Asian crisis should encourage us to include in our surveillance the values-at-risk in the balance sheets of the most important sectors of the economy—i.e. the government, the central bank, and the banking, corporate, and household sectors. More adequate data would be needed, especially in the corporate sector. I think the Board should further examine and elaborate such a balance sheet approach to surveillance before the Fall annual meetings. Uruguay is a clear recent example of how a timely balance sheet analysis would have been advantageous. Even though Uruguay had an investment grade credit rating up until a year ago, the country was severely exposed to exchange rate risks. Only a small fraction of its public

debt was financed in its own currency. Most households had a very large exposure to exchange risk, since mortgage loans were customarily denominated in dollars, while salaries are earned in local currency. The exchange risk of households was a risk for the banks and ultimately for the public finances, as Uruguay's recent crisis has unfortunately demonstrated.

The concept of regional surveillance also needs further work to create concrete surveillance modalities. Looking back on the Asian crisis, it appears that the Fund may have underestimated the spillover of the 1997 Thai crisis onto the rest of Asia, and may also have underestimated the effects on the rest of Latin America of Brazil's change of exchange regimes in early 1999. The impact of the Argentine crisis on Uruguay's bank deposits seems to have surprised the Fund and everybody else once more. The balance sheet analysis which I described earlier could also have proven useful for detecting regional vulnerabilities.

All these vulnerabilities, unnoticed until a crisis erupted, show the importance of improving the quality of data on stocks and cross-border flows for preventing financial crises. They also point up the need for surveillance procedures capable of predicting the potential consequences for its neighbors of a country's external weaknesses. The quarterly vulnerability assessments described in paragraph 13 may be useful at the staff level. But their opacity to the Board makes it hard to assess their contribution to policy improvement. The staff should report the results of these assessments to the Board, perhaps during the informal country matters sessions.

One of the strengths of the Fund is its in-depth knowledge of policies in all countries. This strength is not fully exploited. The Fund should make more cross-country analyses to detect weaknesses in countries and to give more convincing recommendations based on good policy experience elsewhere. This is valid for both surveillance and technical assistance. The Fiscal Affairs Department is making good use of cross country analysis. During a recent Technical assistance mission to Hungary on expenditure management, the staff benchmarked all major fiscal expenditures in Hungary to the levels of similar expenditures in a broad group of similar countries. The results spoke for themselves and the recommendations were convincing.

Last July, we adopted new guidelines to strengthen surveillance at key moments, namely when a program is launched and when it goes off track. We also agreed on the need to re-evaluate conditions and policies from a standpoint outside the program framework, but we have not yet defined specific guidelines for so doing. The Board should make its contribution to the formulation of the new guidance to staff, announced in paragraph 41, concerning surveillance in program countries. I continue to believe that the Fund has insufficient resources to assign separate staff teams to the task of surveying a country's economy and the task of negotiating programs. It is the

explicit responsibility of the Policy Development and Review Department to keep surveillance reasonably independent from program negotiations and reviews.

The new sections in Article IV staff reports, on country authorities' responses to past Fund recommendations, will in time become a good basis for assessing the effectiveness of the Fund's surveillance.

What are the most powerful incentives to pursue good policies? The answer is obvious: these incentives are the prospect of higher growth and cheaper private financing. Promising ex ante large access to Fund resources is not an appropriate way of providing incentives for good policies. Access to Fund resources is appropriate for countries who are addressing real or potential balance-of-payment problems, and are willing to accordingly adjust policies.

Finally, I have a few words on the political economy of Fund surveillance.

The Fund should not limit its policy recommendations to what seems politically feasible. The commitment of Fund members to comply with their Article IV obligation to pursue stability-oriented policies is not lessened by real or alleged political difficulties. The object of Fund surveillance is precisely to help countries overcome present political difficulties, and to foster an ambition that is stronger than the political consensus prevailing in a given country at a given time. Mission chiefs must be more than good economists: they must also be skillful political analysts and outstanding communicators. They must present the Fund's recommendations in such a way that they are seen as not only justified, but also desirable, and therefore politically feasible.

Mr. Padoan supported Mr. Kiekens's comments on the importance of regional surveillance. Although the Fund discussed regional surveillance in a number of occasions, such as on the euro area, it was not adequate. The staff should be encouraged to develop concrete proposals for operationalizing the conduct of regional surveillance and to extend it to other regions where inter-country trade and financial linkages were strong. In that context, a clear separation between program reviews and surveillance would be necessary.

Mr. Yakusha cautioned against the more systematic integration of political analysis as the Fund did not possess the necessary expertise. In addition, the Fund risked becoming part of the domestic political debate, which would not be conducive for maintaining a frank and open dialogue with the authorities. The major function of the Fund staff was still to provide professional economic advice, and it was the prerogative of the authorities whether or not to accept that advice. On the other hand, there was merit in Mr. Wei's proposal that the staff should more systematically describe the reasons of the authorities when they did not follow the Fund's advice.

Ms. Indrawati supported Mr. Kiekens's remarks on surveillance in program countries. It was important for surveillance in program countries to be more independent from program negotiations, so that the judgment regarding the focus, sequencing, and timing of the program would be sounder. Regarding the calibration of policy measures to reduce vulnerability, the policy advice that were earlier prescribed based on the prevailing circumstances would provide a good reference point for the staff to consider the next step of action in similar or differing situations. However, the proposal for an explicit rating of the country by the Fund as one of the incentives for sound policies was not appropriate as the Fund should not assume the role of a credit rating agency.

Mr. Reddy supported the comments by Mr. Yakusha and Mr. Wei on the need for the Fund to be cautious in undertaking greater political analysis. The Fund should be sensitive to, and be respectful of, the democratic process, as well as the role of the authorities in policymaking. The Fund should also avoid giving an impression that it was becoming a credit rating agency.

Mr. Zurbrügg observed that, while there appeared to be a general acknowledgment of the benefits of a more systematic political economy analysis, many Directors stressed the risks that that could lead to, depending on how it was implemented. Could the staff comment on how they would integrate political economy analysis in the surveillance context, so as to avoid the obvious risks that had been mentioned?

The Director of the Policy Development and Review Department (Mr. Geithner), in response to further questions and comments by Directors, made the following statement:

> I will summarize again what the staff sees as the agenda ahead and the next steps, so that Directors can see that they will have opportunities to come back and pursue in more detail some of the issues discussed today.
>
> First, the staff paper referred to a series of initiatives relevant to the analytical work in these areas. Principal among these is the review of the debt sustainability framework, which is scheduled to be discussed in June. This review also encompasses a variety of other issues that relate to the Fund's internal capacity to analyze risk and vulnerability more systematically, including the balance sheet approach. Second, we have the forthcoming review of transparency. Third, we expect to have a discussion with the Board in the coming months about a set of issues related to data provision to the Fund in the context of Article VIII, Section 5. Fourth, we have two areas related to some of the procedural issues on the independence of surveillance in program countries where internal operational guidance is under preparation. One relates directly to the issue of independence of surveillance in a program context. The other relates to the follow-up discussion on the prolonged use of Fund resources, where we want to put in place an internal mechanism for the more systematic use of ex post assessments, which will help in the forward planning of future programs in those cases. The staff will be happy to find a way to brief the Board on the review process itself and how it has evolved

recently. However, it would be preferable to wait to describe in detail the specific procedures within the PDR Department, and more generally, because they are hard to assess.

There are a number of issues that Directors have mentioned, which the staff needs to reflect on further before returning to the Board. I do not have any more to offer on the issue of how the Fund should balance the sensitivities when providing a political economy analysis. The Board will have a chance in the context of forthcoming discussions to find a balance that is appropriate.

On the issue of regional surveillance, the staff will try to do that more systematically in program discussions and surveillance. The staff will reflect on when it would be appropriate to give the Board a report on how the internal vulnerability exercise works and how we can make sure its conclusions are reflected not only in the context of the Informal Country Matters session, but also in the formal discussions on individual programs.

Mr. Tombini asked the staff to comment on the next steps for increasing the effectiveness of surveillance in advanced countries.

Mr. Brooke asked the staff to elaborate on the future work on further enhancing the independence of surveillance in program countries.

Mr. Kiekens clarified that, on the issue of surveillance in program countries, he did not favor having two separate staff mission teams for program discussion and surveillance. Rather, the responsibility for ensuring that surveillance was sufficiently independent from program discussions should rest with the PDR Department.

Ms. Jacklin asked management to comment on the steps taken to properly recognize and encourage the staff who were providing sound, clear, and candid assessments and advice, in an effective manner, in the surveillance process.

Mr. Andersen asked the staff whether there was room for making better use of the lessons learned from cross-country experiences at an earlier stage in the Article IV consultation process. It could be more fruitful for the discussions, and for providing a fresh perspective, if the authorities were provided with a list of the most valuable lessons learned for key policy issues that would be discussed during the consultation.

Mr. Kiekens stressed that a potential strength of the Fund was its good knowledge of policies in many countries. However, cross-country analysis was not sufficiently used by the staff, as observed by Mr. Duquesne and Mr. Padoan. The most convincing way to encourage the authorities to follow Fund advice was to present the policy recommendation in the context of other countries' experiences. Mr. Andersen gave a useful operational suggestion to provide the authorities with documentation of cross-country experiences, together with the questionnaire, in advance of the Article IV consultation. The Selected Issues papers that often accompanied Article IV staff reports should include cross-country experiences, so that

when a particular issue arose during an Article IV consultation, the staff could refer Directors to the relevant cross-country experiences that the Fund had documented over the past several years in that particular area.

The Chairman agreed that utilizing cross-country experiences more effectively in surveillance was important. The Fund often talked about globalization, but had not yet fully integrated cross-country experiences into its surveillance process. Mr. Kiekens made a good point on the importance of regional surveillance. The concept of peer review was relatively new in Latin America, for instance, but in Africa, it was a conceptual pillar in the New Partnership for Africa's Development. The Fund should also encourage peer review in regions.

Mr. Usman supported Mr. Tombini's comment on enhancing the effectiveness of surveillance in industrialized countries, particularly with regard to trade issues. Unlike staff reports on developing countries, trade policies were seldom included in the reports on industrial countries. The Fund should focus on industrial countries' trade policies, and analyze their impact on the growth of developing countries.

The Director of the Policy Development and Review Department (Mr. Geithner), in response to additional questions and comments by Directors, made the following statement:

> On the question of increasing focus on surveillance in the advanced countries, so as to analyze the externalities of their policies, including in the trade area, the staff tries to do so in the context of country surveillance, the WEMD, and the WEO. If we can find some procedural ways of giving that more force, we will do that. However, nothing currently stands between the staff and its capacity to achieve this objective. On assessing the externalities of the trade policies of industrial countries, the staff is trying to provide that not only in terms of general discussions of trade policy, but also in the context of individual country reports.
>
> On developing the next steps to enhance surveillance in program countries, I have described earlier the three opportunities for the staff to do so in the context of forthcoming Board discussions. I do not think it is appropriate at this stage for the staff to go into any more details. Integrating cross-country experiences more systematically into the surveillance exercise is, in many ways, the essence of what the staff is planning to do. Directors made a number of interesting suggestions on how the staff could do this better. If the internal process were to work ideally, before the mission brief, there would be an early effort involving departments to look at strategy, to reassess the broader diagnosis of the principal challenges the countries face, and to make sure that the effort is informed by relevant cross-country experiences. It is not sufficient for this process to be carried out early in a program context. The staff wants to make sure that, as events change, as conditions deteriorate, and as risks to program implementation increase, we

can also can bring to bear broader expertise across departments to ensure that we are thinking about alternative strategies and making good decisions.

Mr. Padoan remarked that the Fund was not the only institution that carried out surveillance exercises, especially on industrial countries—the OECD and the EU Commission also conducted such exercises. Given the fact that industrial countries were, more than emerging market countries, subjected to surveillance, could the staff comment on whether there was value in looking at comparative surveillance experiences by other institutions? The staff could then consider the question of why industrial countries seemed impervious not only to Fund surveillance, but also to surveillance in general.

The Director of the Policy Development and Review Department (Mr. Geithner) agreed that the staff could study the experiences of other institutions in conducting surveillance in industrial countries, so as to draw lessons that may be relevant for the Fund's surveillance.

The Chairman, in response to Ms. Jacklin's question, responded that management encouraged the staff to be candid and independent in providing assessments during the surveillance process. The staff should also be encouraged to express critical views without being intimidated by political considerations, not least from major shareholders, which often influenced the Fund's work at an early stage. Therefore, one counterweight against such political pressures was to encourage the staff to provide sound and candid assessments based on good economics.

The Chairman made the following summing up:

Executive Directors welcomed the opportunity to discuss possible avenues of further enhancing the effectiveness of Fund surveillance, given the central role of surveillance in the Fund's efforts to help prevent crises and achieve financial stability and high and sustainable growth throughout the membership. They revisited relevant conclusions of earlier reviews of surveillance, took stock of the range of initiatives already undertaken to strengthen surveillance, and discussed a number of areas where further work—going forward—would be helpful. While the views expressed by Directors on specific issues addressed in the staff paper were of a preliminary nature, they will certainly help shape the staff's future in-depth work on these issues.

Directors noted that past reviews point to five key ingredients of effective surveillance: timely, comprehensive and accurate information; focused, high quality analysis; openness to different perspectives to minimize the risk of "tunnel vision"; effective communication of assessments to the authorities and the public; and desired impact on members' policy decisions. They agreed that, building on the lessons learned from the Mexican and Asian crises of the 1990s, a range of steps has been taken in recent years to shape Fund surveillance to better meet these criteria.

Directors noted that efforts to strengthen surveillance and crisis prevention have covered a wide range of areas, although there is scope for further progress in virtually all of them. These include: improved data provision to the Fund and data dissemination to the public; more systematic financial sector surveillance—in particular, through the Financial Sector Assessment Program (FSAP); and strengthened assessments of policy frameworks and institutions against internationally recognized standards and codes. In addition, vulnerability assessments have been significantly strengthened, with better analyses of debt sustainability and capital account developments and more systematic consideration of market participants' perspectives. Surveillance in program countries is being strengthened by ensuring that economic conditions and policies are re-assessed from a fresh perspective. Going forward, greater attention will also be paid to ex post assessments of performance under Fund programs. Directors also underscored the important role of greater transparency, which enhances surveillance by increasing accountability, facilitating better risk assessment, and helping to mobilize support for policy actions.

Directors were generally of the view that the strengthened architecture of surveillance that has been put in place in recent years continues to provide a sound framework for the conduct of the Fund's surveillance activities. The first priority now is to take full advantage of the potential of the present framework by ensuring that progress with implementation is sustained—with support of technical assistance where needed—and that the various surveillance outputs are adequately linked. Regular reviews of the experience with the various initiatives will set the stage for further improvements as needed. Directors acknowledged that continued further enhancement of the effectiveness of surveillance will remain an ongoing challenge, and they identified a number of areas in which further work and reflection would be useful.

Calibration of policies to reduce vulnerabilities. Directors saw a continuing need to build on progress with vulnerability assessments by better calibrating the Fund's policy advice to measures that will help members reduce their vulnerability to external shocks. They supported the analytical work that is underway in this area, in particular on the shock absorbers needed to cope with temporary disruptions in access to international capital markets or with sudden capital outflows. The staff will also further explore the development of a well-defined set of criteria for sound policies to provide a more transparent and objective basis for the Fund's policy advice. Many Directors, however, saw considerable difficulty in developing such criteria without falling into a one-size-fits-all approach, and cautioned against allowing such criteria to transform Article IV consultations into a rating exercise. They also observed that this approach should apply to the whole membership as relevant.

Analysis of political factors. Further to their recent discussion on the prolonged use of Fund resources, Directors also had an exchange of views on the contribution that more systematic analysis of political factors influencing the ability to establish and maintain shock absorbers could make to enhancing the effectiveness of the Fund's policy advice. It was noted that fuller discussion in staff reports of available policy trade-offs and a description of why certain policy suggestions were not followed, could be one way of taking political economy issues into account. The merits of carefully building up experience in the area of political economy were recognized. Many Directors cautioned, however, that the staff has limited expertise in political analysis and that political economy considerations should not undermine the technical quality of its policy advice. Directors stressed that, in this area, the scope of the Fund's work, and the potential role of resident representatives, will need to be clearly spelled out.

Incentives for sound policies. Directors took note of various proposals that have been advanced to strengthen incentives to implement sound policies. This could be done in theory either by including more explicit, publicized ratings in the Fund's assessments of members' policies, or by further tightening the link between the quality of a country's present policies and access to Fund resources. Overall, there appears to be little interest in pursuing these specific proposals, and Directors underscored the complex issues that they would involve. Enhancing the incentives for the implementation of sound policies, nevertheless, remains a challenge for effective surveillance. A number of Directors considered that efforts in this area should be guided by the experience that sound policies, based on strong country ownership, pay off in terms of high quality growth.

Systemically or regionally important countries. Directors underscored the importance of effective surveillance of the policies of systemically or regionally important countries, given their potentially strong and widely felt externalities. While the Fund already pays increasingly close attention to the economic and financial spillovers from these countries, Directors did see scope for further efforts to raise the profile of these externalities in the Fund's bilateral, regional, and multilateral surveillance, including with respect to the global impact of the trade policies of the larger economies. Some Directors suggested the inclusion of a specific discussion on externalities in Article IV staff reports on relevant countries.

Cross-country experiences. Directors observed that the Fund's cross-country experience is one of its most valuable assets in its policy dialogue with member countries. They agreed that this asset should be used more fully to ensure that insights from cross-country studies and reviews of past experiences of Fund members are incorporated systematically into

surveillance, in particular at the early stages of the preparation process for Article IV consultations.

Candor and transparency. Today's discussion confirmed the high priority that Directors accord to candor and transparency as essential ingredients of an effective surveillance process. Given the potential tension between candor and transparency, Directors agreed that a key challenge, going forward, is to ensure that the candor of the presentation of the diagnosis and policy recommendations in surveillance reports is fully preserved, while at the same time making further sustained efforts to enhance the transparency of Fund surveillance. Directors noted that they would have a further opportunity to discuss these issues on the occasion of the forthcoming review of the Fund's transparency policy.

Surveillance in program countries. Directors supported the ongoing efforts to ensure that Article IV consultations in program countries involve an independent reassessment of economic conditions and policies, and present this fresh perspective at a time when it is most beneficial. Most Directors also welcomed a number of procedural steps that will further enhance the role of Article IV consultations in program countries, while maintaining the complementarities between surveillance and program activities, and looked forward to assessing the experience with these new arrangements on the occasion of the next review of Fund surveillance. Some Directors, however, suggested that early consideration be given to other steps that would further enhance the independence of surveillance, and asked for a detailed assessment of the pros and cons of greater operational separation between program and surveillance activities. It was suggested that a better understanding by the Board of the internal review process for surveillance reports could be useful in informing future discussions of this topic. Directors saw merit in a further examination of the role and conduct of surveillance in low-income program countries, in particular taking into account the important role that Poverty Reduction Strategy Papers play in framing these countries' policy agenda.

Most Directors generally considered that the present institutional framework of surveillance continues to serve its purpose well. Some Directors expressed interest in undertaking a review of the role of the Board in the surveillance process, particularly of its peer review function, and suggested that such a review be supported by an external assessment of the Board's role.

Directors stressed the importance of adequate assessments of *the effectiveness of surveillance.* Assessing the impact of surveillance raises, however, difficult methodological issues related to the establishment of either counterfactuals or a direct causal link between the Fund's policy recommendations and members' policy actions. In light of this, Directors considered that the various tools used in past reviews of surveillance, including assessments of the implementation of new policy initiatives,

selected country case studies, and surveys of interested parties, remain broadly appropriate. In this context, it was suggested that it would be useful to review the experience with IMF surveillance in situations where other institutions also play a role in monitoring a country's economic policies. Directors looked forward to gaining experience with the recent decision to include in Article IV staff reports more systematic coverage of the authorities' response to key policy challenges identified in past consultations, and to evaluating this measure at the time of the next biennial surveillance review. A few Directors suggested that further steps be explored to enhance the assessment of the effectiveness of surveillance.

Directors noted that several steps are already planned to move the policy agenda forward. These include the review of the framework for debt sustainability assessments; work on the feasibility and desirability of adapting the Contingent Credit Lines eligibility framework set out in SM/03/64 for possible use in surveillance; the review of progress on financial soundness indicators as well as a seminar discussion on the balance sheet approach to financial crises; the review of the Fund's transparency policy; and implementation of the conclusions of the review on prolonged use of Fund resources. Directors will also see the management's guidance note to staff on surveillance in program countries prior to the 2003 Annual Meetings. In addition, it will be helpful to have an informal Board discussion in the Fall of 2003 to help frame the biennial surveillance review planned for 2004. This will provide an opportunity to come back as needed to many of the issues discussed today.

3. INDONESIA—EXTENDED ARRANGEMENT—REVIEW, AND WAIVER OF PERFORMANCE CRITERION

Documents: Eighth Review Under the Extended Arrangement and Request for Waiver of Performance Criterion (EBS/03/35, 3/18/03; Sup. 1, 3/18/03; and Sup. 2, 3/27/03)

Staff: Citrin, APD; Schwartz, APD; Hadjimichael, PDR

Length: 2 hours, 25 minutes

Ms. Indrawati submitted the following statement:

Background

Indonesia has entered the fifth and the final year of the IMF program that began with the Asian crisis of 1997. As the last Asian country to graduate from an IMF program, there have been numerous opinions expressed in the press and even the government on the effectiveness of the program and the government response. The staff has portrayed the domestic political debate as one dominated by sentiment toward the current IMF program and its possible

conclusion, even before the end of the program. I believe this attitude should be viewed as a positive reflection of Indonesia's desire to take on full ownership of and responsibility for its own destiny, as well as increasing confidence in its ability to calculate and manage risks along the recovery path.

The staff's concern that support for reform will waver as we approach the 2004 General Election—although widely shared—is unfounded. Despite the political challenges of rapid democratic reform, and institutional constraints, significant and important progress has been and continues to be achieved. These achievements underline how strong the support for and commitment to reform are on the part of the government, the political parties and the people. The key problem is not the political will to reform but how to build democratic processes and institutional capacity into an improved policy-making process.

An important achievement has been the robust macroeconomic stability that has established the necessary condition for a further recovery. The country is now focusing more on microeconomic efficiency issues and improvement of the investment climate. Indonesia's economic history testifies to its ability to deliver respectable growth for a lengthy period and to significantly reduce poverty. With confidence, my authorities are making full efforts to reestablish the foundations for higher and better quality of growth and continue to reduce poverty, under an early stage of dynamic, challenging democratic political system and difficult geopolitical situation.

Macroeconomic Developments

Indonesia's economy during 2002 developed quite positively as indicated by many indicators. Economic growth in 2002 was 3.7 percent, an encouragingly higher than the previous review projection (3.2 percent). Some details of aggregate demand indicate that overall economic growth is still fragile and unbalanced. Consumption remains the main driving force, with its resilience owing to lower inflation and interest rates, and increased government routine spending. Investment and exports registered a serious downturn in the early part of 2002. Meager investment was evident in construction activities and FDI approvals. The situation has started to improve since QIV-2002 and continued in early-2003, as preliminary data from the Indonesia Investment Coordinating Board (BKPM) show a big jump. FDI approvals in the first two months of 2003 increased by 138.2 percent from last year, mainly in the areas of trade and services, and metal, machinery and electronic industry.

Inflation at the end of 2002 was 10 percent and in February 2003 was 7.3 percent (year on year), a significantly low level, given government forceful policy on subsidy reduction that led to an increase in energy prices. The low inflation rate is also commendable given mounting demand pressures

from last year's decision to increase official salaries by 19 percent and minimum wage by 30 percent, and increasing inflation expectations since QIII-2002 as well as seasonal pressures from religious festivities.

The Rupiah exchange rate in 2002 appreciated noticeably and exhibited greater stability compared to the previous year. Worries that October's Bali bomb tragedy would precipitate a sharp, sustained drop in the Rupiah proved ill founded. During 2002, the Rupiah appreciated on average by 10.1 percent or 16.5 percent (on a point-to-point basis) accompanied by less volatility, making the Rupiah the best performing currency in Asia, according to some media in Asia. Several factors were behind the appreciation of the Rupiah. First, fundamental improvements shifted the balance of payment deficit into surplus. Second, a positive sentiment driven by success in debt rescheduling, disbursements of the IMF loan, upgradings of Indonesia's debt rating by a few credit rating companies, and the implementation of privatization and the divestment of BCA and Bank Niaga. Finally, intervention by Bank Indonesia to reduce volatility also improved the stability of the Rupiah. A stronger Rupiah was also aided by the weakening of the U.S. dollar against the Japanese Yen, which benefited most currencies in the region, including the Indonesian Rupiah.

On the external side, Indonesia's overall balance of payments (BOP) improved, due to, among others, the success of the government and private sector in restructuring their foreign obligations. Other factors included higher capital inflows from privatization, government divestment programs, IBRA asset sales, and the issuance of foreign exchange bonds by a few private firms. Meanwhile, the performance of the trade balance did not match the performance of the capital balance. The value of non-oil/gas exports grew by only 1.2 percent and the value of oil/gas exports declined due to lower volumes of domestic oil production and increased fuel domestic consumption. Imports declined mainly in raw materials and capital goods, indicating continued frail domestic production and investment.

However, more recently Indonesia's external trade has shown strongly encouraging progress, as exports rose considerably in January 2003 by more than 20 percent to reach US$ 4.9 billion monthly revenue—the highest pace in more than two years. Non-oil exports as a measure of industrial activities also show a strong increase in January 2003 by 15.7 percent to US$3.7 billion. With these developments, gross official international reserves reached US$31.8 billion by the end of February 2003, equivalent to around 7 months of imports of goods and non-factor services.

Monetary Policy

From early 2002 through the first two months of 2003, the monetary situation has shown a positive development, with base money moving steadily below the targeted level. Improved inflationary prospects, controlled base

money and a stable and stronger exchange rate provided room for monetary policy to gradually and consistently lower interest rates while continuing to take into account the optimal level of real interest rate and foreign interest rate disparities. With ample liquidity and with lending activities of banks not yet restored, potential pressures on the Rupiah are still imminent, accentuated by a prone swing of market sentiment due especially to fluid geopolitical as well as domestic political situation. BI will maintain flexible but disciplined monetary policy with the objective of maintaining the momentum of recovery while facilitating the improvement of economic fundamentals and providing a consistent signal for markets. The policy on interest rate will be adjusted by taking into account the balance between risks and opportunities to facilitate a robust recovery.

Although this situation remains sub-optimal, banks have taken advantage of this positive monetary climate to restructure credits, to strengthen their capital base, and to expand short-term credit. Lower rates on bank deposits have pushed investors towards bonds and mutual funds. In the real sector, stable monetary conditions have provided an opportunity for the business community to restructure its internal finances and to support strong consumption. Lower interest rates have also encouraged reputable firms to seek alternative financing in the money markets, either domestic or abroad.

Fiscal Policy

Continued fiscal consolidation to ensure medium-term sustainability and bring the public debt burden to manageable level is the main thrust of fiscal policy. The realized fiscal deficit for 2002 is estimated at 1.6 percent of GDP, lower than the initial target of 2.5 percent. On the revenue side, taxes reached Rp.193.7 trillion, almost Rp.4 trillion above the projection at the previous review, owing mainly to the improvement of tax administration. The summary of the last review pointed out the concern of the Board on the ambitious revenue target for 2003. My authorities are continuously working to achieve tax revenue targets, and are fully confident that the targets are appropriately set. Overall revenue last year was 18.6 percent of GDP, slightly above the projection at the previous review.

The deficit is lower than expected, due mainly to low realizations on development spending as project loans have come in below expectations. However, routine spending was also below target even though domestic debt servicing exceeded the target, as domestic interest rates exceeded budget assumptions. Meanwhile, regional budget realizations were approximately on-target. Total overall spending was 20.3 percent of GDP, roughly the same as the budgetary target and the projection based on the previous review. With these levels of revenues and expenditures, the government debt to GDP ratio declined to 81.5 percent of GDP in December 2002.

As a result of the Paris Club III rescheduling in April 2002, Indonesia was granted principal and interest rescheduling amounting to US$5.4 billion in fiscal years 2002 and 2003. As a follow up, bilateral negotiations between the Government of Indonesia and Paris Club member countries are still continuing, with 12 bilateral agreements reached and the deadline for concluding agreements moved from February to March 2003.

Structural Reform—Banking and Corporate Restructuring

The banking sector improved in 2002 to the point where its overall condition is now reasonably favorable. Performance improvements are mainly observed in banks' strengthened capital structure, lower NPLs, and higher profitability. The improved capital structure was evidenced by the increase in average CAR from 20.5 percent at the end of 2001 to 22.5 percent at the end of 2002. Meanwhile, NPLs declined from 12.1 percent at the end of 2001 to 8.1 percent at the end of 2002. Lower interest rates as well as ample liquidity encouraged banks to be increasingly active in financing economic activity. New credit extended by banks during 2002 was up 39.7 percent over 2001. In line with this, the proportion of bank earnings accounted for by credits rose significantly.

The government is committed to continuing divesting banks under government ownership to restore private sector participation in the economy, while remaining vigilant of financial sector conditions. Efforts are currently focused on the sale of the majority stake in Bank Danamon now in an advanced stage, followed by Bank Lippo, Bank Permata, and State Owned Banks such as Bank Mandiri.

With respect to asset recovery from former bank assets, IBRA was able to reach its 2002 target and has set an ambitious target for 2003. This will require stepped-up efforts in loan restructuring and disposal, as loans represent the bulk of IBRA assets. With regard to the disposal of assets pledged by former bank owners through settlement agreements, IBRA is committed to maximizing the recovery for the government from these pledged assets.

Despite a weakening worldwide and regional investors' appetite my authorities maintain a strong commitment to privatization and divestment. One example of the strong commitment of the government is the case of Indosat, Indonesia Satellite Company. Although there was a heated public debate regarding the appropriateness of the privatization, my authorities maintain the agreed plan to sell the company. My authorities recognize that it needs hard work and convincing actions to attract and win over potential investors to sustain the recovery process. Equally important to domestic political support is a well defined privatization strategy, including improved transparency and credibility, and effective communication and explanation of

the rationale and objectives to the public. My authorities have also made a serious effort to gain political support to conclude legal agreements with bank shareholders, including initiating legal action for non-compliant shareholders and commissioners.

The Blanket Guarantee program, introduced in 1998, has successfully maintained public confidence in the banking industry, and third-party fund grew by more than 30 percent during the period 1998–2002, or to 75 percent of total banking assets. However, this program has imposed a great burden on the government's budget and created moral hazard. To this end, a more effective and efficient guarantee program is needed. In accordance with Banking Act No. 10/1998, a working committee, consisting of representatives from the Ministry of Finance, BI, and IBRA, has been established. The team, in the short run, is focusing on formulating a scheme to gradually reduce the guarantee coverage from unlimited liabilities to limited deposits. The implementation of this program will take into consideration the current banking condition in order to avoid any counter-productive impact (e.g., deterioration of public confidence). Meanwhile, the longer-run focus is to prepare for the establishment of a Deposit Insurance Institution, including research on the new guarantee scheme and coverage.

In addition, BI has developed a Master Plan for Improving the Effectiveness of Banking Supervision, to improve regulations and bank supervision to comply with the 25 Basel Core Principles (BCP). The regulation will be passed in mid-2003 and take effect in mid-2004, thus providing banks with spacious time to be prepared. During the transitory period, banks are required to submit trial reports so as to assist banks to be well adapted to this new regulation.

Fuel Subsidy

In 2002, my authorities successfully reduced fuel subsidies by increasing prices. The policy was consulted with both Parliament and the public via various campaigns and communications. The consultations were conducted to convince people that subsidies are misdirected and cancel out the opportunity to spend the scarce and valuable resource on more important and equitable items; and the importance of moving away from poorly designed price subsidies to better targeted interventions. As a result, the fuel subsidy expenditure, which reached an amount of Rp.52 trillion in 2001, was reduced to Rp.31 trillion in 2002 and only Rp.13.7 trillion is budgeted this year.

However, the unfavorable domestic as well as international political environment created a serious backlash when fuel prices rose in January 2003. The risk of social unrest was threatening the economic recovery and prompted the government to agree with Parliament to reduce the planned increase, and to protect people against the currently high international fuel prices. The decision will not affect the initial budget deficit target of 1.8 percent of GDP,

nor create any major change in other budgetary items. The additional subsidy will be absorbed out of higher net oil revenue. As world oil prices return to a more normal level, the buffering mechanism will be phased out naturally and the domestic fuel price with formula linked to world price will be reinstated.

Decentralization

Progress in the area of decentralization is also promising. By completing the reporting of almost all regional government budgets, we should be able to improve our understanding and monitoring of the use of regional government resources. The central government is also continuing the dialogue to improve and expedite on-lending and local regulatory regimes and procurement processes in order to improve absorption capacity as well as accountability of the local government finances. We continue to work to reduce regional barriers to trade and investment and have an initiative to introduce and improve a rating system, which will allow regional governments to assess their performance against their peers.

Legal and Judicial Reforms

Progress has also been made in legal and judicial reforms. The Anti-Corruption Law was passed before the end of 2002, and the Wealth Commissions has functioned well in a non-coercive role and should become an effective component of the Anti-Corruption Committee, which will have enhanced investigatory power. Indonesia has also passed an Anti-Money Laundering Bill and appointed key officials, and is finalizing the establishment of a Financial Transactions Reporting and Analysis Unit. Combined with the recently passed Anti-Terrorism Law, my authorities believe that Indonesia is well equipped with powerful new tools to combat terrorism.

Indonesia has also recently passed the new Labor Law, which will annul the former repressive labor policy that legalized exploitation of workers under law No. 25/1997. The new law is also correcting the controversial Labor Regulation No.150/2000 on severance. The new law strikes a good balance between protecting basic workers' rights and creating a favorable investment climate.

The 2003 Program

Taking into account a worsening geopolitical situation as well as domestic challenges, the prospects for overall economic growth in 2003 remain better than the previous year. Stable macroeconomic conditions are expected to continue this year, which would improve business sentiment and bank intermediation. Simultaneously, development spending should increase and several large projects restart (delayed early on during the financial crisis). This should assist us in our effort to sustain growth.

The Indonesian government has inaugurated the year 2003 as "The Investment Year", which will mobilize concerted national efforts to focus on "what and how" to improve and to establish a competitive investment environment comparable with other emerging countries in the region by liberalizing investment policy and providing incentives. A new investment bill, which was submitted to Parliament in February and will replace the existing laws on foreign and domestic investment, seeks to open all sectors of the economy to foreign investors, minimize the negative investment list, and establishes a centralized one-stop service center for speeding up investment license procedures. The recently announced tax reform package represents a down payment on an investment promotion agenda. The tax measures were designed to offset the rising input prices as a result of the fuel subsidy reduction by eliminating and reducing luxury taxes on electronics, telephones, appliances, and beverages. The second measure is designed to reduce costs and administrative burdens for labor-intensive industries by taking over income tax liability at the minimum wage. Other measures to improve the investment climate are speeding up the rebate of value added taxes and increasing the number of sectors that qualify for expedited treatment for imports or for the gold card program. These programs should reduce costs and administrative overheads for exporters.

Although improvement is taking place, the scope of the economic recovery is still limited. In such a condition, economic growth in 2003 is expected to be in the range of 3.5–4.0 percent. From the demand side, this growth is projected to still be consumption driven. By sector, all economic sectors are expected to experience positive growth, with electricity, transportation (mainly the telecommunications sub-sector), and construction recording the strongest performance as investments in infrastructure are encouraged and start to develop.

On the fiscal side, the 2003 state budget aimed at controlling the deficit while taking into account the negative impact of the Bali incident by accommodating a strong public interest in the fiscal stimulus. The budget deficit is forecast to be 1.8 percent of GDP, virtually unchanged from the preliminary realization in 2002. The 2003 deficit target would be achieved through a continued increase in budget revenues (mainly tax collections), belt-tightening (largely cuts in oil/gas subsidies), and lower domestic debt servicing. My authorities will continue to focus on priority spending, mainly those with social and poverty reduction impact, such as health, education, agriculture, and infrastructure. On the financing side, government financing still originated in domestic non-bank sources—such as privatization and IBRA assets sales—with the balance supplied by foreign borrowings. However, since the net contribution from these sources is small relative to overall needs, the government plans—for the first time since the 1997 crisis—to use government previous savings in the monetary system ("Sisa Anggaran Lebih"; SAL) in the amount of Rp. 8.5 trillion.

In general, the exchange rate is forecast to remain strong in 2003, although it would not strengthen as sharply as in 2002. Inflationary pressures in 2003 are forecast to ease from 2002. There would be limited pressures from aggregate demand, a stronger exchange rate, and lower inflation expectations. One source of inflationary pressure would be the impact of an increase in administered prices and adjustment of income policies, which are estimated to remain substantial, although lower than in 2002.

My authorities will continue implementing vigorously the financial reform program to conclude the process of building sound financial safety nets. The blanket guarantee for the domestic banking system is gradually replaced in a well and careful plan with a Deposit Insurance Institution. We are also working on the transition to an integrated financial oversight body to ensure that future investments in Indonesia are secure, safe, and efficient. The equity and bond markets are going to play a more important and critical role in financing both private and public investments than they did in the past. Indonesia needs a comprehensive approach that treats different but competitive sources of financing in comparable ways.

Concluding Remarks

The excursion for the economic recovery has not always gone smoothly. A key problem has been the magnitude of the reform agenda and the limited time, resources, and institutional capacity to execute and undertake the program. The sheer complexity and number of issues have often distracted rather than focused the nation's attention. My authorities are fully committed to the continuance of reform in order to better prepare the country to face the escalating future uncertainties emanating from both complex geopolitical situation as well as fragile domestic political conditions. My authorities remain vigilant about any possible future developments and continue examining many different scenarios in order to be able to graduate from the IMF program strongly and smoothly. My authorities wish to express their sincere appreciation to the Executive Board, management, and the staff for the strong support for Indonesia as it works to regain a sustainable growth path and promote socioeconomic development. Our previous and current efforts and achievements will further cement the progress being made in returning Indonesia to its high economic growth path. The approval by the Executive Board of our eighth program review and of our request for a waiver of the nonobservance of the end-December PC on the BLBI burden-sharing agreement will bolster our efforts and accelerate the execution of reform measures to regain market confidence to Indonesia

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

Following the financial crisis and sharp contraction in economic activity in the late 1990s, Indonesia has in the past three years witnessed steady real GDP growth, and a restoration of macroeconomic stability as reflected in a gradual decline in inflation, a strengthening of the exchange rate, a buildup of international reserves, and a continual improvement in indicators of banking sector soundness. However, real GDP recovery was driven largely by private consumption growth, while the share of private investment in GDP remains well below pre-crisis levels. The increasing confidence generated by the continued pursuit of reform policies should contribute to a pick-up in investment.

A solid revival in private investment is currently a major objective to be achieved through key structural reform measures planned for this final year of the EFF arrangement. These consist of steps to accelerate financial sector reforms, improvements in the judicial and legal framework, facilitation of labor relations, and a strengthening of public sector governance. Performance under the EFF has thus far been good, notwithstanding the non-observance of a structural performance criterion on the BLBI liquidity credit issue, which is expected to be resolved soon.

The staff points to risks of a slowdown in policy implementation as the period of elections is approached, as already manifested in a recent temporary policy slippage on the fiscal front. In this context, we are reassured by the authorities' strong commitment to reform as conveyed in Ms. Indrawati's excellent preliminary statement. Ms. Indrawati also makes the important point, which is very well taken, that the major remaining challenge in Indonesia is not building political will but strengthening institutional capacity and the policy making process. In view of the authorities' commendable performance and commitment to a bold structural reform agenda, we support the completion of the eighth review. The remainder of our comments focuses on a few issues in the fiscal and financial sector areas.

In the fiscal area, we are reassured by the strong performance in 2002, as reflected in the better-than-expected outturn for the budget deficit, partly due to a pick-up in non-oil tax collection (notably in VAT and excise taxes) due to improvements in tax administration. We are also encouraged by the authorities' intent for 2003 to modernize the tax system, improve public expenditure management and take measures to strengthen the decentralization process.

We are reassured by the authorities' indication that the tax and tariff relief measures introduced earlier this year are temporary. It is important to recognize the importance of not letting these measures persist for too long, for several reasons. First, while we understand from the staff that the measures can be accommodated in this year's fiscal envelope partly due to higher-than-expected oil prices, they could deprive the budget of a contingency cushion

which could well prove necessary given the rather optimistic revenue projections and the downside risks stemming from the war in the Middle East and other global weaknesses. Such a cushion would be especially important given that the already compressed expenditures cannot be easily cut below the 2003 budget levels without reducing priority social and capital expenditures. Second, the measures could prove increasingly difficult to redress as we approach the period of 2004 elections, and it is important not to carry them over for too long given the authorities' objective of precluding recourse to exceptional financing starting next year, and reducing the pace of public debt reduction necessary to ensure fiscal sustainability. Third, some of the measures aimed at protecting certain groups or economic sectors, such as the reinstatement of the VAT exemption on capital goods, tend to induce economic distortions and inefficiency, in contrast to well-targeted subsidies. Fourth, the reversals in tax and tariff reforms could weaken the private sector's confidence in the stability of investment incentives, and could more generally send the wrong signals regarding the vulnerability of the authorities' reform agenda to political pressures.

With regard to financial sector reforms, while we are encouraged by the improvement in indicators of banking sector soundness for 2002, we share the staff's concern on the still-low share in GDP of bank credit to the private sector, and the high share of recapitalization bonds in banking system assets. Given the slow progress in strengthening the governance of state banks over the past year, we very much welcome the steps envisaged to enhance prudential oversight of these banks' activities as well as their operations' transparency and accountability, in preparation for their restructuring and divestment. We also welcome the measures taken to strengthen the financial sector safety net, and we concur with the staff that the blanket deposit guarantee should be removed only gradually, in line with the recovery of the banking system's health and the implementation of key elements of the safety net. High priority should also be placed on the passage of amendments to the BI Law to improve the oversight and transparency of the central bank while preserving its independence, in line with the recommendations of the independent panel of experts published in April 2001.

On an important reform measure in the banking area, we are encouraged by the significant progress made toward the resolution of the BLBI liquidity credit issue, notably through an informal agreement between the BI and the government, pending further discussion and approval by Parliament. While we agree with the staff that a further rescheduling of the performance criterion could be counterproductive insofar as it could appear as a pressure on Parliament to conclude quickly, it is nevertheless important that a high priority be placed, in the reform agenda, on the formal approval of the agreement. We take note of the staff's view that the financial operations between the budget and the central bank are, thus far, in effect being conducted on the basis of the agreement, thus precluding an immediate

macroeconomic impact from the delay in implementation. However, as long as the agreement is not finalized and its provisions made legally binding on all parties, including through the issuance of a promissory note with non-negotiable terms to replace the BLBI bonds, there will remain some uncertainty within the private sector on the significance of those bonds for the financial health of the BI and its ability to withstand exceptional losses. Resolving this uncertainty, and minimizing the likelihood of re-emergence of coordination problems between the two institutions, is particularly important at a time when the authorities are striving to boost private sector confidence in the robustness of the financial sector and stability of the underlying policy framework.

In closing, we congratulate the authorities once again on their strong performance and wish them continued success in their endeavors.

Mr. Padoan submitted the following statement:

In addition to considering the status of program implementation, this review introduces the issue of the "exit strategy" the authorities wish to pursue as this program approaches its completion by the end of the year. The current assessment of the program should be put in this perspective and the staff report does a good job in providing the Board with all the elements of the assessment. We also thank Ms. Indrawati for her very informative and frank preliminary statement.

The intention to exit from the Fund program requires even stronger program implementation:

That a country is ready to exit from a Fund-supported program should always be welcome news if this signals that the economy is reaching a sufficient degree of resilience and robustness. It would be a source of concern if exit from a Fund program were motivated by reform fatigue and by dissatisfaction with the relationship with the Fund. We are comforted to learn that the authorities intend to exit from the program strongly and smoothly.

As the staff report indicates, Indonesia has been making good progress over the recent past both in terms of economic performance and policy implementation. There remains, however, an unfinished reform agenda. This suggests that a successful exit out of the Fund program will be achieved to the extent that the reform agenda is indeed completed. Elections in 2004 leave limited room for maneuver to implement the agenda, especially given the problems that authorities have faced in the past in securing sufficient social and political consensus for the implementation of the program. In this respect we concur with Ms. Indrawati that a better communication policy would add to the chances of success.

Recourse to domestic financing is welcome, but it requires strong financial institutions and confidence building:

The staff report also indicates that the authorities intend to meet the 2004 financing needs without recourse to exceptional financing. The authorities indicate their intention to tap the domestic market through a variety of ways, including the issuance of domestic bonds and drawing down deposits at BI. We welcome a strategy that relies on domestic savings to meet the financing needs of the country, and looking at aggregate savings one could conclude that the needed amount of resources is available. Obviously, such a strategy requires other ingredients: a sound and diversified financial system and enough confidence to attract investors, including foreign investors. This, in turn, requires a strong reform effort now before the program expires. In addition, such a strategy should not be implemented at the cost of increasing vulnerabilities elsewhere in the system. Staff comments on this aspect would be welcome.

Debt Sustainability Requires Strong Export Growth

Debt sustainability is encouraging as it shows that the debt-to-GDP ratio should remain on a declining path and that the path remains under control even in stress-test cases. However external debt remains comparatively high and the positive outlook to materialize requires exchange rate stability and buoyant export and investment growth. We would like the staff to elaborate however on the possible risks to export growth following the appreciation of the rupiah.

Conclusion

Improved macroeconomic performance is welcome but it should not be taken as an excuse for delaying essential structural reforms as the election period approaches. We support the proposed decisions and wish authorities success.

Mr. Mirakhor submitted the following statement:

We thank the staff for the excellent report and Ms. Indrawati for her informative and comprehensive statement. Indonesia has made a remarkable recovery from the 1997–99 crisis through implementation of prudent macroeconomic policies and structural reforms under successive Fund-supported programs. In the last three years, real GDP rebounded while inflation was contained. The external position also strengthened, which is reflected in a steady build up of reserves and reduced vulnerabilities. While these achievements are impressive, many challenges remain. Indonesia has the potential to achieve higher levels of growth and to attain a faster pace in employment creation and poverty reduction. While real GDP growth has

recovered to pre-crisis levels, it remains below the regional average. Near-term outlook for domestic and foreign investment needs to improve to allow faster growth. Over the medium term, growth is expected to pick up; however, this will depend crucially on promoting an environment conducive to private sector activity and investment. By focusing on advancing reforms and strengthening the investment climate, the 2003 program is appropriately ambitious and geared to fostering growth. We agree with the thrust of the staff appraisal and support the proposed decision.

As underscored by Ms. Indrawati, fiscal consolidation is the key to maintaining macroeconomic stability and achieving debt sustainability over the medium term. We welcome the authorities' efforts to strengthen tax administration, bolster revenue, and seek efficiency in tax policy, while ensuring protection for the disadvantaged through appropriate social safety nets. On the expenditure side, commendable initiatives are contemplated to reinforce controls, including plans to restructure budget preparation and strengthen the government payment and receipts system. The intention to reinforce fiscal control at the decentralized levels of government is welcome. Also noteworthy are initiatives to improve fiscal transparency, including through routine auditing of government agencies and consolidating off-budget funds.

With inflation on target and the rupiah stable, the recent easing of monetary policy has been an appropriate stimulus to the economy. It is important, however, to remain vigilant and to ensure that monetary policy is ready to counter any potential fiscal pressures. While the exchange rate appears appropriate—contributing to a strong current account position—it should be closely monitored to preserve Indonesia's external competitiveness. Although the health of the financial system continues to improve, much remains to be done to restore it to full vitality. Banks' restructuring and divestment need to be accelerated, while strengthening governance of those that remain under state control. The planned financial sector safety net initiatives, including the deposit insurance and the independent supervisory agencies, are steps in the right direction. The authorities need to ensure appropriate sequencing of actions to guarantee smooth transition. The reforms of Bank Indonesia—including by improving oversight and responsibility, safeguarding independence, and divesting overseas subsidiaries—should enhance its operational efficiency.

Progress made in key areas of the structural reform—including privatization, IBRA asset recoveries, and the anti-corruption drive—promise to boost private sector activity and investment. It is encouraging to note from Ms. Indrawati's statement that the authorities will maintain the reform momentum in the remaining areas in the pre-election period. Corporate debt is being successfully restructured and corporate financial health has generally improved. It is important to reduce vulnerability to exchange rate risk in the

sizable foreign currency debt, and to ensure that corporate recovery is not threatened by constrained access to new financing. Further improvement of corporate financial health will be critical in attracting bank financing and engendering investor interest. The authorities' commitment to a liberal trade regime is commendable. Strengthening the legal and labor relations framework, including conclusion of the strategy for modernizing labor relations, should remove lingering uncertainties and allay investor concerns.

Over the medium term, the external position is expected to remain strong with large current account surpluses and a comfortable cushion of reserves providing adequate cover for imports and short-term debt. The debt dynamics appear favorable and external vulnerability is set to decline. It is particularly significant that the debt ratios remain robust in the face of macroeconomic shocks. The high concessionality of Indonesia's debt and the low proportion of short-term debt will allow keeping debt service at 20 percent of government revenue over the next five years. While this is considered "manageable," it may not be optimal; Indonesia could use part of this revenue to increase investment and social spending. This underscores the need for a strong fiscal effort and prudent debt management to reduce the debt service burden. Furthermore, in Box 20, the staff rightly points out the importance of exchange rate stability, export growth, and investment flows for the debt dynamics, calling for reinforcement of policies to address key issues.

The authorities' commitment to the program is likely to be tested by the impending elections. Ms. Indrawati's statement reassures that they remain steadfast and will avoid undue policy reversals that would undermine the integrity of the program and investor confidence. We agree that a vigorous public education will be helpful in explaining the authorities' policy agenda and its long-term benefits, thereby enhancing the prospects for its acceptance.

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

Indonesia is entering its final year of the EFF arrangement. The sentiment is widespread within the country that this should be the last program and the end to Indonesia' continuous engagement with the Fund over the past five years. This sentiment as well as criticism towards the Fund is strong and growing. While the Fund's reaction to all this may be the one of discontent and disappointment, it is imperative to examine a few issues that may explain such sentiment. Before commenting on the details of the current review, we will briefly address a few broader issues relating to this sentiment and the success of Fund programs in Indonesia.

The Sentiment

It is not unusual that the society reacts rather negatively to the painful reforms that are needed for the country's revival from a devastating economic

and financial crisis. And since these reforms frequently constitute the core of the Fund's programs in such countries, it is not surprising that the Fund becomes the enemy. Although it may be true that in the first months of the crisis the Fund prescribed some measures that were not very conducive to the economic recovery, this has been widely discussed and lessons have been learned. Why then such an intensification of the hostility as the third program approaches completion? The most probable answer is that the majority of Indonesian people have not seen the benefits of the prescribed reforms as poverty and unemployment levels continue to increase, government's inefficiency remains high, and corruption still widespread.

The Success of Fund Programs

Indonesia's programs with the Fund focused on achieving a combination of macroeconomic stability and a strengthened structural framework. The performance under these programs varied. While the macroeconomic stability has been more or less achieved recently, structural reform agenda is far from being completed. Whereas many structural reforms have taken place, they were obviously not enough to arrest the aforementioned problems as well as a continuing slump in domestic and foreign investment.

The Fund can do only so much in encouraging the country to proceed with the necessary reforms. In this vein, it is hard to argue that the conditionality under the program has been weak. On the contrary, it has been strong and at times even excessive. At the same time, the practice of constantly granting waivers and postponing the completion of important structural reforms has definitely dented the overall strength and success of the program. Thus, while the Fund has been more or less accommodative to the pace with which the authorities had undertaken the reforms, in the end, it was the authorities' lack of a full ownership of the programs that led to a lackluster reform effort. Political game playing and the influence of vested interests have taken their toll on the success of the programs.

Continuation of the Relationship

It is our view that Indonesia should extend its program relationship with the Fund for the next year, perhaps, on a precautionary basis if other sources of financing are secured. We see previous programs as being the main driving force for reforms in the country. It would be unfortunate if reforms were let to stagnate, especially at the time of electoral pressures and significant external risks. Another point to consider for the Indonesian government is the role of the Fund program in catalyzing donor support and external debt rescheduling by the official creditors, both necessary for maintaining the country's sustainable debt position. Finally, not least because Indonesia is one of the Fund's largest borrowers, it is essential for the Fund to stay closely evolved in the country. While post-program monitoring will allow

for such involvement, we would also encourage the staff to stay engaged with the civil society and parliamentarians on the issues related to the current program and on the necessary reforms in general. The need for such involvement is especially obvious since, according to the observers, the authorities' policy agenda is not well understood by the public. At the same time, the authorities need to exert greater effort in improving the public's awareness.

Eighth Review under the Program: Macroeconomy

Macroeconomic stability has been more or less achieved, although substantial risks remain to the short and medium-term outlooks. Growth outlook is sensitive to global growth outcome, consumption and exports performance, and tight domestic fiscal conditions. Inflation targets could be jeopardized by the planned tariff increases, and debt service requirements and principal amortization remain high.

Fiscal objectives for 2003 could prove overly ambitious in light of the optimistic macroeconomic assumptions, mostly regarding growth. While fiscal accounts performed according to expectations in 2002, lags in the implementation of development projects persisted. On the revenue side, we would be interested in hearing the staff's elaboration on the reasons for the decrease in revenue-to-GDP ratios in 2002 and 2003 (comparing to two previous years), at the time when the output growth has been increasing and gains from the improved tax administration are expected to materialize.

Backtracking on the decision to continue a gradual increase in several tariffs and a decrease in subsidies is unfortunate, to say the least. Usually we are sympathetic to the discontent of the poorest groups of the population with tariff increases. However, such discontent may have been avoided had the government done its best in explaining and justifying its decision. While we take note of Ms. Indrawati's account of the events and government's efforts to prevent this from happening, we still believe that the government was unsuccessful in communicating well the fact that low prices were benefiting the wealthy and that the subsidies were poorly targeted. Unfortunately, political rather than economic considerations again have played a more important role in scaling back tariff increases, as fuel price hikes have an inflammatory history in Indonesia. We urge the authorities to resume their original schedule of tariff increases as soon as possible while securing a well-targeted distribution of subsidies to the poor. Savings from the reduction of fuel subsidies should be channeled to a targeted program of assistance to the poor. Increases in telephone and electricity tariffs are not only necessary to lessen the budgetary burden, but also to attract much needed investment in these sectors.

We agree with the staff that granting of VAT exemptions on capital goods was not a proper decision not only from a fiscal point of view, but also because it created a precedent that could lead to further exemptions. While we understand business' dissatisfaction with the inefficiencies of the VAT refund system, would it not have been more prudent to reduce these inefficiencies rather than grant exemptions? We urge the authorities to reconsider this decision.

In the past, this Chair has been very supportive of the commencement of fiscal decentralization in Indonesia. While initial progress has been good, recently there appear to be more and more problems emerging in the implementation of this framework. This is a serious concern in a country that is struggling to put itself on a strong financial footing. Along with previously recognized problems like excessive local taxation, there are reports about imprudent local spending, overregulation and a reduction in the quality of services provided by local governments. We wonder if enough is being done to strengthen the decentralization framework. We regret that the benchmark on the quarterly reporting on local government finances has not been met in full.

Microeconomy

Business and investment climate continues to deteriorate. This is evident by the plunge in the FDI and domestic investment, the fall in demand for capital goods imports and an exodus of high caliber multinationals from the country. The problems surrounding the investment climate are well known and efforts have been made to address them. Unfortunately, they have not been very successful. To tackle the problems in this area the government is planning to establish a National Investment Team and to introduce a new investment law. While this is encouraging, this may not be effective, as similar initiatives have been tried before. What seems necessary is to implement in full the existing laws and address governance and inefficiency problems within the government. We note that new tax incentives for business have been introduced in the recent budget. Besides the aforementioned controversy with the VAT exemptions, how does the staff rate other tax incentives? Are they helpful pro-business initiatives or just another example of favoritism towards several industries? The World Bank, as well as donors, apparently are not supportive of these initiatives.

IBRA's cash recoveries have exceeded the target. While this is good news, many questions remain regarding this process. Since market sentiment has not improved much, the obvious question is who is buying these deeply discounted assets and with what purpose? There have been reports alleging that major debtors (like the Salim group) have been illegally buying back many of the assets that they pledged to the government. There are also reports that assets pledged by the cooperating shareholders are worth less than the

amount of obligations and that the government will likely be unable to recover the shortfall. We would welcome the staff comments on this. At any rate, further divestment of assets by IBRA is far from being guaranteed since the best assets have already been sold. While IBRA continues to recover its costs, the recovery rate still remains too low and the process is not as transparent as it should be, which is quite unfortunate for the Indonesian taxpayers.

While privatization targets have been exceeded, a large number of entities have not been privatized. The privatization of Indostat has raised questions about transparency, since the speed with which the authorities were trying to complete the sale before the year-end did not allow for proper disclosure. This discontent, however, may have been politically motivated. We trust that the staff would have raised this issue if such concerns were present. The privatization agenda is ambitious for the next year given weak market conditions and persistent delays in the implementation of the sales program last year. We wish the authorities success with realizing it this year.

The privatization program includes the divestment of seven banks in 2003. This would be a very important step in revitalizing the banking sector. Improvement in monitoring and accountability of the remaining state banks is essential for this sector's revival as well. It is encouraging that the authorities are advancing their plans to establish a Deposit Insurance Agency. We note that this agency will be responsible for bank closures. We wonder if this is a common practice in other countries and whether this will not interfere with the mandates of other supervisory bodies, such as the soon to be established Financial Supervisory Agency. In this regard, the transfer of the supervisory powers from the BI to the new agency should be done with extra care, so that to ensure a smooth transition. Finally, the deliberations on the amendments to the BI law are taking too long, which is unfortunate, given their importance in improving oversight and accountability of the central bank.

We very much welcome the audits undertaken in public companies, as they have helped to prevent some significant losses. We encourage further such audits, especially since they are below the benchmark. We would ask the World Bank the staff to elaborate on what seems to be a brewing crisis in the forest industry, where illegal logging is said to be out of control. In addition, the problems with highly indebted companies in this sector are stirring controversy regarding the appropriate actions to be taken against them, i.e. liquidation vs. debt forgiveness. Apparently the donors are very concerned about the costs to the taxpayers in case these debts are written off.

The need for the reforms in the legal area is as urgent as ever given the persisting weakening of the investment climate. While we are encouraged by the authorities' agenda, we would seek the staff's views on the ambitiousness and limitations of the proposed reforms and the degree of their potential impact on the investment climate. Are these reforms significant enough to

help reverse the sour sentiment? We do welcome the soon to be operational ACC, but we are apprehensive about its true political independence.

We support the review and the request for a waiver.
Mr. Callaghan submitted the following statement:

Key Points

The authorities have made good progress with regard to macroeconomic stabilization, as demonstrated by the resilience of the economy in the wake of the Bali bombings.

While structural reform has lagged the improvement in macroeconomic indicators, progress has been made since the last review. The report rightly emphasizes that there remains a very large unfinished reform agenda.

A key concern is the continuing depressed state of private investment. Further progress on structural reform, along with an improvement in the security environment, is necessary to improve investment sentiment, which, in turn, is needed for a sustainable boost in economic growth.

The authorities' desire to graduate from Fund support at the end of this year is commendable, but ambitious. To meet this objective will require determination and strong leadership in an increasingly difficult policy making environment.

This is a good, balanced the staff report. It sets out the significant achievements of the authorities but is realistic about the substantial challenges that remain.

The arrangement with the Fund has been successful in helping Indonesia with the process of implementing needed economic reforms. But it is very much "work in progress". The authorities have indicated that they wish to graduate from exceptional financing when this arrangement expires. That is obviously their decision and we should applaud their pursuit of a defined exit strategy. To achieve this goal, the challenge the authorities face over the remainder of this year and in the future is to capitalize on the progress to date by maintaining macroeconomic stability and advancing the structural reform agenda.

We sincerely hope that Ms. Indrawati is right that the commitment to reform on the part of the government, the political parties, and the people is such that there will be no weakening in the reform effort as the 2004 election approaches. It will be a major challenge to ensure that the reform momentum does not slow and that setbacks are overcome. The Fund will need to continue to play an important role in assisting Indonesia meet these challenges and, in

the uncertain world we live in, it will be important that the authorities do not "close any doors".

Macroeconomic Achievements

The authorities have made good progress over the life of the program, particularly with regard to macroeconomic stabilization. Last year was the third successive year of steady growth in GDP—4.9 percent in 2000, 3.3 percent in 2001, and 3.7 percent in 2002. Considerable progress has been made towards achieving fiscal sustainability, with the budget deficit to GDP ratio declining from 3.7 percent in 2001 to 1.6 percent in 2002. This outcome is probably better than many would have predicted a few years ago, given the tumultuous events that have taken place in Indonesia during this period.

Looking ahead, the solid performance of the past few years provides grounds for confidence in the Government's ability to achieve its deficit targets of 1.8 percent of GDP in 2003 and 1.0 percent or less in 2005. The rupiah appreciated by approximately 16 percent in 2002, and has remained relatively stable over the past six months. Reflecting these developments, public debt sustainability has improved considerably.

Inflation has also continued to moderate, but the staff is right to caution that further reductions in interest rates would only be warranted if inflation continues to decline In fact, we wonder whether this is an area where greater ambition may be appropriate. When considered in the context of many Asian competitor countries experiencing much lower inflation, the inflation targets appear to be on the high side.

The benefits of the authorities' efforts have been evident in recent developments. As the staff note, the economy proved to be more resilient in the wake of the Bali bombings than expected—GDP growth held up well and financial markets suffered only modest effects. This is a dividend of good policy.

Structural Challenges

Notwithstanding the positive developments in achieving macroeconomic stability, a key concern which is appropriately highlighted in the staff report is the depressed state of investment. Foreign investment approvals in 2002 fell by 35 percent. Domestic investment approvals fell by 57 percent. Some of the factors impeding investments include: concerns over corruption; administrative delays; labor market concerns; rising wages; and a weak legal system.

Substantial progress on structural reform, along with an improvement in the security environment, will be necessary to improve investment and thus

boost growth prospects. This seems to be recognized by the Indonesian economic team. The challenge is in garnering broader political and public support for continued structural reform, particularly in the lead up to the 2004 elections. We have already seen that the policy environment is becoming more difficult with Government succumbing to pressure to (temporarily) rollback the planned elimination of fuel subsidies. This decision is perhaps understandable, and the appropriate timing and sequencing of measures is always an important consideration. Unfortunately, it does not seem that this environment will change in the near term.

Progress on structural reform has generally lagged progress on macroeconomic aspects over the course of the extended arrangement. It is particularly encouraging there has been some progress in a number of areas since the last review. Notably, the 2002 targets for privatization receipts and IBRA cash recoveries were exceeded, IBRA launched formal enforcement actions against non-compliant shareholders, the divestment of Bank Danamon is proceeding and the authorities conducted a successful bond issue.

Looking to the end of 2003, as outlined in the staff report and reflected in the structure of the program, much remains to be done. The authorities and the staff have identified appropriate priorities—further reforms in tax and customs administration; strengthening the fiscal decentralization process; strengthening the financial system; maximizing recoveries from the remaining stock of IBRA assets; fulfilling the targets of the privatization program; improving the investment environment through legal and judicial reform, strengthening public sector governance and improving labor policies.

As Directors have emphasized in previous reviews, legal and judicial reforms and dealing with corruption are crucial to facilitating investment. The establishment of the Anti-Corruption Commission and the Judicial Commission as independent authorities are important developments. Implementation and operation of these commissions will be all important and they will need the right incentives to confront corruption in an independent and effective manner. The proposal to increase the number of ad hoc judges to the Commercial Court is encouraging and there will need to be a rigorous recruitment process.

The authorities have an ambitious structural reform agenda for the remainder of the year which requires determination and leadership. This is particularly challenging as the election approaches in 2004. With this in mind, it is of concern that observers consider that the authorities' policy agenda is not well understood by the general public. The authorities need to develop an effective communications strategy to explain the rationale for, and benefits, of the chosen policy path. The Fund should be able to assist in this regard, even if it is in a 'behind-the scenes' role given the importance of demonstrating ownership in the context of the current domestic debate. Of course, what can be most powerful in building support is demonstrated progress towards

improving the investment climate such that investment flows pick up to support stronger growth.

2004 and Beyond

As noted previously, a key issue is the authorities' desire to graduate from Fund support at the end of this year. Indonesia does face sizeable debt repayments from 2004 to 2006. We appreciate the staff's discussion of the financing options available to the authorities in the absence of a Fund program and Paris Club agreement in 2004. A condition for long-term debt sustainability and ensuring a manageable financing situation in the short term is the achievement of fiscal targets and this is an area where to date the authorities have performed well.

In the absence of a program and Paris Club rescheduling, the authorities will be much more dependent on domestic sources of financing (as shown in the medium-term fiscal projections presented in Table 9). This could prove to be an ambitious task given it is still early days in terms of experience with domestic debt issuance.

Conclusion

We support the completion of the review and the request for a waiver for the non-observance of the end-December structural performance criterion on the BLBI burden-sharing agreements given the reason for the hold up (i.e. sensitive parliamentary discussions) and, importantly, the delay is not having a macroeconomic impact as operations are already being carried out on the basis of the agreement. Overall, the authorities have made good progress to date, and the challenge is to build on this progress to be in a position to graduate from Fund support and ultimately to improve investment.

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

We wish to thank the staff for this well-focused report on Indonesia and Ms. Indrawati for her insightful preliminary statement. We welcome the authorities' success in achieving the program's objectives and we are encouraged by their prompt and successful reaction to the tragic October event in Bali. The authorities should be commended for meeting all performance criteria set for end-December 2002, and for the good progress made in the implementation of structural reforms.

The continuous implementation of consistent and prudent macroeconomic policies has supported favorable economic results. The economy has expanded in line with program projections, with GDP growth in 2002 estimated at 3.7 percent, while inflation has substantially moderated throughout the year, consistently with a resilient rupiah. The current account surplus in 2002 surprised on the upside, with lower than expected imports and

positive developments in the service account, despite the retrenchment of tourism receipts in the fourth quarter. Looking forward, we agree with the staff that the authorities should strive to maintain the pace of reform, in particular, if they intend to graduate smoothly from the exceptional financing of the Fund.

We commend the authorities for their success in meeting their fiscal target in December and by taking important steps to allow fiscal consolidation to continue in 2003. In this regard, we were encouraged by the pick up on non-oil tax collections occurred in the last quarter of 2002, auguring well for the satisfactory implementation of a number of initiatives including those to improve tax administration. On the expenditure side, we welcome the savings achieved on the execution of current expenditures. Looking forward, we share the staff's support for the 1.8 percent of GDP budget deficit target, as striking an appropriate balance between further fiscal consolidation and supporting the economy in the short run. With respect to the postponement of the planned elimination of fuel subsidies, we agree with the staff that the authorities' intention to smooth out the pass-through of higher international oil prices is understandable at this juncture of highly volatile price developments in this sector.

The authorities should also be commended for their skillful implementation of monetary policy in 2002, which allowed them to reduced nominal interest rates while maintaining a relatively prudent policy stance. The fall in inflation in tandem with the resilience of the rupiah allowed the Indonesian economy to face the adverse October shock from a position of strength. Looking forward, we share the staff's view that further reductions in interest rates could be warranted, as long as inflation remains consistent with the program's projections. In any case, monetary developments should be followed closely to adjust policy in either direction as it may be required.

Regarding financial policies, we share the staff's recommendation on the need of close coordination among the relevant supervisory and regulatory agencies in developing the financial safety net. While substantial progress is not achieved in securing a sound and comprehensive safety net, we agree that the authorities should avoid a premature withdrawal of the blanket deposit guarantee.

Progress in asset recovery through IBRA has been impressive, and the authorities should strive to maintain momentum during the final stages of its operation. Continuation of bank divestiture process together with strengthened bank supervision will be key to limit the flow of problematic assets in the future. With respect to the most recent delay related to the implementation of the burden-sharing agreement on Bank Indonesia liquidity credits (BLBI) between BI and the government, we share the staff's conclusion that putting pressure for a quick resolution at this stage could be counterproductive. In this

regard, we agree with the authorities' request for a waiver for the nonobservance of the structural performance criterion on the end-December BLBI burden-sharing agreement.

Overcoming existing weaknesses in the legal framework is critical to improve the investment climate, and the resumption of stronger levels of investment will be essential to sustain growth in the medium-term. Hence, we encourage further work in this area, and believe that continued World Bank involvement will be essential.

With these remarks, we support the completion of the eighth review and wish the authorities all the best in their future endeavors.

Mr. Bennett submitted the following statement:

Key Points

The staff and the authorities are right to focus on structural reform as the priority for the remainder of the EFF.

While many bold reforms are in the works, it is important that they are implemented wholeheartedly.

Public scrutiny is important for ensuring transparency and accountability. It also gives the people a sense of the government's determination to reform. Thus, we urge the authorities to publish the state of local finances, the financial statements of the state banks, and the findings of independent commissions and audits.

Central bank independence can make an important contribution to the effectiveness of monetary policy. Giving the central bank a clear mandate is one way of achieving accountability while retaining operational independence.

We think that the staff is right to present the final year of the EFF as one in which the policy priorities in Indonesia shifts from macroeconomic stabilization to advancing the unfinished structural reform agenda. We believe that reforms should focus on four areas: (i) increasing public sector governance; (ii) strengthening the financial sector; (iii) improving the legal system; and (iv) enhancing the investment climate. We welcome Ms. Indrawati's assurance that the commitment to reform is shared by the government, the political parties, and the people.

The Indonesian authorities are taking important steps to increase the pace of reform. We note the audits of state funds and state enterprises, the new investment law, and the establishment of the Judicial Commission. It is important that these initiatives are implemented wholeheartedly and that they translate into a transparent and even-handed business environment.

Assuring Public Sector Governance

The Indonesian authorities have taken the bold step of significantly decentralizing fiscal policy. Indeed, the equivalent of 34 percent of government revenues is to be transferred to the regions in 2003. It is important that the regional governments are accountable for these funds. In the short run, with a moratorium on local government borrowing, the risks to the consolidated fiscal accounts are small. It is, nevertheless, important to ensure that these funds are being used effectively. However, in the longer-run, poor budgetary management by the major regions could imperil the country's financial stability. The regions must, therefore, report their finances on a timely basis. The central government and the regions must work on a standardized reporting format to ensure consistency and transparency. We would advise that these reports be made public in an effort to increase the accountability of the regional governments. We would also appreciate the staff's assessment of the state of regional finances in a future program review.

We welcome the authorities' undertakings to improve fiscal transparency by consolidating and auditing the off-budget funds. Transparency and accountability would be well-served by making these audits public.

Similarly, we welcome the authorities' program of performance audits of state enterprises. We note that the first two rounds of audits found sizable efficiency losses, which are currently being addressed through corrective action plans. We look forward to the completion of the third and fourth rounds of audits and to the strengthening of the legal powers of the State Audit Agency. We also believe that these audits and the corrective action plans should be published.

We look forward to the establishment of the Anti-Corruption Commission (ACC) later this year and the appointment of members with a high degree of ability and integrity. We hope that integrating the Independent Commission for the Audit of the Wealth of State Officials into the ACC strengthens its capacity and independent standing.

Strengthening the Financial Sector

While we agree that it is important for a central bank to be accountable, we hope that any future amendments to the Bank Indonesia Law will not result in a loss of operational independence. Central bank independence can make an important contribution to anchoring inflation expectations, with benefits for the entire economy. One way to make the

central bank accountable, while retaining operational independence, is to give it an explicit mandate against which the effectiveness of its policy can be measured. For example, having the central bank and the government agree on inflation targets is a transparent way to ensure central bank accountability, while providing a basis for coherent monetary policy.

In this context, we support the waiver for nonobservance of the structural performance criterion regarding the BLBI credits. We hope that this issue is resolved with regard to the appropriate place of the central bank in the Indonesian economy and that its ability to act as lender of last resort will not be impaired.

On the financial sector's strength, we have concerns about the health of the state banks, which account for 45 percent of the banking system. We note that the authorities are taking steps to improve the governance of the state banks and are planning a divestment strategy. While selling minority stakes in the state banks is a good first step to improving governance, the ability of minority shareholders to monitor bank management depends crucially on the availability of sound and timely information. Thus, it is important that the banks publish their balance sheets and income statements in full compliance with international standards. We would like the staff's assessment as to whether the state banks are sufficiently capitalized and whether they will require additional support in the future?

We welcome the progress made in 2002 by IBRA in selling its assets. In view of the lack of success in previous years, this is a key achievement. We understand that the lesson to be learned here is that the implementation of difficult policies, which is opposed by vested interests, can often depend on the will and courage of committed public officials. Going forward, IBRA faces the difficult task of selling loans related to the Top Five debtors. We urge IBRA to structure these sales in a transparent manner and in a way they can be easily digested by markets.

Enhancing the Investment Climate

High rates of investment will be necessary in order for Indonesia to grow rapidly. In designating 2003 as "The Investment Year", the authorities have recognized this. Since Indonesia is unlikely to be able to generate the savings necessary to satisfy its investment needs domestically, it is crucial that it be able to attract foreign investment. Thus, we welcome the provisions of the new investment law, which proposes to open all sectors of the economy to foreign investors and streamline investment procedures.

The initiatives to strengthen the operations of the Commercial Court are welcome. Putting the Court on a solid financial foundation is an important way of assuring that there is a ready supply of well-paid, qualified judges. We

believe that the establishment of a Judicial Commission is an important step for improving the governance of the Commercial Court and the legal system in general. The Commission should ensure that the Court's decisions and reasoning are made public and that there is the possibility of judicial review. Ultimately, the test of the judiciary will be the appropriateness of the judges' decisions.

As noted above, the development of a secondary market through IBRA's asset sales is an important development. However, while such sales increase market liquidity, they do little to support the value of the claims. In order for restructuring to be complete, it is important that those who buy IBRA assets are able to enforce their claims. This depends crucially on transparent bankruptcy legislation that recognizes creditor rights and a judicial system that applies the law in a fair and even-handed manner. While we welcome the amendments to the bankruptcy law, which will make the law easier to apply in practice by adding definitions and clarifications, it remains to be seen whether creditor rights will be protected in practice.

In this context, we would note that a fair, commercially reasonable, and transparent restructuring of Asia Pulp and Paper will be a key test of the success of improving the investment climate.

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

At the outset, we would like to thank the staff for their thorough report. We welcome the improved policy performance that Indonesia has shown over the past three years. In this regard, inflation has been subdued, international reserves have been rebuilt, the fiscal outcome in 2002 has been better than expected and the banking system has been strengthened. However, economic growth, as Ms. Indrawati notes in her frank and helpful preliminary statement, is still fragile, and consumption has been the main driving force. A strong and sustainable medium-term growth rate will require much higher investment, keeping in mind the persistently decreasing trend in net FDI, to a projected 1 percent of GDP in 2003, down from 6.3 percent in 1997/98. We are, nevertheless, encouraged that the authorities are paying greater attention to microeconomic efficiency issues and improvement in the investment climate, as this will be critical to dissipate the current uncertainties and help to revert the above mentioned trend.

A typical source of uncertainty relates to the upcoming elections. In this regard, we would welcome some the staff comment on the outlook for the reform process, taking into account that Indonesia has entered the final year under the IMF program and that it seems unlikely to be extended. In this regard, Ms. Indrawati notes that the key problem is not the political will to reform, but how to build up democratic processes and institutional capacity into an improved policy making process. Reconciling the objectives of

enhancing ownership and investor confidence is generally a daunting challenge after giving rise to differing perceptions of progress in each of these fronts. This underscores the importance of considered judgment that takes on board each country's circumstances.

We are encouraged by the authorities' commitment to stay the course of reform. In the fiscal area, performance has been consistent with the main thrust of fiscal policy, i.e., to advance in fiscal consolidation and reduce the public debt burden to a manageable level, following the successful reprofiling of the government's domestic debt last year.

Concern was raised about the resort to temporary tax and tariff relief measures. In this regard, we recognize the political economy considerations behind the decision. On balance, however, we share the comments expressed by Messrs. Shaalan and Kanaan, namely that the resource envelope to finance them may require optimistic revenue projections, that the measures could prove difficult to readdress, that they entail distortions and inefficiencies, and, more significantly, that they do not constitute permanent incentives for investment. The socio-political constraints and the need to clearly explain to the population the objectives and the effects of these policies surface clearly from the last UN Human Development Report that shows that only 31 per 1.000 people have access to telephone mainlines. This fact and that private cars are still a relative luxury serve to highlight the potential inefficiency and inequity in the subsidization program.

We welcome the progress made in the banking sector in 2002 and the authorities' efforts to maintain the momentum of the reform agenda. Both Table 7 of the staff report and Ms. Indrawati indicate that there has been a substantial decrease in nonperforming loans and a strengthening of the capital adequacy ratio, which are accompanied by other indicators that show an encouraging increase in new credit and a higher profitability of the banks in 2002. Nonetheless, as the staff report also underscores, the system remains vulnerable and the envisaged next steps to address the still-low share of bank credit to the private sector and the high incidence of recapitalization bonds in banking system assets, and to continue divesting banks under government ownership and strengthen their governance are critical. The Indonesian process of implementation of reforms to restructure the banking system clearly shows the difficulties and challenges still facing the authorities five years after the crisis. Additionally, as recognized by Ms. Indrawati, the Blanket Guarantee program has imposed a great burden on the government budget and created moral hazard. We concur with the authorities and the staff that it would be advisable to delay its removal until the health of the banking system has improved further and the major elements of the financial safety net are in place. In this regard, we welcome the authorities' decision to gradually reduce the guaranteed coverage while preparing, among others, the establishment of a Deposit Insurance Institution with adequate authority and

protection to manage bank closures. On this issue, we would welcome further elaboration from the staff on the progress made and the prospects for having the successor agency in place when IBRA's mandate expires in early 2004.

The investment climate in Indonesia has been affected by governance concerns. In this regard, we are encouraged by the Anti-Corruption Law, passed in November 2002, and the authorities' efforts to ensure that the Anti-Corruption Commission starts its work by year-end. While welcoming the determination showed by the Public Servants' Wealth Audit Commission in performing its duties, the apparent lack of support of the political leadership represents a potentially significant shortcoming that could impair the effectiveness of the new Commission.

Turning to other structural reforms, the annual privatization receipts target was exceeded with the privatization of Indosat. Meanwhile, there is concern that the sale could be annulled. This brings to the fore the uncertainties surrounding the divestiture process. In this regard, we share Ms. Indrawati's assessment on the importance of having a well defined privatization strategy, to bring about needed efficiency gains, enhanced credibility and more permanent signals for stronger investment. In this regard, we attach importance to improving transparency, more effective communication and explanation of the rationale and objectives to the public and, as importantly, of adequate regulatory frameworks. We are encouraged by the draft privatization law that seeks to consolidate the legal basis for privatization currently before Parliament. At the same time, the staff notes that each divestment would require its own approval. Perhaps the staff could comment on the practical significance of this two-step authorization process for meeting divestiture targets in a pre-electoral period. On the labor market, important progress was made to modernize labor relations with the passage of the new Labor Law. The fact that the informal economy may be as large as the formal economy suggests, however, that there may be substantial scope for further efforts in this area to remove obstacles for investment and reduce reliance on fiscal incentives to promote formal economic activity and investment.

With these remarks, we commend the Indonesian authorities for the success of their on-going adjustment of the economy. We support the review under the Extended Arrangement and the request for waiver of performance criterion and wish the authorities every success in their reform endeavors.

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

General Comments

Indonesia has increased its macroeconomic stability notwithstanding the global economic slowdown, owing to the progress made in economic

reform under the current Extended Arrangement. Although the tragic Bali incident adversely affected tourism, its impact was less than feared, due to the security and economic measures taken swiftly by the authorities. However, Indonesia's economic growth is slower than most in the fast-growing Asian region, and its recovery is weak compared to those countries recovering rapidly from the Asian crisis.

We strongly support the authorities' desire to graduate from exceptional financing by end-2003. But to achieve this objective they should step up their efforts to advance the unfinished reform agenda, and complete the remaining reviews this year on a timely basis in order to secure the foundations for stable economic management in the medium-term. The authorities should strengthen their commitment to reform, given that the political environment will become more difficult toward the 2004 election. We must particularly emphasize that they should maintain fiscal discipline, even if revenues increase because of higher oil prices, and should not use the excuse of geopolitical risks to slow down the speed of reform.

The international community is fully attentive to how the authorities' commitment to promote reform can maintain its momentum. If this commitment should weaken, it would be difficult to maintain international confidence toward Indonesia after its graduation from the Fund arrangement. Weakened confidence will bring a vicious circle to the Indonesian economy by destabilizing the exchange rate, deteriorating debt sustainability, and further diminishing market confidence. Box 2, which analyzes Indonesia's external vulnerability, indicates the importance of exchange rate stability. The authorities would benefit greatly from maintaining confidence of the international community.

We concur with the thrust of the staff appraisal and support the completion of the eighth review as well as the request for a waiver on the BLBI burden-sharing agreement, but would like to see the issue resolved quickly. Let us focus our comments on four important areas: macroeconomic framework, fiscal policy, financial sector reform, and the investment climate.

Macroeconomic Framework

The staff projects Indonesia's economic growth in 2003 to be 3.5 to 4.0 percent, and this growth is projected to remain consumption driven, but is the risk not there that consumption growth might weaken this year? The staff's projection seems to assume that propensity of consumption would increase, but is this assumption based on a decline in the inflation rate, or on an increase in confidence toward Indonesia's economy due to the progress made in economic reforms? On the investment side, although recovering somewhat from a sharp drop during the crisis, fixed investment has stagnated so far, and seems inclined to do so in 2003. The recovery of fixed investment

is essential for economic growth to achieve the medium-term objectives of debt and poverty reduction. From this viewpoint, we wish to ask the staff about the magnitude of the remaining excess capacity and how corporate restructuring is contributing to eliminating this.

Fiscal Policy

The 2002 fiscal deficit turned out to be a commendable 1.6 percent of GDP, well within the program target. There were two sources of improvement in the fiscal balance. First, tax administration improved significantly in recent months and we expect the authorities to further strengthen their efforts to enhance revenue in the medium-term. Second, on the expenditure side, current expenditures, including interest payments, declined as a step forward in stabilizing the fiscal balance in the long run, although the delay in implementation of development projects also contributed to the lower outturn.

The 2003 budget targets a somewhat larger deficit than last year, 1.8 percent of GDP, but considering that Indonesia is not yet fully on a track of sustainable growth, we concur with the staff that the budget strikes the appropriate balance between fiscal consolidation and economic support. We must emphasize again that in the event oil prices increase more than expected, the authorities should not loosen fiscal discipline and not waste the increased revenue. The reversal of the fuel price increase and the elimination of the VAT exemption is of concern. As the staff indicates, once the government yields to political pressures, it will strengthen the vested interest groups' power to halt reforms and undermine policy implementation in general, as this chair has repeatedly emphasized. Indeed, it is important to gain political and social consensus to promote reform. To this end, however, the authorities should enhance their efforts to do so by, for example, explaining to the public alternative measures to achieve social goals that the fuel subsidy could have achieved only partially and inefficiently. To gain support toward fiscal policy, we also encourage the authorities to increase fiscal transparency by improving the audits of the public sector.

We encourage the authorities to examine the 2004 budget earlier than in previous years if they wish to graduate from exceptional financing. According to the medium-term fiscal projection in Table 9, net domestic financing is projected to amount to up to 1.8 percent of GDP in 2004. The successful launch of government bonds last December was reassuring, and we expect further development of the bond market to enhance domestic financing. As for the option of drawing down deposits at the central bank, we concur with the staff that the authorities should cautiously examine the pressure on foreign reserves, and, in addition, its implication for the central bank's ability of sterilization.

Financial Sector Reform

Reviving the financial sector remains key to achieving self-sustainable growth and to enhancing monetary policy effectiveness. Progress in IBRA asset recovery is reassuring and we particularly welcome the improvement made in asset recoveries under the settlement agreements with former bank shareholders, which have been lagging behind. We encourage the authorities to increase their efforts in view of the expiration of IBRA's mandate.

The time has come to create a concrete plan for a new financial supervision framework after the current reform for stabilizing the financial sector conditions reaches its goal. A Master Plan for Improving the Effectiveness of Banking Supervision, as stated in Ms. Indrawati's statement, is a welcome step forward. We agree with the staff that the blanket deposit guarantee should not be lifted until unresolved issues are settle and the safety net is working appropriately. And, in addition, new confidence toward a new bank supervision framework should be created before removing the deposit guarantee.

Investment Climate

Improving the investment climate is crucial to enhancing its economic growth. FDI to Indonesia has remained subdued for the past few years and among those that materialized, investments in the service sector are on the increase while investments in the manufacturing sector, which requires a longer-term commitment, are decreasing. As noted in Ms. Indrawati's statement, in February, President Megawati inaugurated 2003 as "The Investment Year" and we welcome this as an acknowledgement by the government of the importance of investment. We hope that the new ministerial committee on improving the investment climate will be established soon and encourage the committee to take stock of its agendas and create a roadmap for reform.

As emphasized by many participants at the January CGI meeting, weak governance and lack of rule of law still impede foreign investment. To eliminate these impediments, strengthening governance, eliminating corruption, and promoting judicial reforms, are all essential. On governance and anti-corruption, we look forward to the establishment of the Anti-Corruption Commission by year-end and look forward to its effective implementation. On judicial reform, amendment of the bankruptcy law is important, and capacity building of the commercial courts is also crucial to enable them to make fair decisions on issues under their jurisdiction, including bankruptcy issues. Given the lack of a reliable legal bankruptcy framework, creditors and debtors are forced to solve corporate restructuring or bankruptcy cases out of court. Even in out of court negotiations, however, a strong

judicial framework is a prerequisite to ensure fair resolutions. Without a working bankruptcy framework and reliable judicial institutions, foreign investors tend to take a negative attitude toward financing or investing in Indonesian corporations. Developing trained judicial personnel is also essential, and we expect that Fund technical assistance would be useful in this area.

In this regard, there is a case of Indonesian corporate restructuring that has long been in dispute involving many foreign creditors including export credit agencies. This case is adversely affecting investors' sentiment toward Indonesia. To attract foreign investors, the authorities should improve the investment climate and treat foreign and domestic creditors equally, including by demonstrating fair and transparent settlements for individual cases to which the government is a party.

Conclusion

Significant progress was made in economic reforms under the current Extended Arrangement but we expect further efforts on the part of Indonesian authorities to advance unfinished agendas, with a view to successfully graduating from exceptional financing by end-2003. The authorities should focus on completing the remaining reviews in 2003 on a timely basis, by enhancing domestic support and improving policy implementation.

Mr. Usman submitted the following statement:

As Ms. Indrawati articulates in her comprehensive statement, the Indonesian authorities have shown strong commitment to reform and have successfully steered the economy from the Asian crisis. The economy has also weathered the storm of a difficult geopolitical environment, including the recent Bali attack. Performance under the current program continues to be strong and we are heartened that the authorities are now seeking an exit from use of Fund resources. As they do so, we encourage them to preserve their stance of credible macroeconomic policies and to maintain and accelerate the momentum of structural reforms.

In our view, ahead of political elections, it is normal to expect some slackening in the momentum of reforms and Indonesia is not an exception in this regard. Having said this, it should be noted, and we concur with Ms. Indrawati, that the authorities are operating under a dynamic and challenging domestic democratic political system and a difficult geopolitical situation. As such, the rolling back of scheduled increase in fuel prices in the face of street protests should not be viewed as major setbacks, but rather the authorities desire to keep policy formulation under control while strengthening domestic ownership. We are encouraged that the authorities intend to catalyze public support and persevere with these measures while

consolidating the achievements made this far. We concur with the staff appraisal, and support the proposed decision. We will only focus on a few areas for emphasis.

Tackling the Constraints to Higher Growth

It is welcome that GDP growth has recovered to pre-crisis levels. Nevertheless, as noted in the staff report, recovery in Indonesia continues to lag other regional economics, and, moreover, the rate of growth remains below the level required to reduce poverty and the high unemployment. In this context, we observe that the recovery so far has been driven mainly by consumption, and to a lesser extend, exports. We encourage the authorities to address the remaining key constraint to Indonesia's growth; investment, which has recovered to about 20 percent of GDP, way below the pre-crisis level of 30 percent. Progress in lowering inflation has translated into lower interest rates; however, this has not resulted in higher investment. Instead, banks are expanding consumer credit, while lending to the corporate sector is still considered risky due to lingering concerns about corporate indebtedness. Meanwhile, foreign investors seem deterred by concerns about the legal environment and the labor framework. We encourage the authorities to pay attention to these concerns in the period ahead, including accelerating corporate financial restructuring, accelerating privatization, and improving the statistical database in the corporate sector.

Fiscal Policy

The authorities should be commended for implementing prudent fiscal and monetary policies. The fiscal deficit has been reduced further. Most, important, the measures taken recently to improve tax administration are showing positive results as VAT and excise receipts exceeded expectations in the fourth quarter. We welcome Ms. Indrawati's assurance that the authorities will persevere on the path of fiscal consolidation, through further measures to strengthen tax administration, strengthening government's payments and receipts system, improving fiscal transparency and consolidating the decentralization process.

Monetary Policy

Inflation has also continued to moderate, and together with the appreciation of the Rupiah, provided room for lowering interest rates, creating the conditions for stimulating private sector activities. As inflation further declines and the currency remaining stable, it should be possible to further reduce interest. We welcome measures underway to improve the health of the financial system, thereby reducing the costs of financial intermediation. Also we encourage the authorities to strengthen state bank governance and to

accelerate the restructuring and divestment of state banks so as to minimize any potential contingent liabilities on the government.

Exchange Rate

Commitment to credible and prudent macroeconomic policies and acceleration of structural reforms will be critical to maintaining stability of the exchange rate. It is welcome that Indonesia's external vulnerability is declining: export performance is encouraging, the debt burden is declining, and short-term debt is covered by reserve accumulation. Accelerating structural reforms would help, not only to promote investment and increase exports but also enhance competitiveness.

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

Key Points

The Indonesian economy has recovered well from the Bali bombing, in large part because the authorities have made progress in recent years in pursuing structural and fiscal policy improvements.

But, for sustained increase in growth, Indonesia will need to attract larger amounts of investment, both foreign and domestic, and put that investment to efficient use.

To do this, additional structural actions are needed, particularly to bolster the investment climate by strengthening Indonesia's institutional capacity, the banking sector, and Indonesia's commitment to fight corruption.

Enhancing the efficiency of fiscal operations would also help keep debt dynamics on a sustainable path while bolstering expenditures for social needs and human capital.

Indonesia's economic and financial situation continues to improve, even in the wake of the Bali tragedy last October. Fiscal consolidation remains on track with the 2002 budget deficit coming in under target, and the monetary stance appears solid with encouraging outturns on inflation and falling interest rates that will help support growth. There are positive structural gains as well. The sale of Bank Danamon has been launched, and the government successfully sold a small amount of its own debt securities in December. We broadly agree with the staff's assessment of what has been accomplished under this extended arrangement.

The staff report notes that overall growth has not materialized as envisaged. Furthermore, Indonesia's external vulnerability indicators (i.e., high levels of debt and debt service) remain a concern. The key to driving higher growth and reduced vulnerability is attracting foreign investment. This

is the critical challenge for the Indonesian economy going forward. Indeed, improvements in the institutional framework for investment in the near to medium term are essential as the country enters a time of increased uncertainty surrounding the 2004 elections.

Given the importance of structural measures to the overall program, we are surprised by the lack of structural performance criteria in the 2003 program. The structural conditionality includes 22 benchmarks, but it is difficult to judge which are the most important. In our view, progress on institutional issues, improving bank supervision, and continuing sales of IBRA assets, including banks, are particularly relevant for putting in place the foundations for higher investment and growth. We urge the Fund and World Bank to continue their strong collaboration on structural issues. This collaboration could become even more important if Indonesia moves beyond a program relationship with the Fund.

Institutional Framework for Investment

The authorities need to make a concerted effort to reverse the perception of Indonesia as an unduly risky destination for foreign investment. Corporate debt restructuring cases, such as the high-profile case of Asia Pulp and Paper (APP), need to be resolved transparently and equitably if 2003 is to be "the Investment Year" as dubbed by the authorities. Attempting to attract new investment from abroad while disputes with existing investors proliferate only contributes to the perception that local insiders will be able to manipulate the courts and government into providing favored treatment over foreign investors. As noted in the staff report, FDI last year was less than one-third of the pre-crisis level.

Regarding the fight against corruption, the World Bank has a variety of steps in train to work with the authorities on the legal system, and we encourage both the authorities and the Bank to give this a high priority. Now that the legislative framework for the Anti-Corruption Commission (ACC) is established, the new body needs to become operational and effective. We note that a structural benchmark calls for the ACC to be 'fully operational' by year-end. Given the delays already experienced in creating the ACC, we encourage the authorities to take steps to make the ACC at least 'mostly operational' as soon as possible, such as hiring the staff, nominating commissioners, and drafting regulations.

We welcome the initiation of legal action against five non-compliant former bank shareholders and expect action soon for the remaining 12. Carrying prosecution of these cases to completion is the end goal. Half-measures on combating corruption will only worsen the perception of Indonesia in this regard.

Steps to improve the governance of state enterprises have begun to pay dividends. Performance audits and corrective measures for state enterprises have reduced inefficiencies, and we urge continued attention to this process. We concur with Mr. Bennett that publication of the audits and management plans, as well as other audits more broadly, would encourage accountability.

We also applaud the authorities' success in exceeding the 2002 target on privatization revenues. This kind of performance again in 2003 would be a positive signal to investors and contribute to improving budget financing and debt dynamics.

Financial System

The authorities have made progress in improving the overall stability of the banking sector. But, the staff report notes that progress in state bank governance has lagged, and the authorities will need to follow through with steps to improve governance and management systems in the banking sector, in particular through sales of the remaining state banks. While the performance criterion for the BLBI settlement agreement was not formally met, we concur with the staff's view that this does not seriously undermine the program given that the Finance Ministry and Bank Indonesia reached agreement on a settlement consistent with the recommendations of the outside experts and have agreed to abide by the agreement even in advance of formal approval by parliament.

We recognize the steps Indonesia has taken to thwart the financing of terrorism, but urge the authorities to redouble their efforts to identify and disrupt the financial networks employed by terrorists. Specifically, we call on Indonesia to strengthen the necessary administrative and regulatory mechanisms to prevent the abuse of Indonesia's financial system. We also urge Indonesia to take the necessary steps to ratify and implement the UN Convention on the Suppression of the Financing of Terrorism. We are pleased with the establishment of the financial intelligence unit (FIU) and the efforts made to amend existing laws on anti-money laundering. We encourage Indonesia to implement any remaining measures needed to make Indonesia compliant with FATF recommendations.

Fiscal Issues

The authorities need to continue the positive progress on fiscal consolidation. The recent partial roll back of fuel price increases, while not greatly affecting the overall fiscal position going forward, raises concerns about government spending as elections approach. The goal of a balanced budget by 2005 is laudable and strong progress has been made thus far. Implementation of the tax administration, expenditure management and decentralization measures detailed in paragraph 17 of the staff report and in

the MEFP are needed to ensure continued progress towards this goal. We thank the staff for the discussion of fiscal sustainability in Box 2.

The initiation of sales of government debt marks an important and positive development in the process of broadening the authorities' financing options. The government will likely have to make greater use of such domestic issuance in the future. In order to reduce the cost of this financing going forward, potential buyers of the debt must have confidence, meaning the structural reform agenda must be implemented and macroeconomic stability maintained.

We look forward to implementation of the amendments to the Foundations Law. As we have noted before, we are concerned about the delays in setting up a regular system of audits of military expenditures for the civilian authorities.

Other Issues

The staff report notes the passage of new legislation for the labor market. We encourage the staff to work with the World Bank to analyze the impact of the legislation and encourage adherence to core labor standards. We also welcome the intention to improve the framework for setting minimum wages.

We encourage continued efforts to address weaknesses identified in the safeguards assessment, following up on good progress made already. We thank the staff for the update in the staff supplement.

Ms. Indrawati's candid and helpful statement emphasizes that the authorities intend to enhance ownership over the program and implement economic reforms in the run up to the 2004 elections. Ms. Indrawati also makes clear that the authorities are properly focused on investment issues. Like many market observers, however, we are concerned that the pre-election season may complicate the implementation of key policies. One step that the authorities could take to reinforce their commitment would be to publish the staff report.

Mr. Reddy submitted the following statement:

We thank the staff for a comprehensive review and Ms. Indrawati for her very useful preliminary statement which helps us to appreciate simultaneously, the macro, institutional, structural and contextual aspects of the reform process in Indonesia. We agree with the overall appraisal of the staff that much has been achieved over the past three years. As indicated, the program priority has rightly shifted to advancing the unfinished structural reforms agenda. From this angle, we welcome the focus of policy discussion by the staff concentrating on this aspect as also strengthening the investment

climate. We agree with the broad thrust of the staff appraisal and support their proposal for the waiver of the single performance criterion concerning financial issues related to BLBI, whose implementation awaits completion of ongoing parliamentary consultations and for the completion of the eighth review under the Extended Arrangement. Having said that, based upon the study of the review report, we would like to touch upon certain broader elements of discussion.

First point relates to the staff view that the growth rate of 3.7 percent of 2002 which is at a higher level than projected at the time of last review, was disappointing since it fell short of the 5–6 percent growth envisaged in the original program. In our view, the overall economic performance of Indonesia in the present juncture has to be viewed in the current global context of continued slowdown and also the setback due to the Bali attack. The geopolitical situation needs to be fully factored in, in this regard, as such problems cannot be addressed by strengthening of domestic policies alone. Furthermore, this should not be construed either as the reflection of weakened commitment of the authorities or as a sign of program setback. Given this context, the growth performance of Indonesia is certainly encouraging.

The second point relates to the interpretation of the political economy issue. While we welcome the staff's attempt to bring in political economy issues as part of review, consistent with the recent decisions, the manner in which these issues need to be addressed may have to be carefully worked out. The comment about the political risk that the support for reforms could diminish as the year unfolds and another comment on Indonesia's post-2003 relationship with the Fund appear very abrupt, not fully taking into account the complexities involved in a democratic decision making process and the give and take and trade offs, adjunct to this process. Such conjectural interpretations, based on some sentiments expressed in the media and one or two instances of strategic decisions by authorities could have a possible negative impact on authorities' goodwill, ownership, and commitment. In the implementation of a line of reforms, there is no single way of optimizing results; it is natural that it raises political debates and questions and some times, necessitating repackaging of reforms in terms of sequencing and pacing and alignment of priorities. These should be considered as essential elements of review and recognized as such, so long as the overall change and progress are in the desirable direction. While commenting upon political economy aspects of reform, we would encourage the staff to keep these aspects in view. In this regard, we fully agree with Ms. Indrawati's statement that the key problem is not the political will, but how to build democratic processes and institutional capacity into an improved policy making process. In fact, to this extent, we need to be flexible in the program details while being consistent with the program design, thus contributing to improvements in policy as well as ownership.

Our third comment relates to monetary policy stance of the BI. We go along with the staff's view that the easing of monetary conditions by the authorities was appropriate. As regards the caution expressed by the staff in regard to pace of further interest rate cuts, we appreciate that the BI will maintain a flexible, but disciplined or prudent monetary policy with the objective to maintain the momentum of recovery, and improving economic fundamentals providing a consistent signal for market. Since monetary policy decisions have to be taken on a short-term basis and policy interest rate changes have to necessarily balance between risks and opportunities to facilitate robust recovery, we have no hesitation in endorsing the approach indicated in the preliminary statement.

The fourth element relates to the banking sector restructuring in the backdrop of overall performance improvements shown by this sector. We concur with the staff that ensuring the return of banks taken over during the crisis to private ownership is important for revitalizing the banking sector. We also note the government's commitment to continue divesting banks under government ownership to restore private sector participation in the economy. At the same time, we appreciate the authorities remaining vigilant of financial market conditions. We commend this cautious approach of authorities as any premature and hasty actions towards privatization under disruptive and volatile market conditions may not produce optimal results. Equally important, as mentioned in the preliminary statement, is the hard work of convincing potential investors, maintaining transparency and credibility and gaining political support to concluding legal agreements.

The fifth point relates to the policy on fuel subsidy vis-à-vis fuel prices. While the government reacted to public protests, and they needed to reduce the planned increases in fuel prices, this should be viewed from two angles. Societies in developing countries like Indonesia cannot withstand very high volatilities in fuel prices which will have serious impact on production costs and consumption levels. Furthermore, any social unrest, if allowed to persist, might cause a break down of the entire reform process itself. Therefore, the moderation in response to public protests is appropriate. Secondly, the budgetary process and the framework of keeping the deficit target at 1.8 percent of GDP remained intact, since the higher net oil revenue acts as a buffer to withstand the cost of subsidy. The authorities have assured that this buffering mechanism will be phased out when normalcy returns.

The sixth comment relates to labor market reforms. It is important to realize that in labor market reforms, we are not dealing with things, but with people and their social well-being. Therefore, we are happy to note that the new labor law in Indonesia strikes a balance between protecting basic workers' rights while still creating a favorable investment climate.

The seventh aspect I would like to touch upon is in regard to the process of building a sound financial safety net. We are encouraged to note that the blanket guarantee on the domestic banking system is gradually replaced in a well thought out and careful plan with Deposit Insurance Corporation. The authorities are also making progress towards an integrated financial oversight body, recognizing the need for a comprehensive approach that treats different but competitive sources of financing in comparable ways, and we presume that it fits Indonesia's preference and requirements.

Before concluding, we would like to mention that while the staff's assessment on the progress made so far is positive, the words of caution in regard to political risks and possible worsening of policy environment do not appear fully warranted especially in the light of overall performance as well as credible assurances from the authorities. The apparent overemphasis on the downside risks may give an impression to observers that the Fund, in its assessment, is overcautious and hedging against future uncertainties. In view of the Fund's transparency policy, we should avoid exaggerating risks so as to maintain credibility.

We endorse the staff's view that 2003 program which is appropriately ambitious, when implemented, should go a long way toward consolidating recent gains in Indonesia's economic performance. Given the record of performance under very difficult times, we believe this is feasible.

We wish the authorities continued success in their policy endeavors, in this critical and final stage of the program cycle.

Mr. Ondo Mañe submitted the following statement:

We would like to thank the staff for this well-written report and Ms. Indrawati for her helpful preliminary statement, which highlights recent achievements, as well as the remaining challenges facing the Indonesian economy. It is reassuring to note that the Indonesian economy is showing some signs of durable recovery. Economic growth was sustained in 2002, despite the tragic events in Bali; inflation has been contained; the rupiah was strengthened, the fiscal deficit was within the program limits and the external position improved significantly. All quantitative performance criteria and targets were met and good progress was made in the structural area. These positive developments have been made possible by the continued implementation of prudent economic policies.

Nonetheless, the situation remains fragile and the investment climate needs to be improved. We also note that there is still an unfinished reform agenda, especially in the structural area. We therefore welcome the Indonesian authorities' commitment to accelerate the completion of the reform process.

As the authorities have stated their desire to graduate from the Fund's exceptional financing when the extended arrangement expires at the end of the year, there is a need to strengthen the adjustment effort and prepare an exit strategy. To this end, we wish to recollect the recent Board discussion on Prolonged Use of Fund Resources during which Directors laid emphasis on the need for the Fund to help member countries in preparing credible exit strategies.

Thus, we would like to draw the Fund's attention on such a need to complement Indonesian authorities' vision, notably by helping them to develop a strategy aiming at increasing Indonesia's access to International Capital Markets and mobilizing more domestic and foreign direct investment. Looking ahead, we wish to reiterate that maintaining the political momentum for reforms and pursuing the implementation of prudent macroeconomic and structural policies will remain of paramount importance.

Fiscal Policy

Restoring fiscal sustainability remains critical to the success of the reform efforts. In this regard, we commend the authorities for measures taken to achieve the program objectives. Indeed, fiscal performance was better than expected, thanks to higher non-oil tax collections, mainly VAT and excise receipts, and lower than-planned current and investment outlays. For 2003, the authorities rightly strike a balance between providing support to the economy and strengthening fiscal consolidation to reduce public debt, without sacrificing the provision of key social services. In this context, we support the package of tax measures recently adopted to further stimulate the economy, and we welcome the authorities' intention to broaden the tax base and improve tax administration, so as to raise non-oil tax revenues.

On the expenditure side, we commend the authorities' ongoing efforts to strengthen tax administration, improve public expenditure management and implement sound decentralization framework. Likewise, increased fiscal transparency and measures to improve public sector governance, notably the completion of various audits of off-budget funds and state enterprises are steps in the right direction. While there is no doubt on the need to further reduce fuel subsidies, it is equally important to proceed gradually, in order to take into account the social setting of reforms. Thus, we can go along with the authorities' intention to smooth the domestic pass-through of recent sharp increase in international oil prices and temporary rollback the planned elimination of fuel subsidies. On the authorities' intention not to seek exceptional financing to meet their debt obligations, we encourage the authorities to carefully review all the options, as long as they do not put undue pressure on foreign reserves or crowd out the private sector.

Monetary Policy and Financial Sector Reforms

We commend the authorities' prudent conduct of monetary policy, which has resulted in the deceleration in inflation and encouraging developments for base money and the exchange rate. If these trends are maintained, we agree that they will give room to the authorities to gradually reduce the official interest rate. However, we encourage the authorities to proceed with caution regarding the pace of further cuts in interest rates, in order to ensure that inflation remains in line with the program's target, and that the rupiah's stability is not compromised, as investors assess the outlook of the 2004 elections.

Structural Reforms

On structural reforms, while welcoming the progress made, we note that increased efforts are needed to improve the investment climate and further advance reforms in the areas of banking sector, asset recovery and privatization. These reforms, if forcefully implemented, will help maintain market confidence at the end of the Fund program and beyond. Regarding the investment climate, recent measures, such as the strengthening of commercial courts, the establishment of the Anti-Corruption Commission, and progress in corporate debt restructuring are important steps to improve the legal and judiciary environment. In the labor market, the recent adoption of bills on labor protection and industrial dispute settlement and efforts to render the framework for setting minimum wage more predictable are welcome. It is important to always ensure that such efforts do not hinder the competitiveness of the economy.

In the financial sector, we commend the authorities for progress made in strengthening the banking sector. Indeed, it is encouraging to see that the profitability of banks is rising, and that non-performing loans, although still high, have been declining. Nevertheless, the process of bank privatization remains difficult, and we encourage the authorities to continue their efforts. In this context, the steps to strengthen state bank governance prior to privatization and the setting up of financial sector safety net are critical in revitalizing the banking sector. So are the authorities' efforts to accelerate the implementation of policies and institutions needed to safeguard the stability of the financial system and improve the oversight and accountability of the central bank. As regards IBRA Asset recovery, we commend the authorities for progress made in returning assets taken over during the crisis to the private sector. However, achieving the 2003 recovery targets and divestment of IBRA banks in advance of its scheduled winding-down remains a major challenge. In this context, we welcome IBRA's detailed asset disposal plan, as well as recent efforts to better enforce the shareholder settlement agreements and steps to take legal actions against noncompliant former bank owners. For this process to succeed, it will be important to strengthen enforcement mechanism to ensure that actions are effectively implemented.

In conclusion, we support the proposed decision and encourage the authorities to maintain steadfastly the momentum of reforms, which are beginning to produce positive results.

Mr. Wei submitted the following statement:

We thank the staff for another well-written report and Ms. Indrawati for her insightful and informative preliminary statement. We welcome the confidence and commitment of the Indonesian authorities in carrying on their economic and structural reforms.

Indonesia has made commendable progress in its economic development over the recent years, especially since the last review. Real GDP has recaptured its pre-crisis level, inflation is within its projected target, the exchange rate has been stable and appreciated, and international reserves remain at a comfortable level. The adverse impact of the incident in Bali has been well contained and almost all the macroeconomic indicators are positive. All end-December quantitative performance criteria and indicative targets have been met.

Besides these achievements, the authorities have conducted appropriate monetary and fiscal policies which have resulted in the excellent performance of the macroeconomy. Furthermore, they have made great efforts with structural reform which was a concern during the last review, has been cleared. Since I am in broad agreement with the staff appraisal, I would like to confine myself to a few areas for emphasis.

Monetary Policy

The appropriate conduct of monetary policy and economic growth go hand in hand. As a result, the inflation has come down sharply and stabilized at a reasonable low level. However, we share the staff's concerns that the pace and the extent of further interest rate cuts should be carefully considered and conducted to avoid too tight a monetary stance. It is encouraging that the authorities have taken the "optimal level of real interest rate and foreign interest rate disparities" into consideration and to note that the authorities are strongly committed to maintaining "a flexible but disciplined monetary policy with the objective to maintain the momentum of recovery while facilitating the improvement of economic fundamentals and providing a consistent signal for markets" as expressed in Ms. Indrawati's preliminary statement. Thus, we agree with the authorities that the present monetary policy is working appropriately under the existing circumstances. However, the authorities should be vigilant that they need to consider adjusting their policy if a change in circumstances occurs.

Fiscal Policy

We take note of Indonesia's lower-than-projected fiscal deficit and higher tax revenues in 2002. As pointed out in Ms. Indrawati's preliminary statement and addressed in the staff report, Indonesia faces great geopolitical uncertainties and the domestic political development might need to be taken into account as well. Therefore, the authorities face a formidable task in pursuing their fiscal reforms and sticking to the planned schedule. However, we believe that the authorities might need to readjust their original reform agenda-in this case, for example reconsidering the timing for reduction of the fuel subsidy and elimination of VAT exemptions on capital goods. The authorities have incorporated these unfinished reforms into their agenda for this year and we are reassured by their strong commitment to them.

On the authorities' financing options for the coming year, we support their decision. However, they are encouraged to consider the staff's suggestions concerning the domestic bond issuance. The main concern is how to activate the domestic bond market.

Structural Reforms

The Indonesian authorities have made noticeable progress in the bank divestment program, the IBRA asset recovery, with legal reforms as well as with the privatization process. This momentum should be maintained. We welcome the authorities' decision to reform the financial safety net to maintain the stability of the financial system. And we agree with the staff that the program to replace the current Blanket Guarantee Program should be addressed in a well-sequenced and gradual manner.

We agree with the authorities' proposal to attach high priority to "improving investment climate" for this year, since tourism and investment revenue has suffered. Therefore, the authorities are encouraged to pursue measures to recover the tourism industry and improve the investment climate.

We believe the authorities' proposed program for this year is well founded and focused. They are encouraged to make these goals and reform measures public in order to gain broad understanding and support.

With these remarks, we support the staff's proposal for a waiver of the structural performance criterion and completion of the eighth review. We wish the Indonesian authorities success in their future endeavors.

Extending her remarks, Ms. Indrawati made the following statement:

I would like to first thank the staff and management who always give strong support and good advice to the government. I have several comments in response to the many supportive statements by Directors. The concerns are mostly related to Indonesia entering the final program with the IMF this year—whether there will be a graduation or continuation. I would like to make a comment on that issue first. Then I would also like to underline the commitment of the government because there are at least two issues that are cited most in the preliminary statements, that is, the fuel subsidy policy and the VAT tax policy. On others, I will just wait for the staff to also give their comments and address several questions raised by Directors.

First, on the graduation from the IMF program, in Indonesia we call it the exit policy—a very popular word, which means the exit from the program. Many people, even the ministers, are confused because when we talk about exit from the IMF, they think that we will also withdraw our membership from the IMF. I personally had to explain the difference between the IMF program and the membership of the IMF to senior politicians.

There are at least two issues that are becoming very important. The first is, of course, concern regarding whether Indonesia can be sufficiently financed after an exit from the IMF program and without Paris Club rescheduling. While the concern is mainly for FY 2004, it also goes beyond 2004. The second related concern is the question of whether Indonesia can have sufficiently strong policy discipline with regard to economic management in 2004 and beyond, especially as the next cycle of elections is scheduled to take place in early 2004.

On the first issue regarding financing, my authorities have been seriously considering many alternative scenarios, and based on the good long-term record of Indonesia's fiscal policy, my authorities will carefully explore all possibilities and keep them open at this time. I also welcome the comment made by Mr. Callaghan suggesting that the authorities not close any possibilities. Technically, Indonesia is still keeping all possibilities on the table, although politically I should say that it is less and less favorable to have an extension of the IMF program due to the lingering sentiment since the start of the program in 1997, as well as the current geopolitical sentiment toward the western countries and the IMF. However, this is not to give you the impression that the Indonesian authorities are now lacking their commitment to reform, or making decisions based on political rather than on technocratic considerations. I still believe that the government has the ability to make the right decision by the end of this year regarding what is best for the Indonesia post-IMF support.

On policy discipline, before the IMF program in 1997, Indonesia has put in place the Indonesian Development Plan and the Indonesian Annual Development Program. Some politicians are confused with the contents of this

Annual Development Program and the Long-term National Development Program, most of which are similar to those in the Letters of Intent, suggesting a strong influence of the IMF in some ministers' views. This is just to show you how the IMF program has become the political anchor for any political party that will govern Indonesia. So I am quite optimistic that there is policy discipline and a political anchor that will be directing the policy of Indonesia even post-IMF program.

The problem is that there is always a sense of the IMF giving a seal of approval. My question is what should be the best attitude of the Board and the staff toward Indonesia. I think that the Fund should support any initiatives by the government. I would like to thank the staff for communicating and creating good and constructive relationship with the authorities along that line. The market always listens very carefully to the tone that is coming from the staff and the IMF in general. So it makes a lot of difference if the Fund can offer constructive and realistic encouragement for the government to do their best. The Fund should send a positive signal that the government is doing the right thing, which is what the government has done in this case and it has maintained the discipline to continue the necessary reform.

With respect to the unfinished reform agenda, every country always has an unfinished reform agenda. So it does not just apply to Indonesia and I do not think it is relevant to say the unfinished reform agenda. Rather, we should assess whether the process has been internalized, whether institutional capacity has been built, and whether the discipline has continued.

On the fuel subsidies, I disagree with the staff's use of the phrase "rolling back a scheduled fuel price increase," as that suggests that Indonesia is backtracking. What has actually happened is that the government of Indonesia slowed down the pace of increase in fuel prices; fuel prices are in fact still increased. The current international oil prices are so high that the government has to take action to ensure a smooth adjustment of the country's oil prices. The scaling back of the price increase is actually from an average increase of 21 percent to 12 percent on a weighted basis. In 2002, the government of Indonesia already increased fuel prices by 23 percent, which was substantial. Yet the economic performance in 2002 was still impressive, with lower inflation and sustained growth. We should not underestimate the achievement of the government, and this fuel subsidy alone should not be used as the basis for saying that the government's commitment is reduced. My authorities intend to maintain and normalize the price mechanism based on the international prices of oil, once oil prices return to more normal levels.

On the VAT exemption, the Indonesian authorities introduced a tax package in 2003, which includes, among other things, delaying the extension of VAT to capital goods and various infrastructure items, such as toll road, electricity, and animal feed. I would like to stress that these are just delays.

My government is not proposing to withdraw the policy, but to put off the planned implementation for a year. This is designed in part to reduce the price shock associated with the impact of the higher fuel and electricity prices. So, this is just to provide more room for maneuver for producers in Indonesia who have been hard hit by many cost pressures. Nevertheless, the government's principle is to extend VAT coverage as broadly as possible and enlarge the tax base, while holding down the rate. I would like to reassure the Board that my government will proceed with this agenda in the years to come, perhaps as part of a larger revision of the tax structure.

The staff representative from the Asia and Pacific Department (Mr. Citrin), in response to questions from Executive Directors, made the following statement:

I would like to start with some comments on the overall reform strategy and prospects this year, as well as issues related to 2004, which Ms. Indrawati has already touched upon. There were a number of interrelated comments and questions in this area that touch on a number of complex issues.

With regard to recent progress on reforms and prospects for this year, it is clear, as we acknowledge in the staff report, that Indonesia has made good progress not only on the macroeconomic front but also on the structural reform agenda. The staff remains confident that the key members of the economic team, as well as President Megawati herself, remain fully supportive of the reform agenda. Our contacts with parliamentary leaders and civil society also indicate support at a general level as well. I think that the staff, management, and the Board has recognized that the reform process in Indonesia must continue to take due account of the evolving democratic decision-making process as well as nascent institutions. And, indeed, conditionality under the EFF has been applied flexibly in due regard to this consideration, as evidenced on the occasion of this review by our support for the request for a waiver with regard to the implementation of the BLBI agreement on the grounds that it would be counterproductive to impose conditionality on Parliament on this measure at this time. Another example is the timing of the sale of IBRA's banks, which has been adjusted on a number of occasions to take account of a two-step procedure that now includes consultation with Parliament.

As noted in the staff report, we will need to be prepared for the likelihood that the climate for the implementation of reforms will become more difficult as the year unfolds and next year's elections approach. The staff tried to convey in the staff report that the issue is not so much the question of whether the climate will become difficult, but how the government will navigate toward its desired objective. No one disputes what its desired objective is against the headwinds and how the Fund and the international community can best support the authorities in that effort.

On the part of the government, it will require not only determination but also, as several Directors have stated in their preliminary statements, strong leadership that includes paying increased attention to both transparency and public relations, so as to build public support for the implementation of the program agenda. On the part of the Fund, we will need to show continued flexibility, but only so long as there is continued progress overall and key measures under the program are implemented.

Moving on to 2004, as noted in a number of preliminary statements, the importance of adhering to this program agenda is, of course, even more important if Indonesia is to succeed in its desire to "graduate" from exceptional assistance from the Fund and the Paris Club in 2004. In our discussions with the authorities as well as in our public statements, we have fully supported the aim of the government for Indonesia to move to the next stage of its recovery from the crisis and stand on its own feet. We have emphasized that this is an attainable objective. At the same time, it will require successful implementation of the program so as to ensure that sufficient confidence of both domestic and foreign investors that would allow that a smooth financing of the fiscal and external accounts is maintained. Otherwise, as several Directors have noted, the exit will risk either renewed pressure on foreign exchange reserves and the exchange rate or crowding out in domestic capital markets or some combination of those two. So we fully support the stated objective of the government to graduate, but at the same time this has a number of implications for the conduct of policy. As one Director has said, and as Ms. Indrawati has stated in her opening remarks, given all the uncertainties, the government should not close any doors.

There were a number of questions and comments related more specifically to the structural reform strategy and program design for 2003. The government's structural reform agenda for 2003 has the following priorities: first, continued progress in IBRA's asset recovery process; second, further strengthening of the banking system through bank divestment, improving state bank governance and other improvements to the regulatory framework; and, third, progress on legal and other institutional reforms aimed at improving the investment climate. Together with key measures in the areas of tax administration and expenditure management, the structural benchmarks specified under the program are designed to capture what the staff considers key milestones in these priority areas to judge overall progress under the program.

While the program for 2003 does not include any structural performance criteria, in practice in the context of program reviews, the mission and the authorities have not distinguished much between structural benchmarks and structural performance criteria. Satisfactory progress in relation to both types of measures taken together has determined whether or

not the staff and management are prepared to recommend to the Board the completion of program reviews.

With regard to the priority areas more specifically, let me just address a few specific points raised by Directors. One priority is state banks. These banks are currently sufficiently capitalized, and their financial position did improve over the course of 2002, in line with private banks such that all four of the state banks earned net profits. At the same time, they do have a large share of restructured loans in their portfolios, leading to continued concerns about asset quality, which will need to be addressed as we move forward through improvements in risk management, procedures, and also further restructuring. We do not think that further significant injections of public capital are needed at this stage. The program for 2003 includes steps toward privatization of these banks, restructuring of one of the four banks, and several other initiatives to strengthen the oversight of the banks' activities.

Another priority area noted is IBRA asset recoveries. The year 2002 was marked by an acceleration in asset sales, and we certainly hope that this success will be repeated this year. At the same time, to ensure that public support for the sales is maintained, the program includes a number of measures, as it did last year, to ensure good governance in the sales process. The sales mechanisms are conducted in a transparent and market-oriented manner. Bidders are required to affirm in writing that they have no relationship to the original debtors. Also, all asset sales mechanisms are vetted by IBRA's independent oversight committee. So IBRA is doing what it can to ensure transparency and prevent former debtors from illegally buying back their NPLs. Of course, despite success in sales of both NPLs and other assets, recovery rates are falling well short of the amount of obligations and gross cost of the bank bailout for the government. In large part this is due to the fact that the market value of the assets taken over during the crisis was well below the book value to begin with, and moreover, delays in asset sales led to further deterioration in their value. In some cases, the shortfalls have resulted from misrepresentation of debtors of the original value of pledged assets. In those cases, the shortfalls are being recouped by requiring debtors to pledge additional assets.

Finally, with regard to the ambitiousness of the legal reform agenda, and its potential impact on the investment climate, in the staff's view, the authorities' agenda is appropriately ambitious. That said, the main issue in the legal area is implementation, and even if all the new institutions and regulations are established exactly as planned under the program, the investment climate will not improve if in practice good governance is not followed.

Another staff representative from the Asia and Pacific Department (Mr. Schwartz), responding to specific questions from Executive Directors, made the following statement:

> If I could just take a couple of minutes to address a few of the specific questions raised in the preliminary statements. First of all, there were a number of questions on the macroeconomic framework, in particular about the risk that consumption growth could weaken in the year ahead. I would note that, in fact, the staff incorporated somewhat of a slowdown in consumption growth in the 2003 projection from the rate of almost 5 percent in 2002 to just over 4 percent in 2003. Even at that level, consumption growth would be the main driver of the recovery in 2003, and there is, indeed, a risk that consumption could weaken, which is why a pickup in investment is so important to sustain the recovery over the medium term.
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> However, that said, I would point out that there are a couple of factors mitigating the risks. First of all, the household sector is not particularly highly leveraged at this time, and there is considerable evidence that bank credit is picking up in the consumer sector, which should help to feed consumption growth over the next year or so, if not beyond. Second, there is evidence that there is still some pent-up demand from the legacy of the crisis, and hence scope for consumption of durables in particular to remain strong over the coming year.
>
> On the magnitude of excess capacity in the economy and the extent to which corporate restructuring might contribute to eliminating this, it is very difficult to get a precise fix on the extent of excess capacity because data in this area are so limited. Anecdotal evidence suggests that there is still a sizable amount of excess capacity and no evidence of demand pressures on inflation. Internally we are working with an output gap in a range of 3 to 4 percent, and as noted in Box 1, unemployment and underemployment are still quite high. It could be expected that corporate restructuring will help to eliminate the excess capacity. As noted in Box 3, financial restructuring is set to pick up. However, we would expect that the operational restructuring of corporations may take somewhat longer. So we should be very patient with respect to seeing results of corporate restructuring feeding into a reduction in the extent of excess capacity.
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> A question was raised on the inflation target of 9 percent in the 2003 program and whether this was sufficiently ambitious. I would point out that the inflation target in the program is the inflation assumption underlying the 2003 budget that was passed in November by Parliament, and the authorities preferred to maintain that inflation assumption as a target for the coming year. In the event, headline inflation on an annual basis has come down to below that level, as noted in the staff report. We do, however, expect headline inflation to pick up perhaps over the next few months, because the recent

decline in inflation can be attributed to some temporary factors as well as base effects from last year. Nevertheless, it is quite possible that if current trends continue, inflation could come in well under the 9 percent target, and of course the authorities may wish to reevaluate the inflation target in the context of upcoming reviews.

On the question of whether the current level of the rupiah and the recent appreciation would be a concern for the future course of export growth, we do not think that the current level of the rupiah—at about Rp 8,900 per dollar—is problematic. Our latest estimates continue to show, in fact, that there is probably some scope for further appreciation of the rupiah over the medium term. We estimate the long-run equilibrium exchange rate in the order of Rp 8,000–8,500 per dollar. In our discussions with exporters, we do not hear much complaint about the level of the exchange rate; on the contrary, there is substantial evidence that the recent stability of the exchange rate has been a contributor to the positive export growth witnessed over the last several months.

In the fiscal area, a question was raised about the reasons behind the sharp decline in the revenue-to-GDP ratio in 2002, by about 2 percentage points from the previous year. The factors here are relatively technical, so I will just be very brief. The decline in the tax ratio in 2002 is due mainly to a decline in oil and gas revenues as a share of GDP, owing to somewhat lower production levels and the appreciation of the rupiah in 2002, which led to a decline in oil receipts in rupiah terms. For 2003, the decline in the projected revenue ratio is due mainly to a projected decline in non-tax revenues, owing to declines in expected revenue receipts from the issuance of logging permits.

Regarding the new tax incentives, setting aside the issue of the VAT exemption on capital goods, the tax initiatives include reductions in luxury taxes, lower thresholds for personal income tax, and lower VAT on electricity and toll roads. We do not see any of these measures as particularly problematic. They are relatively small in size and, other than the VAT exemption on capital goods, do not lead to a distortion in the tax system. However, we are not sure at this stage whether it would contribute very much to business activity, as these measures are relatively small. Luxury good taxes were not being collected aggressively in the first place. So it remains to be seen whether there would be much of a positive impact, but, ex ante, we would not expect much of an impact.

Lastly, on the financial safety net, questions were raised as to the mandate and timing of the new Deposit Insurance Agency, whether the plans envisaged for Indonesia are consistent with best international practice, and whether the Deposit Insurance Agency would be up and running in time for IBRA's wind-down in early 2004. First of all, with respect to the mandate, the issue here is whether the Deposit Insurance Agency should also have

responsibility for bank closures. As it turns out, there is not a generally accepted practice in this area. What is envisaged in Indonesia is that the Deposit Insurance Agency would have the mandate for bank closures, which the staff thinks is a generally good practice because it aligns the incentive under one roof, whereby the Deposit Insurance Agency has an interest in limiting losses in the banking sector, such that it would be aggressive in addressing banking problems as they arise. So the plans envisaged in Indonesia are very much in line with the staff's advice, and we continue to support that approach.

In terms of timing, plans are underway for the design of the Deposit Insurance Agency, but it is not certain at this stage whether the agency would be up and running when IBRA closes in early 2004. The authorities are aware of the need to avoid a vacuum in this important area, and in their planning are conscious of the need to ensure a smooth transition. If the Deposit Insurance Agency is not ready in time, then another agency would be temporarily given that mandate.

Mr. Szczuka made the following statement:

I support the proposed decision to complete the eighth program review and I agree to grant the waiver for the nonobservance of the structural criterion on the BLBI burden-sharing agreement. The authorities are to be commended for meeting all the end-December 2002 quantitative performance criteria. Some welcome progress has also been made in implementing structural reforms, but even the authorities themselves admit that the reform agenda is still far from being completed, and as Ms. Indrawati said, it can never be completed actually because we have to move forward.

The most worrying aspect of the recent economic developments in the Indonesian economy is the persistent weakness in investment activity. To boost investors' confidence and bolster growth, the authorities need to consolidate the progress in restoring macroeconomic stability, and to decisively push forward reforms aimed at strengthening the financial sector, improving governance, and restoring trust in the legal system.

I agree with the staff's assessment that growth is still low, though the EFF-supported program has been successful in reestablishing macroeconomic stability. The less-severe-than-feared impact of the Bali incident and the relative stability of the rupiah also indicate that the Indonesian economy has become more resilient to exogenous shocks. The significantly increased foreign exchange reserves—more than fully covering now the outstanding short-term debt—also provide a welcome cushion against any sudden shifts in investor sentiment. However, the level of external debt, the cost of its service, and the corporate sector's exposure to foreign exchange risk remain substantial. As noted in Ms. Indrawati's comprehensive statement, the ample

liquidity in the banking sector could easily translate into pressures on the rupiah in the event of any major external or domestic disturbance.

This certainly calls for the continuation of prudence in the conduct of monetary policy. I thus support the staff's recommendation to proceed cautiously with any further interest rate reductions. The program's inflation target of 9 percent does not appear particularly ambitious, and this should leave enough scope for monetary policy to support economic activity while maintaining the relative stability of the exchange rate.

The fiscal results achieved in 2002 provide both a proof that the government remains committed to macroeconomic stability and some reassurance that this year's 1.8 percent deficit target can be within reach. It is quite encouraging that improvements in tax administration contributed to raising fiscal revenue, while it is less welcome that expenditure savings had mainly affected development-related spending.

Like many other Directors, I regret that the government felt compelled to reduce the scope of the planned fuel price increases, and I have some doubts about some components of the announced tax package, in particular the VAT exemption on capital goods. I agree with Messrs. Shaalan's and Kanaan's comment on this issue, and like them, I hope that most of these measures would be strictly temporary.

On the fiscal reform side, the measures aimed at strengthening the reporting of fiscal outturns from the regions and the enhancement of central oversight over regional regulations can significantly contribute to improving fiscal transparency and the overall position of the general government. I certainly hope that the authorities and the staff will soon be able to report on a timely basis data showing a consolidated fiscal position. I also welcome the government's intention to continue the process of auditing and consolidating off-budgetary funds and, like the U.S. chair, look forward to the implementation of the proposed amendments to the Foundations Law.

While Indonesia may have reached its pre-crisis GDP growth level, it may be questionable to take just one quarter of 1997 as the reference point. It is still far from the average 8 percent growth rate recorded in the years 1990 to 1996. The external environment is certainly less conducive now than before, but the main problem lies with the depressed level of investment. The authorities seem to be fully aware of this problem, as confirmed by their decision to proclaim 2003 as the investment year. It is only to be hoped that the envisaged measures, including the adoption of the new investment law, will be sufficient to turn around the negative sentiment of domestic and foreign investors.

The big jump in new FDI approvals in the first two months of this year is a very welcome sign, but as we say in my country, one swallow does not yet make a spring. I believe it is summer in this country. So the message is the same. To improve the investment climate, the government will have to vigorously implement a comprehensive reform agenda in such areas as financial sector governance and legal and judicial systems. The fair and transparent settlement of all ongoing commercial disputes is also one of the prerequisites for a durable improvement in investor sentiment. The authorities also need to aim at ensuring social and political stability in their own country, but, unfortunately, they can do very little to change the international situation.

I have noticed with appreciation the achievement of the program's target with regard to IBRA asset recoveries and revenues from privatization. Less welcome is the further delay in finalizing the BLBI issue and the delay in the third round of special audits of state enterprises. The divestment program for banks under direct and indirect control of the government is quite ambitious, and it is off to a good start with the Bank Danamon transaction already being in a quite advanced stage. However, one of the Indonesian officials has recently indicated that the outbreak of war in Iraq may contribute to a delay in implementing the privatization program. Would the staff see such a risk and would the staff recommend adhering to the dates indicated in the program regardless of the current market conditions? While putting a specific deadline for the completion of the privatization transaction may help in pushing forward the structural reform agenda, it may also result in weakening the government's position vis-à-vis potential buyers.

I also have a question to the staff regarding the Anti-Corruption Commission. I certainly welcome its establishment, but I wonder whether the staff is reasonably assured that adequate checks have been embodied in the procedure for nominating its members and that this process will result in an effective and credible commission.

My final comment is on the authorities' reported desire to graduate from relying on exceptional financing after the expiration of the current arrangement. This is certainly a very ambitious undertaking, but also a welcome development which should, in my view, deserve our support. There is no doubt that, to achieve this objective, the authorities will need to do their best to restore market and investor confidence by reinforcing their commitment to macroeconomic stability regardless of the political cycle, and by completing the program's structural agenda. The authorities should also redouble their efforts to develop the domestic capital market on which they will have to rely as a future source of financing. There are certainly risks to this graduation strategy, and I agree with Mr. Callaghan that the authorities should not close any doors, a point to which I understand Ms. Indrawati also agrees. However, I found some comfort in Ms. Indrawati's assurances that her authorities remain strongly committed to pursuing the reform agenda. I also

believe that their awareness that, after expiration of the Fund program, they will have to strongly depend on private markets and on bilateral donor support as reminded by Mr. Yagi. This will act as an important disciplinary factor.

The final question will be to the staff. How would the staff envisage post-program cooperation? Would this be limited to Post-Program Monitoring or could a precautionary arrangement be a kind of bridge between the current program and the future without the IMF?

With these comments, I would like to wish the authorities further success and also a successful graduation.

Mr. von Kleist made the following statement:

We thank the staff for a concise and well written report and Ms. Indrawati for her helpful statement and her additional remarks at the beginning of the meeting. Recent economic developments are encouraging and the authorities are to be commended for what has been achieved under the program so far. But we should not overlook that the structural reform agenda is far from being settled. A still weak investment climate is part of the cause that growth has fallen short of expectations of the original program targets and lags behind the performance of the neighboring countries. It is reassuring to hear from Ms. Indrawati that the authorities remain committed to continue on the reform path and we hope that necessary decisions and their implementation will not be impeded by the upcoming elections. Concerning the "exit" question, I support the comments of Mr. Padoan in his preliminary statement, taking note of Ms. Indrawati's oral remarks.

Against the background of favorable macroeconomic developments and the observation of all quantitative performance criteria, we support the completion of the eighth review and the granting of the requested waiver. With respect to the latter, however, we have strong reservations. This is the fourth time that a waiver needs to be granted for the non-observance of the BLBI burden-sharing agreement. The repeated granting of a waiver for the non-observance of the same criterion, with the repetitive promise that completion is nearing, undermines program conditionality and puts the government's and the Fund's credibility at risk. As in similar cases in the past, we have to ask whether such repeated granting of a waiver for the same performance criteria implies that the condition is not that macro-critical after all, or whether the condition is just poorly drafted. On the program itself we broadly concur with the analysis and recommendations in the staff report. In view of the large number of preliminary statements, I can confine my further remarks to four points:

First, like staff we regret the reintroduction of the previously abolished fuel subsidies and the reversal of the elimination of the VAT exemption on

capital goods. Although, thanks to higher oil revenues, these measures will not lead to an increase in the budget deficit, government's credibility could be damaged. Pressure groups might be encouraged by this success in pushing through their interests, making it harder for the government to finish the reform agenda. Therefore, we encourage the authorities to treat these measures as temporary and abolish them before the pressure from entrenched interests in the run-up to the elections starts to gain momentum.

Second, consumer prices were still in the double digit range last year despite the exchange rate stabilization. We share staff's cautious assessment regarding the pace of further interest rate cuts until the recent trend of declining inflation has stabilized. We agree with Mr. Bennett that keeping operational independence of the central bank is an important contribution to the effectiveness of monetary policy and to anchoring inflation expectations. This should be taken into consideration in the discussions of amendments to the central bank law.

Third, regarding the financial sector, we are encouraged that indicators of banking system soundness have improved in 2002. However, we regret that the four government-owned banks, comprising 45 percent of the sector, remain subject to weak shareholder oversight and insufficient governance controls, which makes them vulnerable to external shocks and to defaults from large domestic borrowers. Strengthening the reform efforts in the banking sector is crucial to develop a viable banking system and to increase the still low volume of bank credits to the private sector.

Fourth, we share staff's assessment that the asset recovery process through further IBRA asset sales and privatization needs to continue. But it is equally important that the assets that are still under IBRA's control are processed in a fair and transparent manner. Ms. Jacklin and Mr. Baukol's preliminary statement contains more extensive comments on this topic, which I support. Further legal, judicial, labor market and public sector reforms are necessary to improve the investment climate which is badly needed to push forward the privatization process. In this regard, the establishment of the Anti-Corruption Commission is an important step and we hope that it can start work as intended by the end of the year. I also welcome the additional oral remarks by staff on this topic.

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

Mr. Basdevant made the following statement:

First of all, let me thank the staff for their well-documented report, and Ms. Indrawati for her excellent informative statement.

The general macroeconomic picture portrayed by the report is rather reassuring. The 2002 results seem slightly better than those anticipated at the time of last December's review regarding growth, fiscal deficit, inflation, and external balances. Despite international tensions and the effects of global demand, Indonesia seems able to reach in 2003 the upper end of the growth rate range specified in the November report. The country's strong resilience to external shocks highlighted in Box 2 of the staff report is also heartening.

The macroeconomic stabilization achieved by Indonesia over the past years is quite impressive. In this regard, the decision of Paris Club members to reschedule only 50 percent of interest falling due in 2003 should be viewed as a sign of confidence in the country's economic future. The results achieved to date are presently opening a window for the country to graduate successfully from exceptional financial support. I understand from Ms. Indrawati's preliminary statement that the authorities are seriously considering this option. However, it might be to the country's benefit to envision a smoother transition from the current EFF. In this regard, I am interested in the staff's opinion as to how Post-Program Monitoring could provide useful benchmarks for the authorities at this particular stage, considering the present level of uncertainties in the economic environment. In any case, the authorities must be aware, and it must be stated clearly, that without an arrangement for the IMF, it will not be possible to conclude an agreement with Paris Club creditors. Maintaining a link with the IMF would also enable the country to deepen structural fronts.

Despite positive macroeconomic results, the economy is still not reaching the growth level that would enable it to make a dent in unemployment and poverty trends. At this juncture, I share the concerns expressed by other Directors related to the lack of investment and the reduction in FDI inflows. While the stabilization of the macroeconomic environment should provide an opportunity for an increased rate of investment, this awaited pickup has not yet materialized. This observation tends to indicate that an improvement in both business regulations and environment is still necessary to put the economy on a higher path of growth. The information provided by Ms. Indrawati in her preliminary statement shows clearly that the authorities are thoroughly cognizant of the problem and are determined to improve the situation.

I have another concern about the external competitiveness of the economy considering the important real appreciation of the currency and the substantial growth in minimum wages incurred in 2002. While the currency appreciation has a positive impact on the level of external indebtedness, does the staff think that the productivity gains so far will enable Indonesia to sustain the current evolution?

Regarding policy and program implementation, the program has been successfully implemented. I have in mind tourism in particular. First, the fiscal outcome reveals that the authorities have taken courageous decisions despite a difficult social context to rein in the deficit and have proved at the same time their ability to improve revenue collection. These achievements are very commendable.

Second, on financial sector reform, the authorities are demonstrating a real commitment for which they have to be commended as well. IBRA asset recoveries and privatization of public banks have proceeded well. However, even with the completion of these official restructuring operations, there would still probably be room for further consolidation in the banking sector, considering the high number of operators, some of which experience low profitability rates. The program's streamlining of the financial safety net is welcome, as it will increase confidence and also prove the extent to which the impressive drop in non-performing loans underlines a real significant decrease in banks' vulnerability.

While governance issues underscored during the last review is a major element of concern, there seems to be some positive steps. I am particularly pleased to note the progress achieved in this field. I am heartened by the authorities' strong commitment to keep pressure on former bank shareholders to fulfill their obligations under the settlement agreement. The constitution of the Anti-Corruption Commission last year is a welcome step as well. I urge the authorities to stick to the schedule outlined in the letter of intent so as to make this institution operational as soon as possible. I also thank the staff for keeping the Board informed of its developments. I welcome the steps taken to actively address money laundering and invite the authorities to ensure the effectiveness of the anti-money laundering institutional framework. I note the authorities' intention to bring the AML into conformity with FATF requirements. The authorities should be cognizant that they have to implement changes if they want to have the implementation of countermeasures. I consider the proposed trend to be heartening and support the proposed decision.

Mr. Alazzaz made the following statement:

I compliment the Indonesian authorities for their continued adherence to the economic program supported by the Extended Arrangement. All end-December quantitative performance criteria have been met with comfortable margins. The authorities' sustained efforts have paid off in improved economic performance and increased resilience. Indeed last year, despite the Bali attack, geopolitical uncertainties, and the weak global economy, growth accelerated, inflation decelerated, and reserves rose. Moreover, market sentiment has strengthened recently and further progress has been made in reforming the banking sector.

The challenge now is to advance the reform and adjustment effort further for a robust and sustained recovery. In this regard, the Letter of Intent and Ms. Indrawati's comprehensive preliminary statement underscore the authorities' awareness of the challenges and their commitment to address them. Against that background, I support the completion of the review and the granting of the requested waiver.

The authorities are to be commended for the overperformance on the fiscal front. In particular, I welcome the lower than expected current spending. I am also encouraged by the authorities' commitment to achieve the 2003 targets. The focus on broadening the base and strengthening tax administration should improve non-oil revenues in 2003 and over the medium-term. On the expenditure side, I welcome the stress on improving the budget structure by reducing current spending as a percent of GDP while increasing development expenditures.

Turning to the monetary and exchange rate areas, the authorities deserve credit for the progress on the inflation front. I am also reassured by their commitment to maintain a disciplined monetary policy in the period ahead. There appears to be scope for further easing of monetary conditions in view of the inflation outlook. However, caution is needed here, given Ms. Indrawati's comments on the imminence of potential pressures on the exchange rate.

On structural reform, good progress has been made on a number of fronts. In particular, the improvement in the health of the banking sector and the higher than targeted IBRA cash recoveries are welcome. I am also encouraged by the authorities' commitment to press ahead with the reform agenda, as noted in Ms. Indrawati's statement. In this connection, successful divestments of Bank Danamon and Bank Lippo as well as greater progress in privatizing the remaining banks will send a reassuring signal. Pressing ahead with the plan to reform the financial sector safety net should further enhance confidence.

In addition to these reforms, the importance of strengthening the economy's legal framework cannot be overemphasized. Indeed, adequate confidence in the sanctity and enforceability of contracts is essential for enhancing private sector investments. Here, it is important to press ahead with the authorities' plan in that regard.

Mr. Gigineishvili made the following statement:

I will try to be brief here since Directors have already addressed most of the issues. I will pick up on some general topics here.

The staff report and the very helpful preliminary statement by Ms. Indrawati make it clear that Indonesia has made significant progress toward macroeconomic stability. We are pleased to learn that GDP growth and inflation, as well as the fiscal, monetary, and external sectors, outperformed the projections, and that all program targets were met. We commend the authorities for their achievements and support the completion of the review and request for the waiver of the structural performance criterion.

With a track record of sound macroeconomic management over the past few years and a relatively low risk of an external crisis due to a flexible exchange rate regime and a comfortable level of reserves, the 2003 program rightly focuses on an unfinished agenda of structural reforms. However, given the still fragile macroeconomic environment, there is no room for slippages, and we would urge the authorities to continue pursuing prudent policies. With contained inflation and a stable exchange rate, the easing of monetary policy in 2002 has provided support for economic activity. Like other Directors, I would caution against further interest rate cuts as they may fuel inflation expectations.

On the fiscal front, revenue-raising reforms in tax administration and customs, expenditure optimization, and the timely removal of oil subsidies are critical for long-term sustainability, especially when the revenue-to-GDP ratio is projected to fall for the second year in a row. We urge the authorities to more expeditiously proceed with the restructuring and divestment of their remaining state banks and to accelerate the process of IBRA asset recovery. We welcome the authorities' intention to introduce a Deposit Insurance Agency and to gradually phase out all of the existing blanket guarantee. We agree with the staff that the timing and sequencing is particularly crucial to preserve public confidence in the banking sector and to ensure the stability of the financial system.

We support the Indonesian authorities' intention to graduate from the IMF program and wish them every success.

Mr. Droop made the following statement:

We note and welcome the positive macroeconomic outcomes achieved over 2002 as well as the decline in external vulnerability, and we agree with the staff and many Directors that sustaining the pace of structural reforms is now the priority, particularly with the 2004 elections on the horizon and an active debate on graduation underway. In this context, we would feel that the publication of the staff report could be an important contribution to this exit debate.

On the macroeconomic outlook, like Mr. Callaghan in his preliminary statement, we would note with concern the reduction in foreign investment

approvals in 2002 as well as some evidence that the efficiency of investment has declined over the past few years. In this context, we would welcome the authorities' prioritization of the investment issue in 2003. We also noted with some concern the stall in the overall pace of poverty reduction noted in the staff report. Clearly, the increase of 2002 is modest in the context of the sharp falls since 1999; nevertheless, it is something to be noted with concern. In the context of the poverty reduction agenda, we believe that the PRSP process can deliver important benefits, and we would encourage appropriate focus on growth in the investment climate in that process.

On fiscal policy, like many others, we commend the performance of 2002 and welcome the ongoing commitment to fiscal consolidation signaled by the 2003 numbers. We note, though, like others, that there are a range of risks to achieving these 2003 targets and concur with the staff that the climate may worsen in the coming months. More specifically on fiscal issues, we would concur with Mr. Bennett in his preliminary statement that fiscal decentralization promises tremendous benefits, but that the risks need to be managed, and, in this context, we would urge the authorities to strengthen regional expenditure controls and accountability.

We share Mr. von Kleist's view on fuel subsidies, and, on that topic, we would particularly stress the inequitable nature of these subsidies and would put the scale of the subsidy, 0.6 percent of GDP, in the context of total central development expenditures, which at just 2.3 percent of GDP in 2002 was relatively small. We welcome the budgeted increase in development expenditures to 3 percent of GDP in 2003.

On banking sector reform, we agree with the staff that concern remains regarding the vulnerability of the financial sector, and like Mr. Yagi and Mr. Toyama, we welcome the authorities' efforts to overhaul the regulatory and supervisory framework. In particular, we do find the authorities' proposed approach of creating an independent financial supervisory agency, the OJK, a reasonable one, and the timeline set out in Ms. Indrawati's statement would appear to be manageable and attainable. But like the staff, we would stress the importance of good governance principles in this process.

On legal and judicial reforms, we welcome the decision to make the development of the Commercial Court system the centerpiece of the legal reform process in 2003. We agree that the importance of addressing weaknesses in the bankruptcy framework is central to the investment climate.

On the anti-money laundering framework, I would echo the Mr. Basdevant's comments. On privatization, like Mr. Szczuka, I would be interested to hear the staff's view on the implications of current events on the pace of the privatization program.

With these comments, I would like to support the proposed decision.

Mr. Prader made the following statement:

We are pleased with the results of Indonesia's economic policies since the last review of the EFF. The fiscal performance was better than expected because fiscal policy exercised expenditure restraint, and remained quite conservative even when some setbacks required the authorities to partly rescind their plan to cut petroleum subsidies. Growth was also higher than expected and the negative effects of the security situation were not as severe as had been feared. All performance criteria have been met, and only a single waiver (for a structural performance criterion) has been requested. I also understand that the technical cooperation between the Fund and the Indonesian institutions has been very constructive. I can thus agree in most respects with the positive assessments of most of my colleagues and their recommendations for completing the unfinished reform agenda. At any rate, the reform agenda for 2003 is quite ambitious, and time is short. How much of it can be achieved during the remainder of the Fund program remains to be seen. I hope the Fund can make a useful contribution by focusing the discussions on the essentials. At this stage, I have only a few remarks.

Mr. Padoan and others have stressed the importance of durably reviving private investment at a time when growth is sustained wholly by private consumption and investment is below the crisis level. We have been informed that 2003 has been declared the Year of Investment. There has been an increase in FDI approvals, but apparently the Year of Investment is not off to a good start in every respect. If one were to take issue with only one single problem, that problem would be the omission of any reference to IBRA's treatment of Asia Pulp and Paper, which might have strong effects on the perceptions of foreign investors. Neither the staff report nor Ms. Indrawati's helpful preliminary statement make any mention of this high-profile case, which is a source of massive irritation to many creditors, including the export credit agencies of several major creditor countries. The U.S. written statement and Mr. Von Kleist have also referred to this case. I understand the reason for the staff's stand-offish position, on the grounds that this is a commercial case. But whatever one thinks of the case, its resolution will send an important signal about whether Indonesia's investment climate has really changed for the better, with foreign and domestic interests being treated transparently, equally and fairly, as pointed out in Ms. Jacklin's and Mr. Baukol's written statement. What is the assessment of the staff and Ms. Indrawati concerning a satisfactory solution of this problem?

Another important consideration for foreign investors is the possibility of reversals in tax and tariff reforms, which is rightly stressed in the preliminary statement of Mr. Shaalan and Mr. Kanaan. Like them, I am concerned that reversals in tax and tariff reforms will deter investors and give

the impression that the reform agenda of the Indonesian authorities is easily altered by political pressures. The re-introduction of tax exemptions is an equally counterproductive step.

With regard to the present debate in Indonesia about whether of not to exit from the Fund program after the end of the current EFF, I tend to agree with those who welcome, in principle, any graduation from Fund programs; but I also agree with the view that the issue should not be decided until that ending is imminent and everything is clear. It should be based on a hard look at the situation at the time the program expires. Mr. Padoan makes a valid point when he says that graduation from the Fund program means a more difficult and even stronger program involvement. Perhaps Ms. Indrawati can tell us about the current state of this debate, and especially in particular on whether those advocating a graduation from the Fund do so in the expectation that there will be more, or less, implementation of reform policies. At any rate, we appreciate Ms. Indrawati's reassurances today that Indonesia's institutions and the political will are strong enough to continue the reforms in the absence of the Fund's sometimes burdensome but useful disciplinary framework.

Concerning the formal approval by parliament of the BLBI liquidity credit agreement between the BI and the government, I fully subscribe to Mr. Shaalan's and Mr. Kanaan's thoughtful remark. Uncertainties stemming from coordination problems between the institutions must be removed; any further delays would be inconsistent with the reform agenda.

Mr. Moreno made the following statement:

I would just like to make a brief statement supporting the proposed decision on the completion of the eighth review and the requested waiver.

On the issue of the exit strategy and graduation from exceptional financing, we welcome the authorities' desire to take full ownership of economic policies and their intention to graduate strongly and smoothly, as stressed by Ms. Indrawati. We will have further opportunities to discuss the exit strategy in upcoming reviews.

At this stage, we join other Directors in stressing that a successful graduation will depend mainly on further implementation of the unfinished reform agenda. In this respect, the authorities' commitment to press ahead with the necessary structural reforms and the emphasis of the 2003 program on investment-enhancing measures are encouraging. The reform agenda should stress as priority areas the strengthening of the financial safety net, continued efforts to improve public sector governance, and fiscal reforms to improve tax administration and expenditure management with a focus on priority spending. In this last aspect, and as a brief point on fiscal policy, we

welcome the authorities' efforts to regain the level of development expenditures in the 2003 budget as a percentage of GDP in the context of a decreasing ratio of central government expenditures to GDP. We hope that this part of the budget will be fully executed, and that the rising trend of social expenditures will continue in future budgets as one of the measures to enhance social stability.

With these remarks, we wish the authorities success.

Ms. Kupča made the following statement:

At the outset, let me thank the staff for the well structured and candid report and Ms. Indrawati for her informative preliminary statement.

The Indonesian authorities have made good progress to restore the macroeconomic stability in the country, and Indonesia's performance against end-2002 quantitative program targets was good, with inflation being subdued, international reserves being rebuilt, and the fiscal outcome being even better than envisaged. It is encouraging to learn that the weakening in the tourism sector was offset by better than expected private sector performance and the impact of the October Bali attack seems to be less severe than originally envisaged.

However, on the structural front Indonesia's performance has been mixed with one performance criterion repeatedly being missed and several structural benchmarks not being fully met. Like Mr. Bennett, I think that the staff has the right approach in presenting the year 2003 as the year in which policy priorities in the country will shift from macroeconomic stabilization to advancing the unfinished structural reform agenda. Indeed, a lot remains to be done, but the upcoming elections in 2004 limit the political room for maneuver. As Indonesia enters the final year of the extended agreement, I would like to urge the authorities not only to consolidate gains made so far under the program but to make every effort to address the remaining reforms.

As I am in broad agreement with the staff appraisal, in this phase of the discussion, I would like to limit myself to a few points for emphasis on structural issues.

There is no doubt that an improvement in the business environment is crucial for regaining sustainable growth, which so far has not materialized as envisaged. The key driver of the growth would obviously be foreign investments. However, the investment climate has remained weak and suffers from a perceived high corruption level, a lack of confidence in commercial contracts and their impartial and predictable enforcement. In this regard, I would like to associate myself with Ms. Jacklin and Mr. Baukol pointing out that any disputes with existing investors need to be resolved transparently and

equitably avoiding any contribution to the perception that local insiders are provided favored treatment over foreign investors. Going further, we cannot overemphasize the importance to make every effort to implement measures designed to improve the investment climate, in particular, making the Anti-Corruption Commission fully operational by the end of this year.

I welcome the progress made in the banking sector's recovery over the past year. Nevertheless, the banking sector is still fragile, and financial sector reforms and the strengthening of the financial safety net have to remain a core part of the authorities' reform agenda. I am pleased to learn that the authorities are preparing a comprehensive plan to ensure the coordination and proper sequencing of a number of new institutions and policies needed to safeguard the stability of the financial system. Indeed, there has to be an institutional setup in place by 2004 when IBRA's mandate expires. I share the staff's recommendations on the step-by-step institutional building process and a gradual removal of the blanket deposit guarantee.

Finally, I would like to associate myself with Mr. von Kleist about the reintroducing of fuel subsidies.

With these remarks, I can support the proposed decision to complete the eighth review and grant the requested waiver on the structural performance criteria. I wish the authorities success in their policy endeavors and, in conclusion, I encourage them to consent to the publication of the staff report.

The staff representative from the World Bank (Mr. Edwards) made the following statement:

I have a brief statement with regard to the forest sector. Illegal logging is indeed a serious problem in Indonesia. The country is experiencing deforestation at a rate that appears to be accelerating, exceeding two million hectares per year. Illegal logging is one of the causes of deforestation, along with fires, conversion for plantation, and agricultural encroachment. Plywood, pulp, and paper industries are the largest consumers; they are able to process 40 million cubic meters per annum at full capacity. Overcutting by logging concessionnaires also constitutes illegal logging and is probably the largest contributor to forest loss.

In all of its forms, illegal logging is a symptom of underlying problems that are a legacy of 30 years of forest sector mismanagement during the Suharto era. We see a failure of law enforcement, official corruption, and, most significantly, the development of excess capacity in the wood processing industry. This excess capacity is developed under highly favorable regulatory and tax structures that are designed to increase export revenues. These structures effectively insulate the wood processing industry from market

forces. It is for this latter reason that many donors working on conservation and forest management issues in Indonesia are considering how highly-indebted forest sector companies are being handled by the state. Favorable treatment toward the industry perpetuates, and perhaps even worsens, the vast imbalance between log consumption and supply, while at the same time the government is trying to come to grips with this through replanting and industry downsizing.

Mr. Szczuka said that, according to Annex II on the World Bank/IMF relations, the poverty situation seemed to have worsened. He wondered whether the staff representative from the World Bank could quantify the extent of such deterioration and offer some initial evaluation of the draft interim poverty reduction strategy paper (I-PRSP). It was surprising to note that the PRSP process was taking place outside of the PRGF framework, which raised questions about the role of the PRSP/PRGF in this case.

The staff representative from the World Bank (Mr. Edwards) replied that, as a representative from the financial sector side, he was not in a position to quantify the scope of poverty reduction in Indonesia. To his knowledge, poverty had not declined at the rate earlier observed. Indonesia's interim poverty reduction strategy program had been adopted by the government. The Bank was engaged in a robust dialogue to place that in the framework of a formal program that would last from three to five years. The process has not been finalized yet.

Mr. Kruger recalled that the high price of rice had been the single largest contribution to poverty in Indonesia, owing to the government's rice support program for farmers. He asked whether that rice policy was still in effect, and whether there was any plan to phase it out so that the price of rice for Indonesians would be market-based.

The staff representative from the World Bank (Mr. Edwards) responded that the government had recently raised a rice tariff, which resulted in a slight increase in the price for the consumer and brought it closer to world market prices. It was hoped that that measure would have a positive effect on the agricultural sector. The government's rice policy—championed by the rice distribution agency, BULOG—had been changed from time to time. BULOG had recently changed the form of its mandate; it was currently an agricultural supplier of all types of commodities.

Mr. Baukol inquired about the state of play with regard to the World Bank's discussions with the authorities on forestry issues and the receptiveness of those discussions, as well as the macroeconomic implications of an unsustainable forestry situation.

The staff representative from the World Bank (Mr. Edwards) responded that, although the Bank's dialogue was conducted principally through the Ministry of Forestry, there were a number of different counterparts involved, including the Ministry of Agriculture, which controlled many of the forest supplies in the country. A number of private sector constituents, including those that had timber concessions, were also involved, and thus had some influence on policy. In general, what was lacking was coherence on the part of the

government. There was not a single voice through which the government spoke on forest sector policy.

The staff representative from the Asia and Pacific Department (Mr. Citrin), responding to further questions and comments from Executive Directors, made the following statement:

> Let me start with Mr. Szczuka's question on whether or not the authorities had thought about the type of possible relationship with the Fund in 2004 that might give some added discipline to policy-making, particularly about the relative benefits of Post-Program Monitoring (PPM) vis-à-vis a precautionary arrangement. The staff has had extensive discussions, especially with the Minister of Finance during the last mission. The Minister and others are very concerned about finding a framework that would provide appropriate discipline to the conduct of macroeconomic and structural policies next year, while also providing a good signaling effect to markets, both domestically and internationally. The staff explained to the Minister that, even if the authorities were to decide not to enter into another formal arrangement with the Fund, at a minimum, we would engage in PPM. The staff also explained to him the modalities of PPM, and he was quite satisfied that periodic visits from the Fund to discuss in detail the government's own economic program, which would be presented to the Fund the staff on the occasion of the mission visits, would provide an adequate disciplining device for the government. For example, a the staff visit at the beginning of next year in the period between the expiration of the arrangement and the elections to conduct our Article IV consultation would provide a very good vehicle for presenting to the world the Fund's endorsement of Indonesia's policy. The Minister thus thought that the PPM would be an adequate device in that regard. This is, of course, abstracting from any financing considerations.
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> With regard to a precautionary arrangement, to the extent that a precautionary arrangement would involve a letter of intent to the Fund, it would not be seen as being much different from the current arrangement. So, from the government's point of view, I think that if it is going to graduate, it would rather graduate into a PPM than to have a precautionary arrangement. Nevertheless, the Minister and others are aware of the benefits of having some kind of a disciplining framework in place. In that sense, they have not closed any doors.
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> On the timing of privatization sales, over the past couple of years, we have never really pushed certain transactions to take place according to a given timetable at all costs, thereby leading to a fire sale of assets. At the same time, during the initial years of the program, there was always some reason why it was not a good time to sell an IBRA bank or to sell certain assets. It is clear that, once the sales finally took place last year, starting with the divestment of Bank BCA, it triggered a sharp upward swing in confidence and

appreciation of the rupiah at the beginning of 2002. While certain officials are in favor of delaying sales, others are saying that there is not going to be any change in the strategy, notwithstanding the current geopolitical situation. The staff, therefore, is confident that the authorities intend to continue with their plans this year. With regard to any concerns about selling at too low prices, there is a reserve price mechanism in place. If bid prices are unduly low and fall below reserve prices set in advance, then the authorities would likely not proceed with the transaction, and we would not force them to sell at prices below reserve prices.

On the waiver of non-observance of the performance criterion on the BLBI burden-sharing agreement, we acknowledge that it is the fourth time that a waiver has been sought. This issue has been rather intractable and has taken sometime to resolve. The staff supports the waiver on this occasion for two reasons. First, at end-January, the government did take the important step of forwarding the proposed agreement to Parliament. Second, there is full agreement between the central bank and the Ministry of Finance on how this issue should be handled, and they are currently operating on the basis of the agreement, with regard to the financial operations of the central bank and the budget. So, while this is an important issue—which is why it is specified as a structural performance criterion to begin with—at this point, we do not see the delay as having a significant macroeconomic impact.

On the question of Asia Pulp and Paper (APP), we agree fully with the comments of several Directors that failure to reach a mutually satisfactory agreement in restructuring APP's debt could have potentially serious ramifications for future investment in Indonesia. The staff has quietly encouraged the authorities to do what they can to reach a solution that is satisfactory to all parties. Mr. Prader asked about the March 31 deadline and the prospects of reaching agreement by then. This was an internal deadline set by IBRA. While it was a target date by which IBRA wanted to conclude the restructuring, the comments made by IBRA Chairman, which were reported in the last few days, suggest that it is not a strict deadline, and the authorities are willing to continue discussions beyond that date. There are reports that IBRA has recently presented a compromise proposal to the official creditors. We have not heard any reactions from the creditors at this stage, but there is still hope that a satisfactory resolution can be reached. Last year's Selected Issues paper did contain a box on this particular issue. Thus, in the interest of streamlining the staff report, it has not been discussed this time. Certainly, there is scope for an update in a future the staff report.

Mr. Szczuka asked about the procedures for the nomination of the members of the Anti-Corruption Commission (ACC). The staff is satisfied that the new law provides for a transparent and participatory process. In particular, there is a screening committee for nominations made by the public, which is made up of both government and civil society representatives, and

which is tasked with vetting the nominations put forward by the public to the president, who then chooses, I believe, five out of a list of ten names and submits her list to Parliament for final approval. So, the process is quite transparent, with which the staff is satisfied.

Mr. Prader said that he was satisfied with the staff's response on the APP case, and suggested that it would be useful to follow up on that issue for future reference.

Mr. von Kleist asserted that the staff's explanation on the waiver was exactly why he had raised the question. If the BLBI liquidity credit issue did not have a macroeconomic impact in any critical way, why had it been included as a performance criterion? The staff representative from the Policy Development and Review Department might wish to comment on that as it was more of a basic question of program design. If the Fund could afford to grant a waiver four times consecutively for the same performance criterion, it raised questions about the appropriate application of performance criteria, as discussed in the context of review of conditionality.

Mr. Kanaan added that the BLBI issue had been regarded as important, with its implications extending beyond macroeconomic aspects, which had explained why that particular performance criterion had been retained since December 2001. While the staff had rightly noted that financial operations of the central bank and the budget were effectively conducted on the basis of the burden-sharing agreement, that only addressed the macroeconomic impact of the flows of interest payments between the central bank and the budget—whether the interest payments due would remain within the central bank or be transferred to the budget. Besides its macroeconomic importance, the BLBI liquidity credit issue also had an impact on the private sector's confidence in the financial health of the central bank, in particular the significance of the BLBI bonds on the capital adequacy of Bank Indonesia and its ability to withstand shocks.

The staff representative from the Policy Development and Review Department (Mr. Hadjimichael), responding to the question on the performance criterion on the BLBI burden-sharing agreement, made the following statement:

> The questions on this particular performance criterion are well put. In general, in terms of program design, structural conditionality in the form of both performance criteria and structural benchmarks are required by the new conditionality guidelines to be critical for the achievement of the objectives of the program. That can mean, in a narrow sense, the macroeconomic objectives in a particular year or, in the broader context, the medium-term objectives or even beyond the life of the program if the results of the specific structural reforms would materialize over time. So, the interpretation of the timing and the magnitude of the impact is somewhat vague and the structural reform measure is not required to be achieved within a certain period of time or until the next review. It is a matter of judgment as to how that criticality is presented in the staff reports or explained to the Board. In the specific case of this particular performance criterion, the wording is a little bit too broad, and I

could read that it is not explicitly required that this measure receives the approval of Parliament; it requires the implementation of the agreement. It says implementation of the burden-sharing agreement on BLBI between Bank Indonesia and the government. In this particular context, the way the steps were envisaged to achieve this implementation were first to be an agreement between the Ministry of Finance and the central bank, and then for this agreement to be submitted to Parliament for endorsement, not as a law, but as a kind of political endorsement of the process. This broad description is probably too expansive to be captured fully by the wording in the performance criterion.

Over time, we have seen some progress but it was not enough to be satisfied that that particular performance criterion has been fully observed. What has been the difference this time that has encouraged the staff not to ask for either the postponement or the retention of this performance criterion is that not only agreement has been reached between the Ministry of Finance and the central bank, but the agreement has been submitted to Parliament and debate has started. But, given the political environment, the issue has not come to a conclusion at this stage. In addition, the Ministry of Finance and the central bank have been applying de facto whatever is required in the context of this agreement, and the macroeconomic implications so far are on the interest payments due by the government to the central bank.

I grant that the broader implication of the impact of such a legally or politically endorsed agreement on the confidence that the private sector may have in the viability of the central bank is something that is still open, but is not something that can be quantified or that one could in good faith claim is causing problems. On balance, the staff and management felt that significant progress has already been made for us to go along with what has been achieved. Even though we would very much welcome the whole completion of this process and parliamentary endorsement, we do not see a need to call for another future date for this endorsement to be given, since the implementation is, to a large extent, already taking place.

The staff representative from the Asia and Pacific Department (Mr. Citrin) added that there was no objection to any of the financial terms of the agreement by Parliament, the government, or other concerned parties, and there was not much of a concern about the financial viability of the central bank either. The reason for the delay in the resolution of the BLBI issue was more related to the question of who had been morally and legally responsible for providing liquidity credits during the 1997 financial crisis. The provision of liquidity credits by the central bank to the large private banks in the midst of the crisis had remained at the core of the problem, around which the current debate was evolving. The staff had felt that any attempt to delay the review or impose conditionality on Parliamentary on that issue would be counterproductive.

Mr. von Kleist stressed that the repeated waiver, which was similar to the case of Pakistan's tax agency, was a cause for concern because it raised the question of principle. If the BLBI burden-sharing agreement had been implemented de facto, as the staff had confirmed, the parliamentary debate should no longer be sensitive. Only when the outcome was not known would parliamentary debates normally be considered sensitive. Of concern was the possibility that the parliamentary debate on the BLBI issue might result in a reversal of the agreement.

Mr. Baukol asked what the macroeconomic impact of the forestry sector was, and whether the authorities intended to publish the staff report.

The staff representative from the Asia and Pacific Department (Mr. Citrin) replied that the forestry sector, based on measured activity, accounted for slightly less than 2 percent of GDP. The staff understood that the authorities remained reluctant to publish the staff report.

Mr. Szczuka said that he joined Directors who encouraged the authorities to publish the staff report.

Ms. Indrawati made the following concluding statement:

> I would like to touch on some of the concerns about the IMF program for Indonesia, and to also follow up on Mr. von Kleist's concern about the design of the program, especially with regard to the BLBI issue. First I would like to comment briefly on the current discussion of the exit policy. This issue is not exclusively debated by the IMF and the government of Indonesia; other multilateral institutions like the ADB and World Bank, as well as CGI meeting and bilateral talks between Indonesia and some French countries, also pay considerable attention to it. I am confident that the government of Indonesia, with valuable advice and constructive encouragement, will come up with the most sensible option by the end of this year. The mandate given by the people assembly is for the government to exit from the Fund-supported program, although legally it can still be debated whether the government can decide on that or simply follow the instruction. Given the political pressure at this time, the government has few choices, but it has made every effort to ensure a soft landing or a smooth exit from the program. President Megawati has not given a firm position yet whether that decision should be taken by the government. So, the issue remains open to debate.
>
> On the commitment of the government, especially with regard to the privatization of state-owned enterprises, a question was raised whether the current geopolitical situation, the market climate, and a very low appetite of investors will affect the government's privatization plan. I think that we should appreciate what Indonesia has already achieved on the privatization of state-owned enterprises. First, the government succeeded in divesting Bank BCA, which is the largest private bank owned by a close crony of Suharto.

Despite the difficulties and political sensitivity, and after extensive debates on how to deal with the assets taken over by the government, at the end the government could reasonably execute the transaction. I fully share the frustration of the staff as decisions are often made at the last minute. But I believe that this is understandable under an early democratic system. That is why in my preliminary statement I underline the important process of internalizing this democratic mechanism within Indonesia's still fragile institutional framework.

A second privatization case is the most recent sale of Indosat's sister company, the largest international communications company in Indonesia, and an extremely politically sensitive case. Even the spokesperson of the people assembly participated in demonstrations, asking the government to annul the transaction. Despite tremendous pressure, the government is still firm on that decision. The government has recently announced its decision to sell Bank Danamon, and is now in the process of short-listing. These examples are meant to show to the Board that political difficulties and obstacles always exist in Indonesia and sometimes escalate with geopolitical developments. Nevertheless, the government always has the determination to arrive at reasonable solutions, and that should be commended.

Ms. Jacklin/Mr. Baukol, Mr. Prader, Mr. Bennett, Mr. Yagi, and, to a lesser extent, Mr. Callaghan, raised the APP case and debt settlement. Just recently eleven ambassadors sent letters to the President, requesting action to settle this commercial dispute. IBRA has already taken care of this issue, and tried to reach a commercial solution that is acceptable to all parties. But the letters from ambassadors to the President have elevated the discussion up to the political level. One factor that limits IBRA's ability to respond in this case is perhaps the need to satisfy the export creditor group without violating the capital stock exchange regulation. The government is always faced with considerable trade-offs. I would also like to stress that constructive pressure such as that from IMF, CGI, or other multilateral institutions, is very much welcome by the Indonesian government and authorities. At the same time, however, they should understand that everything has to be decided within the capacity of the institutions and within the regulatory and legal systems, where numerous changes have been made to keep pace with the demand for restructuring and supporting the economic recovery. The government of Indonesia should be encouraged to continue to respond constructively to the demands from all sides and the pressures from both the market and the international community.

On the BLBI issue, especially that related to the interesting question raised by Mr. von Kleist, I have to really thank Mr. von Kleist for raising the question of program design. I always question what should be the focus of the program for Indonesia for the rest of this year. We certainly do not want to see an extended program without a focus. It will be important as a learning

process for the politicians and the people of Indonesia to understand the logical sequences and connections from the start of the program in 1997 to the end this year. That deserves particular attention by the Board, and I believe that the staff has been working very hard to come up with a well-designed program that can be understood and supported by the government and the people of Indonesia.

Finally, I would like to extend my greatest appreciation to the staff who has been working very hard and has been very patient and supportive of the Indonesian authorities. I also appreciate the flexibility given in the program, which is the most appropriate stance that should be continued. I would like to also thank all the Executive Directors for their written and oral statements, which give constructive encouragement to the authorities of Indonesia to continue the reform agenda.

I also wish that Indonesia can become a good example of how a country has emerged from a crisis and subsequently graduates from the Fund program.

The Acting Chair made the following summing up:

Executive Directors welcomed Indonesia's continued progress in policy implementation under the program. They were encouraged by signs that a durable economic recovery is taking hold: despite the October terrorist attack in Bali and ongoing international tensions, economic growth has been maintained, inflation and interest rates have declined further, and financial markets have been resilient. Nevertheless, Directors noted that the recovery is still fragile, and that it has been driven mostly by consumption demand. They stressed that strong and sustained medium-term growth will require much higher investment, which, in turn, will require vigorous efforts to improve the investment climate—including, inter alia, acceleration of legal and judicial reforms and strengthened governance. In this context, Directors welcomed the increased pace of structural reforms in 2002, especially in the areas of IBRA asset recoveries, privatization, and bank divestment.

Directors welcomed the authorities' desire to exit successfully from exceptional balance of payments support when the Fund arrangement expires at end-2003. However, they emphasized that, for the authorities to achieve this objective, the envisaged reform agenda has to be finalized. Moreover, domestic and external uncertainties remain, in part related to the 2004 elections. Against this background, Directors emphasized the importance of maintaining fiscal discipline and the momentum of reform in 2003. Given the difficulties the authorities have encountered in the past in securing a political and social consensus in support of the economic reforms, Directors considered that a stronger effort should be made to communicate and explain to the public the authorities' policy agenda and its long-term benefits.

Directors were encouraged that the 2002 fiscal deficit was well below the program target of 2½ percent of GDP, and that revenue performance was boosted by improvements in tax administration. They considered this outcome to be an important step toward achieving a lasting fiscal consolidation and a significant reduction in public debt.

Directors agreed that the 2003 budget deficit target of 1.8 percent of GDP maintains an appropriate balance between ensuring continued fiscal consolidation and providing support for the economy. They noted that the authorities have revised some of the policies underlying the budget, notably the decision to partially reintroduce petroleum subsidies. While Directors acknowledged that these changes reflected a response to the unusual situation in global oil markets and did not threaten the budget's overall targets, they urged the authorities to eliminate fuel price subsidies and revert to the automatic pricing mechanism as soon as possible. However, they recommended that steps be taken to protect the disadvantaged through appropriate social safety nets. Directors underscored the importance of continuing efforts to broaden the tax base, reform tax and customs administration, and strengthen treasury and budget operations. They urged the authorities to reconsider the decision to exempt capital goods from the value added tax.

Directors noted that the budget would be fully financed through external support from the Consultative Group of donors, Paris Club debt relief, and asset recoveries and other sources of domestic financing. In this respect, they welcomed the steps taken to further develop the market for government securities and strengthen public debt management. However, with regard to the utilization of government deposits at the central bank, Directors agreed that the authorities should proceed cautiously in order to avoid putting pressure on foreign reserves.

Directors considered that more needs to be done to strengthen the decentralization framework. They stressed that timely and effective budget reporting by local governments is crucial to ensuring the fiscal sustainability of the decentralization framework, and advised that these reports be made public. Directors welcomed the authorities' commitment to address weaknesses in the legal framework governing regional borrowing.

Directors were encouraged by the prudent conduct of monetary policy, which has contributed to a steady decline in inflation and continued strength of the rupiah. In light of these developments, Directors considered that the gradual easing of interest rates was appropriate. They urged the authorities to maintain a cautious approach toward further easing, to ensure that inflation remains in line with program targets and that the rupiah's stability is not compromised.

Directors welcomed steps to maintain the momentum of bank divestment. They noted that the sales process for Bank Danamon is expected to be concluded soon, and looked forward to the sale of other banks. They underscored the importance of returning to private ownership banks that had been taken over during the crisis, and endorsed the authorities' goal of divesting IBRA's remaining banks by the end of the agency's mandate in early 2004. Directors also welcomed the steps taken to advance the restructuring of the state banks, including the planned initial offering of shares in Bank Mandiri in the coming months.

Directors commended the authorities for exceeding the 2002 targets for IBRA asset recoveries and privatization receipts, and emphasized the importance of maintaining a transparent recovery process. They welcomed the measures to enforce the agreements with former bank shareholders, but stressed that a more vigorous and sustained effort is needed to enforce legal actions against noncompliant shareholders. They also underlined that an effective compliance strategy involved ceasing legal actions against those shareholders who had fully complied with their agreements. Directors noted that a large number of enterprises remain to be privatized, and called for stepped-up efforts in this area.

Directors stressed the importance of continued financial sector reform, noting that development of a strengthened financial sector safety net would require close coordination among relevant agencies. They looked forward to the preparation of a comprehensive plan encompassing the key reforms in this area, including the creation of a deposit insurance agency, the adoption of an improved lender of last resort function at Bank Indonesia, and the transition to an independent Financial Supervisory Agency. It will be important to ensure that these reforms are carefully sequenced, and that the removal of the blanket deposit guarantee is gradual and linked to the achievement of key milestones in the reform plan. Directors also stressed that financial sector stability requires strong oversight of the state bank sector, and in this respect welcomed the authorities' plans to improve the monitoring and accountability of state bank activities.

While agreeing that the central bank needs to be more accountable, Directors hoped that any future amendments to the Bank Indonesia law will not result in a loss of operational independence. They also stressed the importance of further strengthening the anti-money laundering framework to bring it into compliance with FATF requirements.

Directors granted a waiver for the non-observance of the structural performance criterion on the implementation of the burden-sharing agreement between Bank Indonesia and the government on Bank Indonesia liquidity credits (BLBI). While they expressed disappointment with the repeated non-observance of this performance criterion, they noted that the delay at this

stage does not seriously undermine the program given that the Finance Ministry and Bank Indonesia are abiding by the terms of the agreement even in advance of formal approval by Parliament. Directors looked forward to the conclusion of the Parliament's review of the agreement.

Directors drew attention to the depressed levels of foreign direct investment, and called for a more vigorous effort to create an environment conducive to private investment. They noted the proposed new investment law, which seeks to further liberalize investment policy and streamline investment procedures. However, they stressed the importance of also addressing the governance and efficiency problems within the public sector, maintaining a liberal trade regime, improving the labor relations framework, and enforcing commercial and bankruptcy laws in a fair and even-handed manner. In this respect, they welcomed the recent passage of new labor legislation, the steps to operationalize the Anti-Corruption Commission, and the measures to strengthen the operations of the commercial court. Directors looked forward to the finalization and implementation of the amendments to the Foundations Law as soon as possible. Some Directors also underlined the importance for the investment climate of resolving corporate debt restructuring cases, especially those to which the government is a party, in a fair and transparent manner, and of treating foreign and domestic creditors equally. Directors supported the ongoing performance audits of state enterprises and the consolidation and auditing off-budget funds, and encouraged the authorities to publish the audits.

Given the authorities' good track record of policy implementation, Directors concluded the Eighth Review under the Extended Arrangement. Some Directors encouraged the authorities to publish the staff report.

The Executive Board took the following decision:

1. Indonesia has consulted with the Fund in accordance with paragraph 3(d) of the Extended Arrangement for Indonesia, as amended (EBS/00/8, Sup. 4, 2/7/00) and the last paragraph of the letter dated November 20, 2002 of the Coordinating Minister of Economy, Finance and Industry, Minister of Finance, and Governor of the Bank of Indonesia.

2. The letter of the Coordinating Minister for Economic Affairs, the Minister of Finance, and the Governor of Bank Indonesia dated March 18, 2003 (the "Letter") with its attached memorandum of Economic and Financial Policies (the "Memorandum"), shall be attached to the Extended Arrangement, and the letters dated January 20, 2000, May 17, 2000, September 7, 2000, August 27, 2001, December 13, 2001, April 9, 2002, June 11, 2002, and November 20, 2002, with their attached Memoranda of Economic and Financial Policies, shall be read as supplemented and modified by the Letter, with its attached Memorandum.

3. Accordingly, the performance criteria set out in paragraph 3(a) for March 31, 2003 and June 30, 2003 shall be as set forth in Table 2 to the Memorandum attached to the Letter.

4. The Fund decides that the eighth review contemplated in paragraph 3(d) of the Extended Arrangement for Indonesia, as amended, is completed and that Indonesia may make purchases under the arrangement, notwithstanding the nonobservance of the December 31, 2002 structural performance criterion on the finalization of the burden-sharing agreements on BLBI credits specified in paragraph 3(b)(ix) of the Extended Arrangement for Indonesia on the condition that, with respect to the purchases subject to the performance criterion specified above, the information provided by Indonesia on performance under this criterion is accurate. (EBS/03/35, 3/18/03)

Decision No. 12973-(03/30), adopted
March 28, 2003

4. PERU—REVIEW UNDER STAND-BY ARRANGEMENT

Documents: Second Review Under the Stand-By Arrangement (EBS/03/34, 3/17/03; and Cor. 1, 3/27/03)

Staff: Wolfe, WHD; Fetherston, PDR

Length: 1 hour, 30 minutes

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

This statement provides information that has become available since the staff paper (EBS/03/34) was issued. The new information does not change the thrust of the staff appraisal.

Real GDP grew by 4.6 percent in January (year on year), and the 12-month inflation rate (CPI) rose to 2.8 percent in February; core inflation was 1.7 percent.

Gross reserves have increased by US$867 million since end-2002 (to US$10.6 billion as of March 21), mainly reflecting two international government bond issues (US$750 million). In addition, the central bank has purchased some US$145 million in the foreign exchange interbank market.

On March 13, 2003, the government issued a decree aimed at capping retail fuel prices by adjusting fuel excise taxes in the event of a substantial further increase in international crude prices. The decree, effective for 90 days, reduces the specific excise tax on fuels if West Texas Intermediate (WTI) crude prices exceed US$40 per bbl over any 10-day period. The tax

would be unchanged if WTI prices are between US$30-40/bbl, and would be raised if they drop below US$30 per bbl (to recover any previous revenue loss). So far, in 2003, the state-owned petroleum refinery has raised prices by 12 percent on average (with the private refinery following suit). The authorities have told the staff that they remain committed to the fiscal targets under the program and would absorb any temporary revenue loss through delays in certain investment projects and cuts in current outlays. In light of this commitment and given the likely small size of the potential impact of the measure on the budget, the staff's assessment is that the authorities' fiscal program remains intact and appropriate.

On March 21, 2003, the authorities issued regulations to establish a system of primary dealers of domestic government bonds, selected five banks as primary dealers, and announced the bond placement calendar for 2003.

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

Recent Developments

In 2002, Peru's macroeconomic performance was strong, with rapid growth, low inflation and limited external vulnerabilities, thus weathering well the international and regional turmoil. All end-December and continuous performance criteria under the Stand-By Arrangement were observed, and the authorities' commitment to continued prudent macroeconomic policies and structural reforms is expected to sustain the recovery in economic activity that began in the second half of 2001, opening the way for a marked reduction in unemployment and poverty over the medium term.

GDP growth in 2002 exceeded program expectations (originally 3.7 percent), closing at 5.2 percent according to the latest national account figures, one of the highest in the western hemisphere. The rise in private consumption (4.4 percent) and exports (5.7 percent) contributed significantly to this result. GDP growth in 2003 is forecasted in the range of 4 to 5 percent. Continued expansion of exports and private consumption and the foreseen improvement in corporate profitability—as well as their effect on private investment—would contribute to achieving the forecasted growth. However, the authorities are aware of the risks associated with a weak global recovery, including the possible consequences of the conflict in Iraq that could result in increased uncertainty and lower domestic growth.

The upturn in private consumption in 2002 resulted from prospects of an improvement in income, the expansion of consumption credit, and higher employment (the year-on-year increase in the latter was 3.7 percent in Metropolitan Lima). Copper and gold exports experienced substantial increases (25.2 and 10.6 percent, respectively). In addition, the value of non-traditional exports is also growing at a fast pace (estimated roughly at

15 percent in 2003), spurred by the extended Andean Trade Promotion and Drug Eradication Act, which enables Peruvian textile and agricultural goods to enter the U.S. market free of tariffs.

Private investment gathered significant pace since mid-2002. Real growth rates in the third and fourth quarters were 4.5 and 4.3 percent, respectively, after eight quarters of continuous decline, and the increase envisaged for 2003 is approximately 5 percent. Investment growth has been the product of greater dynamism in construction and higher capital imports, and has been reinforced by improvements in corporate profitability.

The robust external position—with official reserves rising by $985 million in 2002, and amounting to around twice short-term debt—as well as favorable growth prospects and confidence in policy continuity, contributed to greater investor discrimination, as evidenced by Peru's ability to tap international capital markets. It is also worth emphasizing that in 2002 the trade balance turned to positive after several years. In the banking system, both local and foreign currency deposits rose, and prudential indicators improved. Progress was made in implementing the authorities' structural reform agenda, including the continuation of a comprehensive reform of the tax system and of the Private Investment Promotion Program.

Macroeconomic Policies

The program for 2003 will aim at maintaining prudent macroeconomic policies, including a moderate fiscal adjustment that would be a first step in the medium-term plan of fiscal consolidation. The 2004 budget and the revamped law on fiscal prudence and transparency will be key signals of the government's commitment to its medium-term goal of fiscal consolidation. In this context, the 2004 budget will be consistent with the government's plans in the areas of fiscal decentralization and tax reform, as well as with the medium-term macroeconomic framework. The overall public sector deficit is to decline from 2.2 percent in 2002 to 1.9 percent in 2003, reflecting the tax reform measures taken in 2002. To enhance taxpayer compliance, the government has stated its intention not to introduce any tax amnesty schemes. Current expenditure will remain under strict control, with no generalized wage increase planned for 2003, and the government stands ready to take additional measures that may be needed to ensure that the fiscal deficit targets are observed.

Programmed disbursements by the World Bank, the Inter-American Development Bank, the Andean Development Corporation, and bilateral creditors are expected to be similar to those in 2002, in support of the government's efforts to improve the delivery of social programs, key structural reforms, and public investment projects. The government's gross financing requirements for 2003 have been secured before the end of the first

quarter after tapping international markets. Building on a successful reentrance into the international private capital market in 2002, Peru has placed a total of $750 million of sovereign debt this year, thereby covering its financing needs from external sources for 2003. On January 30, Peru sold $500 million in 12-year global bonds with a yield of 10.10 percent. The operation was well received by investors, as reflected by a healthy performance in the secondary market. On March 3, Peru carried out an additional issue for $250 million as a reopening of the previous one. The 9.43 percent yield on the new operation—which drove the total cost of the sale to 9.88 percent—compares favorably with the yield paid by some higher-rated emerging economies. In this way, Peru has consolidated its presence in the international capital market and protected its financing plans for 2003 from the possibility of unfavorable developments in international markets.

In 2003, the authorities will move forward with the phasing out of regional and sectoral tax exemptions, in accordance with their objectives in the area of tax reform. A key step in this field is the fiscal decentralization law, which will regulate coordination with the sub-national governments, and is expected to be submitted to congress in May. In particular, it will introduce mechanisms for the exchange of tax exemptions for investment in infrastructure and social programs, as an incentive to encourage the process. Additionally, the authorities will persist in their efforts to reduce tax evasion by broadening the coverage of the retention and withholding schemes introduced in 2002 and continuing to implement tax audits. Steps will also be taken to further enhance the Superintendence of Tax Administration's human resources and computing processes associated with the merging of the internal tax and customs administration agencies, and to continue to improve taxpayer services. Full implementation of the comprehensive tax reform introduced during 2002–2004 is expected to yield around 2 percent of GDP on an annual basis over the medium term.

The central bank will continue to pursue a prudent monetary policy under the inflation-targeting framework and a floating exchange regime. In 2002, the monetary policy aimed at preventing the development of deflationary pressures by providing adequate liquidity so as to lower interbank interest rates. The annual inflation target—2.5 percent plus or minus one percent—was attained: at end-2002, the 12-month inflation rate stood at 1.52 percent, just above the lower limit of the target range. In addition, maturities for central bank certificates of deposit have been extended, to 9 months in 2002, and to 18 months and two years in 2003, reflecting lower inflation and greater stability and confidence.

With the normalization of financial market conditions after the regional turbulence experienced in the second half of 2002, the interbank interest rate returned to low levels (3.8 percent as of end-2002, similar to its present level). Additional liquidity, together with improvements in the banks'

loan portfolios and profitability indicators, fostered an increase in bank credit to the private sector at a rate of 1.7 percent in 2002, which compares favorably with the 3.5 percent decline registered in 2001, and an even greater dynamism is expected in 2003. It should be stressed that the currency composition of bank credit is changing, with an increase in credit in domestic currency of 10.6 percent in 2002, while credit in foreign currency continued to fall (-2.9 percent).

For 2003, inflation is projected at the center of the target range, 2.5 percent, and monetary policy will continue to be administered flexibly to ensure the attainment of the target in a context of favorable growth prospects. At the same time, risks associated with the evolution of international oil prices will be properly taken into consideration to avoid any second-round effects or the generalization of inflationary pressures. Furthermore, starting this year, the central bank's monthly policy announcements are placing additional emphasis on the interest rates used in its operations with the banking system, as a way to strengthen the guidance of market interest rates as an operational target of monetary policy, and to further reducing their variability.

Structural Reforms

In 2003, the government will continue working on a legal framework for fiscal decentralization that will ensure that the process is implemented in an orderly, gradual and fiscally neutral manner to protect the public finances over the medium term, as already stated in the legislation enacted so far. The introduction of the fiscal decentralization law, mentioned above, is a main element of this strategy. In addition to facilitating the phasing out of tax exemptions, the law would propose the several policies, including the following.

They will have to define the scope of revenue collections for sub-national governments, with the aim of ensuring the resources necessary to fulfill their functions. This will be a systematic process, consistent with local and regional governments' institutional capacity.

They will also have to introduce criteria for central government transfers to local and regional governments, notably provisions on full and uniform reporting (along the lines of those for the central government).

In addition, they will place further controls on regional and local government borrowing, in addition to those proposed in the draft law on fiscal prudence and transparency. In particular, it is stipulated that debt can be contracted only to finance capital expenditures.

The authorities will also specify fiscal rules, in accordance with the principle of fiscal responsibility, mainly: (i) limits on expenditure;

(ii) accountability mechanisms (multi-year performance reports); and,
(iii) sanctions for noncompliance.

The development of a fixed-income market in domestic currency will favor a process of financial de-dollarization. In this regard, an important element of the government's structural program for 2003 is to improve the functioning of the domestic market for local-currency denominated government securities, and in particular, the auction system. Recently, the authorities issued regulations on the placement of sovereign bonds in the domestic market, and announced the creation of a system of primary dealers. Furthermore, to best ensure a well-functioning market, a calendar of scheduled domestic bond auctions has been published.

Bank supervision will continue to be strengthened in 2003. Significant attention is given to the strengthening of exchange rate risk management and monitoring for dollar lending to clients whose operations generate income streams in local currency. In this respect, legislation has been passed to require banks to increase their information base and their analytical internal risk models, so that they can explicitly incorporate an evaluation of exchange rate risk in their overall credit risk calculation. Legislation has also been approved that increases the penalties for actions resulting in or involving an intent to destabilize the financial system, and draft legislation to provide statutory protection to SBS staff in the discharge of their responsibilities has been submitted to congress.

The government will continue to implement its trade policy strategy of reducing the average level of import tariffs, always with a view to ensuring that such reductions are consistent with the fiscal program. In 2002, the average tariff level was reduced from 11.8 percent to 10.9 percent, and the government intends to lower this further. The government's longer-term objective is to enter into a hemispheric free-trade arrangement by 2006.

Regarding governance issues, in 2003 the authorities intend to continue their efforts to root out corruption in all levels of government—having passed last year important anti-corruption legislation—and work toward strengthening the independence and efficiency of the judiciary.

Our Peruvian authorities remain committed to their reforms plans, and are confident in their ability to press forward with them. In this regard, coordination with congress has been satisfactory, as reflected in the passing of essential legislation for the authorities' initiatives. The enhanced political sustainability of the reform program is also a major element bearing on investor sentiment that has contributed to Peru's narrowing yield spreads and increased access to international markets, thus reinforcing a virtuous circle of good performance, political support and reform implementation.

Mr. Mirakhor submitted the following statement:

We thank the staff for their well-written and concise paper, and Messrs. Le Fort and Pereyra for their helpful statement. Despite regional turbulence and the difficult political domestic situation, the Peruvian economy performed commendably in 2002. Growth picked up strongly, inflation was at the lower end of the target range, and reserves increased significantly. This contributed to a sound track record, needed to restore a sustained climate of confidence and help the authorities successfully address the remaining vulnerabilities, notably, the high degree of dollarization and the large public debt.

The recent steps toward a comprehensive fiscal reform are laudable, and we encourage the authorities to strengthen their efforts in this area. In particular, fiscal consolidation over the medium term will enhance policy credibility, reduce the public debt-to-GDP ratio, and contribute to maintaining a stable macroeconomic environment. To this end, completing the tax reform, mainly through the phasing out of regional and sectoral exemptions, ensuring fiscally-neutral decentralization, and rationalizing public expenditure, while supporting recovery and enhancing protection of the most vulnerable segment of the population, are crucial issues. As indicated by Mr. Le Fort and Mr. Pereyra, the planned introduction of the Fiscal Decentralization Law in 2003 is an important element in the fiscal consolidation strategy. The authorities are encouraged to persist in building early consensus required for implementing these key reforms.

The authorities are to be commended for their conduct of monetary and exchange rate policies. Inflation targeting is being appropriately monitored, and sustained low levels of inflation could help restore confidence in the domestic currency. The exchange rate is relatively stable and the present regime should continue to help the economy adjust to external shocks. In this regard, we welcome the authorities' commitment to limit central bank intervention in the spot exchange market to smoothing needs and to avoid direct intervention in the forward exchange market.

The process of financial de-dollarization will also benefit from enhanced functioning of the domestic bond market. The recent measures taken by the authorities in this area, as outlined in the staff paper and the statement from Messrs. Le Fort and Pereyra, are encouraging, and should translate into strengthened domestic financial intermediation.

We also welcome the authorities' renewed commitment to strengthen oversight and management of the financial system and their plan to grant legal protection to bank supervisors. This should enhance the soundness of the

financial system, help mitigate the risks associated with the high level of dollarization of the economy, and support sustainable growth.

Strong and sustained growth is needed to address the high rate of unemployment. We are encouraged by the authorities' commitment to continue implementing sound macroeconomic policies and appropriate structural reforms in order to address the prevailing risks and vulnerabilities and to promote further private participation in the economy. We are pleased to support the completion of the second review.

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

We would first like to thank the staff for a rigorous and candid paper and Mr. Le Fort and Mr. Pereyra for their very helpful statement.

The Peruvian authorities' pursuit of sound macroeconomic policies and structural reforms has enabled the country to weather unfavorable global and regional conditions in 2002. The recorded GDP growth rate during the year was one of the highest in Latin America, and employment took on an upward trend. This growth was achieved within a stable monetary and financial environment, as reflected in low inflation, stable exchange and interest rates, and a sound and well-capitalized banking system. In addition, large capital inflows associated with increased investor confidence improved the external position and allowed the central bank to accumulate sizeable official reserves. Despite these impressive accomplishments, Peru, like most countries, is still vulnerable to external shocks not only because of the global and regional environment, but also because of the high level of dollarization in the banking system. Addressing dollarization requires a full recovery of confidence in the economy, which can be achieved by sustaining the growth performance. The latter in turn requires a strong commitment to prudent monetary and fiscal policies and structural reforms.

In view of the authorities' steady progress in program implementation under the current arrangement, and their commitment to the reform agenda, we support the completion of the second review. We broadly agree with the staff appraisal, and will limit our comments to some fiscal and monetary issues.

Structural fiscal reforms implemented in 2002, which included important pension and tax reforms, have helped the authorities maintain fiscal consolidation and meet program targets. In particular, the new measures to improve tax administration and increase the VAT and income tax have yielded 0.2 percent of GDP in 2002, and are expected to yield an additional 0.8 percent of GDP in 2003. We welcome the authorities' intention to complement these measures through the tax audit program and the VAT withholding schemes. The targeted reduction of the overall public deficit to

1.9 percent of GDP is appropriate and its achievement requires a prompt implementation of the proposed revenue measures and strict control of the wage bill. It is reassuring that the authorities are prepared to take additional measures if needed to ensure that the fiscal target is met. While we share the authorities' concern with the impact of an excessively tight fiscal stance on economic activity, we are of the view that an over-performance in budgetary revenue due to higher than expected growth should be used for further lowering the budget deficit and public debt. Further consolidation will speed up the convergence to the medium-term deficit target and enhance the credibility of the government's program. Saving additional revenues will also allow for the operation of automatic stabilizers in support of the inflation-targeting regime.

In the medium term, ensuring fiscal sustainability requires a steadfast and timely implementation of the envisaged fiscal strategy. Higher priority should be accorded to the completion of the tax reforms, including the elimination of regional and sectoral exemptions, which have been delayed due to inadequate political support. We are encouraged by the actions taken thus far, especially the establishment of the legal framework for the decentralization process and the submission to congress of the revised law on fiscal prudence and transparency. Given the political difficulties associated with implementing the decentralization process and its significant budgetary implications, it is essential that the fiscal measures be skillfully sequenced. Appropriate sequencing will ensure not only the needed political support to implement the reforms on a timely basis, but also fiscal neutrality of the process in the medium term. The law on fiscal prudence and transparency is particularly important for the medium-term strategy as it sets a limit on the deficit and insures fiscal consolidation at all levels of the government. Finally, plans to protect the most vulnerable groups of the population, including through targeted subsidies and improvements in the quality of social expenditures, need to be adequately incorporated in the fiscal strategy.

On monetary and exchange rate policies, the current policy framework, which relies on the inflation-targeting regime and a flexible exchange rate, has served the country well in 2002. Inflation was reduced to 1.5 percent and the exchange rate has been stable through most of the year. We commend the central bank for promptly responding to exchange rate pressures in the second half of last year, and restoring stability by tightening monetary policy. However, the high level of dollarization, in addition to being a source of banking sector vulnerability, exerts constant pressure on the central bank to maintain a high level of official reserves, thereby reducing the flexibility and effectiveness of monetary policy. Addressing this issue should thus be given high priority in the central bank's agenda. We concur with the authorities' view that reducing dollarization will take time and require continued prudent macroeconomic policies, a further strengthening in bank supervision and a deepening in financial intermediation. In the meantime, we

encourage the central bank to continue its policy of maintaining a high level of official reserve coverage of dollar deposits and sound regulations on dollar lending, as well as retaining the current level of reserve requirement on dollar deposits.

With these comments, we wish the authorities success in their reform efforts.

Mr. Usman submitted the following statement:

We thank the staff for a very helpful set of papers and Mr. Le Fort and Mr. Pereyra for their detailed and comprehensive statement. The Peruvian authorities are to be commended for implementing sound economic policies, which contributed to robust growth and enabled the economy to withstand regional turbulence. Nevertheless, the country still faces a number of challenges. While the adherence to macroeconomic policies in the context of a Fund-supported program and the progress made on reforms have served the country well, key vulnerabilities remain, including the high level of dollarization, high public debt, and an uncertain external environment. Since we are in broad agreement with the paper, we will comment only on the following areas for emphasis.

Fiscal Policy

In our view, moderate fiscal adjustment would contribute to sustainable medium-term fiscal position. In this context, we welcome the authorities' commitment to avoid any tax amnesty schemes, and we urge them to pursue efforts in strengthening tax administration. This should be supported by the tax audit program and expansion of the VAT withholding schemes already in force. In addition, we would urge the authorities to adopt a fiscal decentralization law this year, which is needed to promote medium-term fiscal sustainability. In this regard, it will be important to ensure that the decentralization process is fiscally neutral. The authorities should phase-out regional and sectoral tax exemptions, and resist any pressures for increasing spending in the regions. The reforms should be vigorously monitored to avoid any loss of momentum. Furthermore, pressures to accelerate the decentralization process in advance of having a sound legal framework in place should be resisted.

Monetary Policy

We welcome the authorities' preparedness to tighten monetary policy in order to achieve the set program targets. We agree with the authorities that restoring confidence in the local currency requires a track record of macroeconomic stability, continued prudence in banking system oversight, and further development of domestic capital markets. The authorities'

commitment to strengthen bank supervision, through the finalization of the consolidation and rationalization of the norms of the (superintendency of banks) SBS on provisioning and loan classification to improve transparency is also welcome. We support the view that the authorities should resist any pressures for relaxing provisioning requirements. We encourage the authorities to grant statutory protection to SBS staff in the discharge of their duties and to implement the pending FSAP review recommendations. Furthermore, the authorities should remain vigilant, and should further strengthen the prudential framework so as to contain the vulnerabilities arising from dollarization.

With the above remarks, we support the proposed decision and wish the authorities every success in their endeavors.

Ms. Indrawati submitted the following statement:

We thank the staff for a very concise paper on Peru and Mr. Le Fort and Mr. Pereyra for their informative and helpful statement. The economy improved significantly in 2002 with GDP growth of 5.2 percent and low inflation of 1.5 percent. The Peruvian authorities deserve commendation for their strong achievements since the last review in December 2002 despite external vulnerability as well as challenging domestic political situation.

To sustain these achievements, the authorities need to continue pursuing sound macroeconomic policies to be supported by parallel improvement on the structural front. The remaining risks in the medium-term relate to challenging domestic political environment, sizeable public debt and high level of dollarization, which could thwart the momentum of progress already underway. As the authorities were able to fulfill all end-December performance criteria and most of structural benchmarks, we therefore support staff proposal that the second review under the Stand-By Arrangement for Peru be completed.

We concur with the broad thrust of the staff's findings and recommendations, and will therefore focus our comments on several issues for emphasis.

Fiscal Reforms and Public Debt

Fiscal performance in 2002 was notably satisfactory reflecting the fruits of on-going efforts in strengthening the tax system as well as the tax administration. We agree with staff that achieving a healthy fiscal balance through gradual consolidation over the medium-term is the key to reducing debt-to-GDP ratio to a sustainable level as illustrated in Table 10 of the staff paper. While this is necessary, the authorities need to strike a balance between the pursuit of consolidation and growth in the fiscal strategy. Looking ahead,

the authorities have to be firmer in implementing the remaining reforms including the phasing out of regional and sectoral tax exemptions, expansion of VAT withholding schemes, and implementation of more tax audits. We welcome the authorities' plan to cease granting of tax amnesties as an important development in efforts to strengthen public finances over the medium-term. On the expenditure side, we are encouraged with the authorities' intention to rationalize current spending and to give additional priorities to capital outlays.

With respect to fiscal decentralization, it is encouraging to learn that significant progress has been achieved particularly on the legal aspect including the recent passing of Law on Regional Governments late last year. We agree with the authorities on the need to adopt a gradual and orderly approach. We urge the authorities to pursue timely enactment of the law on fiscal decentralization that would ensure the impact of fiscal decentralization on the public finances is broadly neutral. Having said that, we concur with the staff on the importance of resisting the pressure to accelerate the decentralization process unless the legislative framework has been firmly in place.

Monetary Policy and High Dollarization

We concur with staff on the appropriateness of the monetary policy under inflation-targeting framework and floating exchange rate regime, which so far has worked well for Peru. However, high-dollarization of the banking system continues to be a potential source of vulnerability. In this regard, we are encouraged to note that the strengthened reserve position and well-capitalized banking system would help mitigate direct risks due to exchange rate depreciation and unfavorable external developments.

However, we would encourage the authorities to implement measures to discourage and gradually reduce dollarization over the medium-term. Recent achievement in reducing dollarization as pointed out in the statement of Mr. Le Fort and Mr. Pereyra is encouraging including the authorities' current efforts in improving the functioning of fixed income market in domestic currency. We urge the authorities and staff to explore additional measures including offering lower rates for dollar-denominated deposits and increasing reserve requirement ratio for credit extended in dollar terms, among others. However, the key factor to restore confidence in the local currency would depend on continued pursuit of prudent macroeconomic policies, strengthening of banking system and additional efforts in the development of domestic capital market.

Medium-Term Outlook

Prospects for sustained growth over the medium-term will depend on the progress on the implementation of structural reforms particularly in relation to fiscal area and further development in export activities. As mentioned in the statement of Mr. Le Fort and Mr. Pereyra, we are encouraged to note that, apart from traditional mining industry, export contribution from textile and agricultural sector has increased in importance thanks to Andean Trade Promotion and Drug Eradication Act. However, export as a percentage of GDP still remains at a lower level of around 14 percent; therefore, there is an urgent need to strengthen export performance particularly the untraditional exports. In this context, additional measures should be implemented to ensure economic growth sustainability.

With these remarks, we wish the Peruvian authorities continued success.

Mr. Bennett submitted the following statement:

Key Points

Skillful economic management has helped Peru weather a turbulent external environment, but the persistence of important economic vulnerabilities require that the authorities remain vigilant in implementing their economic reform program.

While performance under the program has thus far been good, critical reforms in terms of tax reform and engineering a fiscally-neutral decentralization are yet to come, and the political capacity to implement these reforms is uncertain. Consensus-building efforts will be critical and structural benchmarks should be reoriented to focus on achieving key objectives under the legislative agenda.

Relative to other countries in the region, the Peruvian economy has shown remarkable resilience to domestic and external pressures, thus reinforcing the important benefits of adhering to a macroeconomic policy framework, conducive to improving economic fundamentals. The authorities are to be commended for their economic management in a number of areas, including the successful move to an inflation-targeting regime, a commitment to building up official reserves, and ongoing efforts to strengthen prudential regulation in the financial sector. Nevertheless, important vulnerabilities persist, that relate primarily to the high level of dollarization in the banking sector and the relatively large debt burden, the bulk of which is denominated in foreign currency.

Given the uncertain external environment and nature of macroeconomic risks, there is no scope for policy complacency. The program is well designed from the perspective of promoting economic stability, but requires a sustained commitment by the government to the implementation of key legislative items and structural reforms. Furthermore, establishing a solid foundation for sustained strong economic growth requires decisive action to address pervasive problems with governance.

As we largely concur with staff's appraisal and the recommendation to complete the Second Review, we will confine our remarks to a few key areas for emphasis.

Weak Ownership

The analysis of ownership and the political capacity to implement the program contained in Box 1 of the staff paper is, perhaps, the most important contribution by the staff to this discussion on Peru. We strongly welcome the inclusion of this analysis, which in our view, should feature in all UFR documentation, as it is critical in making informed judgments on whether a program can be supported; it can also help increase the probability that a program will be successful by enhancing policy design and sequencing.

Weak political ownership has long been regarded as the key risk to this arrangement and we continue to have serious concerns in this regard. While the authorities remain confident that there is sufficient support for their economic program, we encourage them to embark on a major consensus-building campaign so as to sustain the momentum for reform and to "fence in" new initiatives that might derail economic objectives under the program. On the latter, proposals that would give Congress the authority to create spending initiatives, as well as expand the government's right to intervene in private sector activity, are especially problematic as they would compromise fiscal consolidation efforts and undermine the climate for investment.

As a part of this consensus building effort, I encourage the authorities to publish the staff paper. In addition, the staff might consider meeting with representatives of Congress and participating in press conferences to help deepen the social understanding of key economic and legislative issues. Presidential vetoes may be required to avoid an undue watering down of major legislative items, especially relating to the phasing-out of regional and sectoral tax exemptions and engineering a fiscally-neutral decentralization.

Given the lack of widespread political ownership, we support modifying program conditionality to include structural benchmarks on the passage of key legislative items, such as the fiscal decentralization legislation and a 2004 budget, consistent with stated decentralization and tax reform objectives and revised rules on fiscal prudence and transparency. The strategy

of complementing benchmarks on legislative submissions with benchmarks on their passage in later reviews, was employed in the recently-approved program for Ecuador, where weak ownership was the primary concern. In our view, this helped strike a sensible balance between providing the country with an opportunity to build a consensus for reform and confronting the reality, that IMF support is contingent upon actions and not good intentions.

Governance and the Institutional Context

In terms of Peru's institutional context, there is no question that pervasive governance problems and weak institutions are an impediment to growth and stability. Indeed, corruption is rated as a major obstacle to business development—bribes to secure procurement contracts are commonplace—and rule of law institutions, including the police, army, and judiciary, are rated as the most corrupt government agencies. Against this backdrop, the anti-corruption legislation passed last year is a welcome step, but market participants are interpreting the political reshuffling within the interior ministry as a weakening of the government's commitment to reform key institutions and root out corruption and political patronage. This casts some doubt on whether the increase in investment, which occurred in the third and fourth quarters can be sustained—the staff's comments would be appreciated.

More generally, we believe that addressing governance and weak institutions is an area where the Fund can and should do more, including by increasing coverage on this topic in future staff papers as well as through the provision of technical assistance (in collaboration with the World Bank). The latter should focus on establishing a "roadmap for reform" which should feature more prominently in future Fund supported arrangements.

Fiscal Policy

Sustained fiscal consolidation within the context of authorities' medium-term fiscal consolidation plan should remain the focus of fiscal policy. The swift passage of the strengthened law on fiscal prudence and transparency would reinforce the authority's commitment to fiscal sustainability. Over time, however, the authorities will need to target budget surpluses and put in place a framework that achieves budget balance over the cycle.

In terms of immediate priorities, current expenditures should be rationalized to increase productive capital outlays while preserving important social expenditures. The authorities' commitment to withhold wage increases in 2003 is welcome and pressure to reduce the retirement age will also need to be resisted. On the revenue side of the equation, broadening the tax base, most notably by eliminating regional and sectoral exemptions, and improving tax

administration and compliance, are the key priorities. Like staff, we see merit in linking the phase-out of regional and sectoral tax exemption to the process of decentralization, as a means of building a consensus for reform. Congress has now passed laws that help articulate the decentralization process. In practice, however, decentralization should not be implemented until the appropriate conditions are in place as elaborated upon in Box 2 of the paper.

In terms of improving tax administration and strengthening compliance, we welcome the authorities' commitment to refrain from further amnesties as they would only frustrate the benefits of ongoing tax reform by distorting incentives. I note that the implementation of the tax-auditing plan is well advanced. Could the staff elaborate on the impact of this strategy in terms of increasing revenues and strengthening compliance?

Monetary and Financial Sector Issues

The monetary framework, which consists of inflation targeting and a floating exchange rate, has helped Peru cope with external shocks and contributed significantly to promoting economic stability. On monetary policy, the current monetary stance appears consistent with keeping inflation within the target range this year, but the authorities should remain vigilant and stand ready to tighten monetary policy, if necessary, to achieve the target. In addition, given the degree of dollarization in the economy, it is understandable that the authorities keep an eye on exchange rate movements and are prepared to intervene in foreign exchange markets for smoothing purposes. However, currency volatility and dollarization risks will recede over time if prudent macroeconomic policies are sustained, such as increasing foreign exchange reserves, and as progress is made to further strengthen banking supervision and deepen domestic capital markets.

Briefly, on strengthening the banking sector and improving financial sector supervision, we welcome the introduction of norms intended to minimize the risks of foreign currency mismatches in bank balance sheets and the plan to grant legal protection to banking supervisors. The authorities should move swiftly to finalize NPL norms and begin on-site inspections to ensure that new prudential norms are being observed. Finally, we urge the government to implement outstanding FSAP review recommendations as detailed in Appendix VII of the staff paper.

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

Just over a year into this precautionary program, we believe Peru is headed in the right direction. Despite ongoing political divisions, and we appreciate the report in Box 1, tough structural reforms are under way. Economic performance has been good as described by Mr. Le Fort and Mr. Pereyra. Program targets are being met; and Peru has successfully

maneuvered around the difficulties experienced by some of its neighbors. We broadly concur with the staff assessment, and have just a few issues we want to highlight.

Fiscal Issues

First, the fiscal consolidation now underway is encouraging and we agree with colleagues that it is important for Peru to continue to reduce its deficits. The planned law of Fiscal Prudence and Transparency seems sound. We support the government's plans to eliminate the widespread tax exemptions and urge authorities to move forward with these plans expeditiously. However, we continue to question the desirability of earmarking the increased revenues generated by this process for expenditure in the regions. We support the ongoing decentralization process, but urge that prudent fiscal rules for all levels of government be put in place as authority is devolved to the regions, to ensure that the process is implemented in a fiscally-neutral manner with full transparency and accountability at all levels of government. The inclusion of fiscal reporting requirements is therefore quite welcome.

However, as the staff highlights and we have discussed before, high foreign exchange-denominated debt and dollarization with an exposed corporate sector continue to leave Peru vulnerable to exchange rate and confidence shifts. Recent improvements in financial supervision and regulation should help mitigate these risks, and the staff's assessment of the soundness of the inflation targeting regime will contribute to maintaining confidence. However, that leaves little room for fiscal expansion and therefore we strongly support the authorities' plans to increase budget flexibility and retarget spending, while continuing to strengthen the overall fiscal position.

There are, of course, other factors that can contribute to maintaining stability and competitiveness, such as labor market and price flexibility. We recall that the staff expressed some concerns at the last review about changes in the labor market code. We would welcome staff comments on the extent to which there are problems with price and labor market flexibility and what might be done about it.

Financial Sector

We welcome the establishment of a system of primary dealers of domestic government bonds and ask staff to keep us updated as the system evolves. We regret the decision of the authorities to extend Banco de la Nación's consumer lending program for another two years, reversing their decision at the time of the last review.

We particularly welcome plans to grant statutory legal protection to bank supervisors. We also welcome progress on a number of the main FSAP review recommendations, as shown in Appendix VII. However, we note that the same appendix shows the authorities do not intend to take action against several weaknesses addressed in the FSAP review. We would urge the authorities to reconsider.

Growth

Staff projections show high real growth rates over the medium-term. Achieving this entails improving the investment climate. The reaction following the announcement by foreign owners to withdraw from the third largest bank last quarter highlights the sensitivity of at least the banking sector to changes in investor sentiment, although the foreign investor decided ultimately to remain. Mr. Le Fort and Mr. Pereyra highlight in their statement the stronger growth in exports, including non-traditional exports to the United States We welcome this evidence of the potential for export diversification and its follow-on job creation and growth effects.

Growth would also get a boost if financial intermediation can be increased, and the incipient recovery in credit to the private sector in the second half of 2002 is encouraging. We also agree with staff that a reversal of the decline in public sector capital spending would help boost growth and fight poverty. Finally, we urge the authorities to reinvigorate efforts to secure more private sector participation in state enterprises, such as operating concessions (even if privatization seems off the table for now).

Mr. Pereyra made the following additional statement:

First, I would like to thank those Directors that have issued statements and made suggestions for the benefit of the authorities. I would also like to make a few points for clarification.

One Director was concerned about weak program ownership in Peru, which might undermine the program. However, the markets seem to be taking a different view as confidence has improved, which is evident from the authorities' increasing ability to tap international markets owing to reduced risk premia and growth in investment. Furthermore, the authorities have built a strong track record with the passage of important legislation and progress with reform initiatives. The executive branch of government has also been able to influence the legislative process through oversight, which has enabled them to modify laws that jeopardize the program.

Ultimately, this debate over ownership revolves around the government's ability to generate political consensus for reforms, which has always proven to be a difficult endeavor. Nevertheless, the government has

been rather successful in building support for the program and individual reforms thus far, and the authorities do not believe that the program is in danger. Furthermore, given the ongoing process of democratic consolidation in Peru, the process of political debate over proposed reform measures is encouraging, and a sign of democratic progress.

Regarding program conditionality, I would like to stress that the major legislative initiatives proposed by the executive branch are already covered by structural benchmarks. However, these benchmarks are formulated such that the authorities are ultimately responsible for negotiating and passing the required legislation without explicitly imposing an obligation on the congress. In this light, I would like to emphasize the authorities' view that imposing obligations directly on the congress for the passage of various laws would seriously threaten to undermine ownership and public acceptance of the program, and even the credibility of the Fund. For this reason, any increase in the rigidity of performance criteria would be misguided. This is particularly true when Peru's success with respect to the program is considered, and any such modification to the program's conditions could have an adverse impact on the future of the Stand-By Arrangement.

There was also concern about the strength of domestic institutions and the extent of corruption in Peru. The authorities have been working to address corruption since the political crisis of the late 1990s, and several laws have subsequently been passed. These include legislation aimed at regulating and improving the transparency of government procurement through the use of the Internet and other mechanisms.

Regarding the financial sector, there were a few concerns about the Banco de la Nación, and I would like to assure the Board that the authorities are aware of their concerns. In this light, they are attempting to focus the program in question on current and retired employees of the institution, in order to ensure that the repayments of loans that have been granted can be withdrawn directly from their disbursements, which will result in a negligible default rate. Furthermore, the size of this program is governed by a quantitative benchmark, which further reduces the possible risks associated with this initiative.

Regarding the FSAP review, the authorities acknowledge that some Directors encouraged the implementation of all of the FSAP review recommendations. Nevertheless, the authorities believe that many of these outstanding recommendations reflect legislation or reforms that have already been implemented or proposed. In other cases, banking system regulation is sufficient to address the concerns raised in the context of the FSAP review, which is reflected by the fact that the Peruvian financial system has been resilient to both market volatility and financial shocks over the past few years, especially in the wake of the Russian crisis of 1998.

Regarding fiscal decentralization, Directors expressed some concerns over the practice of earmarking the proceeds from the elimination of tax incentives for certain types of regional investment. The authorities acknowledge that in general, earmarking can become subject to manipulation, which can lessen the government's control over expenditures. However, phasing out tax incentives while permitting limited concessions for certain regions can serve as a positive incentive for public and regional acceptance of the reform process. In fact, there is significant evidence suggesting that the newly elected decentralized authorities are seriously considering accepting the elimination of these exemptions, as they require the resulting funds for infrastructure maintenance and development. In this light, the authorities believe that this policy is justified.

Mr. Mirakhor expressed his concern over paragraph seven of Mr. Bennett's statement, which suggested the imposition of structural benchmarks on the passage of legislation that was in the process of legislative deliberation. Although Mr. Bennett's statement noted that there might have been instances where such conditions were appropriate in the past, it seemed likely that this type of conditionality had adverse consequences for program ownership. In the case of Peru, the government and the authorities had been broadly successful in implementing the program, which left little justification for considering program conditions on legislative deliberations and actions. Furthermore, past Board discussions on conditionality had encouraged a cautious approach to the use of such measures.

Mr. Gallardo made the following statement:

We wish to commend the authorities for the sound macroeconomic policies implemented during 2002 under the Stand-By Arrangement. Real GDP grew by 5.2 percent, compared with 3.7 percent assumed in the program. Growth was led by exports, and consumption, reflecting the fiscal stimulus package implemented in the second half of 2001, and a pick up in consumer and housing lending by banks. Private investment began to recover in the third quarter after falling eight consecutive quarters. The 2002 combined public sector deficit was 2.2 percent of GDP, in line with the revised fiscal program.

Important steps have been taken to strengthen public finances, but key reforms remain to be implemented, including the completion of the tax reforms, implementation of a fiscally-neutral decentralization, and a revised law on fiscal prudence and transparency. The government is facing political opposition in congress that can complicate the introduction of key structural measures to reform the tax system. The planned phase-out of regional and sectoral tax exemptions, a key element on the reform agenda, has been integrated into the ongoing fiscal decentralization process to garner in congress the necessary political consensus. The draft law to be approved in 2003 is to ensure that the medium-term impact of decentralization on the

public finances is neutral. In this connection, we concur with staff that any pressures to accelerate the process before the law is approved should be resisted. In addition, we support the authorities' decision to carry out decentralization in a gradual and orderly manner. A draft law to strengthen the Fiscal Prudence and Transparency law was sent to congress in November last year and is expected to be approved by congress in mid-2003.

Real GDP growth for 2003 is projected in the 4 to 5 percent range. The economic program for 2003 envisages an overall fiscal deficit of 1.9 percent of GDP, lower than the 2.2 percent registered in 2002. Inflation is projected at 2.5 percent in 2003, higher than the 1.5 percent registered last year. The program has secured financing requirements from official sources, and from the placement in the first quarter of 2003 of US$750 million 12-year bonds.

The authorities remain committed to continue prudent management of monetary policy under the inflation targeting framework. The financial and banking indicators improved in 2002, but financial dollarization is an important weakness. In 2002, the share of foreign currency deposits in total deposits was 73 and 78.8 percent of total loans was denominated in foreign currency. The authorities are aware of this vulnerability and are committed to maintain macroeconomic stability, and prudent oversight of the banking system to restore confidence on the domestic currency. In this connection, we encourage the authorities to implement the pending FSAP review recommendations to include in the banking law the "least-cost" principle for bank resolution, and to establish a time limit for required capital increases. The external position is strong, and gross official reserves at end-2002 stood at US$9.7 billion, covering 103 percent of dollar deposits in the banking system and 206 percent of short-term external debt.

We wish the authorities success in the implementation of the program, and we support the staff's recommendation to complete the second review.

Ms. Lanza made the following statement:

Let me begin by thanking the staff for their concise paper, and Messrs. Le Fort and Pereyra for their informative statement.

The Peruvian authorities should be commended for their tremendous progress to date, and for weathering the regional turmoil and global slowdown. Growth has outperformed expectations in 2002, inflation has remained subdued, and international reserves have increased. However, looking ahead, we have some concerns about the risks the Peruvian economy could potentially face.

As we broadly agree with the thrust of the staff appraisal, we can confine our remarks to the following areas: forecasts of real variables; the

high degree of dollarization of the economy; and, fiscal consolidation and the political climate.

The staff's projections of GDP growth of between 4 and 5 percent for the current year, despite being broadly in line with average consensus forecasts, may prove overly optimistic in light of an outlook that appears increasingly uncertain. In addition, taking a closer look at the consensus survey, eight of twelve forecasters see a growth rate below 3.8 percent. Moreover, staff projections for exports in 2003 foresee a growth rate of 11.1 percent, which could prove quite challenge given that Peru's largest commercial partners are the United States and the United Kingdom, which absorb some 38 percent of the country's total exports.

This does not have to be a significant source of concern, particularly if the authorities can promptly arrange corrective measures to contain the fiscal impact. However, while the staff envisages a plan for fiscal consolidation if revenues turn out to be higher than expected, nothing is mentioned of a plan to deal with the situation if the case proves to be the opposite. We would greatly appreciate the staff's comments on this matter.

Another important vulnerability of the Peruvian economy, which may be exacerbated by a weakening of the global outlook, relates to the high degree of dollarization of the economy. As we have already stressed at the time of the last review, a highly dollarized economy is quite vulnerable to external shocks or an extreme loss of public confidence. While we commend the authorities for increasing their levels of international reserves and improving prudential regulations, we note that the slow but steady process of de-dollarization of the economy seems to have come to a halt in recent months. It is evident that amidst the political hurdles that currently face President Toledo stemming from opposition to the government's reform agenda, U.S. dollar deposits are sought after as a safe heaven. However, this heaven may quickly disappear if a combination of political hurdles at home and unfavorable external developments materialize. We therefore strongly encourage the authorities to keep up the pace of structural reforms, with particular attention to measures devoted to decreasing financial dollarization. We would appreciate the staff's comments on this issue. We see great merit in the authorities' proposal to develop, with the assistance of the staff, a debt sustainability analysis that incorporates dynamic responses to shocks in case of a sustained depreciation of the exchange rate. This could prove to be a very helpful exercise, which, if successful, could be extended to other countries, in order to enhance the value of debt sustainability analyses.

Finally, the fiscal decentralization process coupled with the elimination of regional and sectoral tax exemptions should also be pursued with great care in that it could easily jeopardize the achievements of the authorities. Coordination and control problems in the decentralization process

will likely materialize at a time of weak government popularity. The risk is in fact not only that the President will have to face increasing opposition with respect to the reform agenda but, even more worryingly, that once in place, fiscal decentralization may give rise to free-riding behavior or a refusal by some provinces to participate and coordinate efforts with the central government. This has already been the case in some Latin-American countries in times of political instability. The authorities should therefore proceed cautiously with the implementation of the law if it is approved by the Parliament later this year.

Mr. Basdevant made the following statement:

We would first like to thank the staff for a comprehensive paper and Mr. Le Fort for his interesting statement. For today's discussion, I would like to comment on several issues.

First, regarding monetary policy, we welcome the fact that the central bank has implemented an inflation targeting system, as the inflation rate was kept within the targeted band. We would also like to point out that inflation targeting was officially adopted once inflation had been reduced. This probably contributed to the success registered so far, and we would be more cautious when countries adopt such a system while inflation is still in the double-digit range. Nevertheless, we have a few concerns about the level of inflation, because although it was kept within the targeted band, it was near the lower limit. Thus, we wonder if the central bank kept interest rates too high. However, inflation is expected to increase to 2.5 percent in 2003—the midpoint of the target band—owing to a reduction in interbank interest rates. We welcome this measure, as it will sustain growth while maintaining the credibility of the target.

Regarding dollarization, we would simply like to mention that we strongly support the authorities in their assessment of the role of confidence and reputation. Prolonged economic stability will be the main tool to reduce dollarization and we share the view that direct measures to reduce dollarization can be counterproductive. This is another reason for the continuation of a prudent monetary policy and maintaining inflation within the targeted band. We also encourage the authorities to continue their efforts to strengthen banking supervision, and we welcome the measures aimed at improving risk evaluation.

Although the flow of FDI increased in 2002, and has been well-above the initially forecast value, a sharp decrease is forecast for 2003. FDI flows are rather volatile, but this result may still appear somewhat counter-intuitive, given the good performance of the economy. Therefore, we welcome the staff's comments on this issue.

The level of debt is relatively high, and its structure reveals some vulnerabilities—e.g., 80 percent of the debt is denominated in foreign currency. Thus, debt sustainability will remain dependent on the stability of the exchange rate. We strongly support efforts to reduce this share and to develop a domestic bond market.

We support the tight control of public expenditures, and we welcome the authorities' efforts to lower the budget deficit from 2.2 percent of GDP in 2002 to 1.9 percent in 2003. We particularly welcome the fact that the authorities will move forward with the phasing out of tax exemptions. We also welcome the rationalization of public expenditures. Nevertheless, we would like to ask the staff if they could elaborate on the current social program of the government, and how they intend to reduce poverty while keeping expenditures under control.

Reducing poverty will indeed be a major challenge, and will be much needed in order to build political support for structural reforms. Although structural reforms are moving forward, several unfortunate measures, like tax exemptions and the development of specialized banks, were undertaken in the past to maintain a political consensus. Thus, we strongly recommend that the authorities continue their efforts to build broad political and social ownership for measures that will strengthen stability and growth. With these comments, I wish all the best to the Peruvian authorities.

Mr. Antic made the following statement:

At the outset, I thank the staff for a short, but comprehensive analysis of the present economic situation in Peru, as well as Mr. Le Fort and Mr. Pereyra for their helpful statement. I share the staff's assessment that Peru's overall macroeconomic stance remains strong, especially compared to its neighbors. Positive economic results were delivered in the situation characterized with diminishing public support for the current administration. That is the sign that a skilful managing of the economic policies has to be accompanied by a capacity to garner political support.

On the fiscal front, the outlook for 2003 foresees decreasing fiscal deficit. Government's firm intention to maintain fiscal discipline and to implement tax reform makes the reduction of the fiscal deficit viable. Nevertheless, the established goal depends on a sustainable economic growth, capable to create more job opportunities. The present economic growth is largely based on mining exports that are intensive in capital, but less in labor. The level of FDI in 2002 is encouraging and could have a positive impact on more labor-intensive sectors, which would alleviate substantial social pressure. Thus, diversified growth can underpin prudent fiscal policy. Can the staff comment on sectors that are attracting FDI?

Regarding decentralization, I welcome the authorities' efforts to gradually move ahead with decentralization. The process has been primarily conducted by forming a sound legal framework. The challenge will be to balance the differing interests of the central and sub-national governments. Successful balancing guarantees an ordered process and a reasonable degree of autonomy. Moreover, fiscal decentralization should help local and regional authorities to collect taxes.

Keeping the impact of decentralization on public finances neutral is of a high importance. Nevertheless, we reiterate one of our comments from the first review of the Stand-By Arrangement—that the hidden costs of a centralized tax system should also be taken into account in order to establish neutrality criteria. With these remarks, I wish the authorities success.

Mr. Droop made the following statement:

Let me begin by noting our support for the proposed decision. Performance over the last year has been strong despite the difficult regional and global environments. This strong performance has translated to improved market confidence, which has facilitated an improvement in the profile of the debt stock. Nevertheless, like the staff and many other Directors, we recognize that some risks remain.

We strongly support the government's efforts to manage the reform process within a clear and fiscally neutral framework, and we welcome the program's focus on this issue. Furthermore, we believe that if managed well, the reform program will contribute to stronger delivery of public services, which will support the government's poverty reduction efforts.

Regarding the high level of dollarization in the banking system, like other Directors, we welcome the staff's comments on the appropriateness of the current regulatory framework for dollar deposits and the level of reserve requirements.

We also welcome the staff's very useful debt sustainability analysis, and support the authorities' interest in augmenting the analytical approach by including more dynamic interactions and endogenous policy responses in the modeling exercises. For instance, it seems likely that a significant depreciation of the currency would be followed by a tightening of monetary conditions. We would like the staff to outline how the inclusion of monetary responses in such exercises would change the outcomes of similar debt sustainability analyses. The staff should also attempt to determine the possible implications of policy slippages, for example, if tax reforms were only partially implemented or if decentralization was not revenue neutral.

Mr. Garner made the following statement:

At the outset, we would like to thank the staff for a well-written set of papers, and Mr. Le Fort and Mr. Pereyra for their helpful statement.

Paragraph one of the staff paper describes the formula for economic success. High official reserves, a well-capitalized banking system, globally diversified trade links, and limited dependence on international capital markets are what we consider the key ingredients for sustained growth. We join other Directors in commending the authorities for their commitment to sound macroeconomic and structural policies. Having said this, we support the proposed decision and we will limit our comments to two issues—the country's fiscal reform agenda and monetary policy.

We concur with the staff that the political situation could complicate the fiscal reform program, and that the authorities should be cautious of the pace of the envisaged changes in order to avoid unnecessary animosity toward the adjustment program as a whole. We welcome Mr. Pereyra's comments at the beginning of the meeting indicating that the authorities have been working to create the necessary support for reforms by promoting a better public understanding of the need for these measures.

Regarding monetary policy, we believe that the current framework is working well, and that inflation is within the acceptable program limits. The authorities have also indicated that they remain ready to use monetary policy to attain the programmed target. In the same way, exchange-rate policy is well managed, as the government has indicated that it will intervene in the market only to avoid unwanted fluctuations in the exchange rate. On the other hand, the high level of dollarization continues to be the weakest point of the program. For this reason, we welcome the information given to us by Mr. Le Fort and Mr. Pereyra, who noted that the government is improving the functioning of the domestic market for local-currency denominated instruments. In spite of this, the authorities are right to note that a solid commitment to sound macroeconomic policies is critical in order to support a recovery of investor confidence in the nuevo sol.

Finally, I agree with Mr. Mirakhor's statement concerning Mr. Bennett's suggestions regarding program conditionality. With these comments, we wish the authorities success.

Mr. Prader made the following statement:

The Peruvian authorities are faced with the challenge of generating a sustainable recovery while improving Peru's public finances. This will be no easy task given the current global slowdown, general financial and political turmoil in Latin America, tax revenues among the lowest in the region,

congressional populism, and a fiscal decentralization, which threatens to increase the pressure on the public finances.

Still, recent figures are promising. The authorities have firmly held the line on the public finances and met all end-December performance criteria under the Stand-By Arrangement. I also appreciate the assurances of the staff representative that the decree capping retail fuel prices will have only a small effect on the budget and will keep the fiscal program intact. Since late 2001, the economy has been recovering, with sound export growth, a moderate revival of consumption, and a resumption of domestic investment growth. Worries include Peru's high public debt, low per capita income, and the narrow base of its commodity-dependent economy.

The process of decentralization, which the authorities have set in motion, requires them to establish the central government's authority over, and control of the economic policies of regional governments. We commend the authorities for the soundness of the existing legislation, and their plans to submit a fiscal decentralization law to the congress. Success will require the implementation of a clear, fully defined long-term strategy characterized by fiscal neutrality and backed by a strong monitoring system. However, I also share the concerns of Ms. Lanza about the problems of decentralization.

The written statement of Mr. Le Fort and Mr. Pereyra, and recent remarks from Peru's finance minister about the gradual elimination, over two or three years, of all regional and sectoral tax exemptions were most welcome. Elimination of the exemptions would boost revenues and reduce the fiscal deficit. Unfortunately, this plan now seems to be losing momentum. Could this be a sign of problems with Peru's program implementation capacity?

We were also encouraged by the authorities' ability to secure the financing required for 2003, partly thanks to the reactivation of the domestic bond market. However, we were disappointed by the stalled privatization program, which is hindering deficit reduction and helping increase 2003's public-sector debt.

Despite the steady improvement of prudential regulations, Peru's banking system, consisting of a handful of players, remains vulnerable: at the mercy of external shocks, the threat of contagion, and a high level of dollarization.

The system's indicators compare well with those of other Andean countries, but it would be useful to develop mechanisms for assessing the true financial health of a bank, or to develop better systems to give early warning of problems. The recent changes in prudential regulations are steps in the right direction, but there is room for more, particularly in the areas of supervision and implementation.

Now that domestic demand is recovering, there are also signs that inflationary pressures are rising, albeit slowly. Thus far, inflation is still under control, but the central bank must remain vigilant and ready to tighten monetary policy as needed to ensure that the inflation rate stays within the target range.

The nuevo sol is among the most stable currencies in Latin America, a result achieved by the central bank's "hands-off policy" which allows the market to determine the exchange rate. The central bank plans only small interventions to provide liquidity in case of external or domestic shocks.

With these remarks, we support the proposed decision, wish the authorities all success in maintaining a broad political consensus around their macroeconomic program, and continued progress on structural reforms, including privatization.

Mr. Lissovolik made the following statement:

We would like to thank the staff for their insightful paper on Peru, and Mr. Le Fort and Mr. Pereyra for their helpful statement. In the course of the past year, Peru posted impressive growth rates, which was based on the superior performance of the country's exports. There are grounds for optimism on the growth front this year in view of the recovery in private investment, though we also note that both total investment and total savings as a percentage of GDP continued to decline in 2002. Notwithstanding important achievements, there remain areas, where reform is as necessary as it is politically and economically difficult, and first on the priority list is fiscal stability.

On the fiscal front, the key challenges lie in moving ahead with decentralization, while at the same time curbing the numerous tax exemptions that undermine the viability of the fiscal position. The role of eliminating exemptions in setting the fiscal position on track appears to be non-trivial, given that the costs of exemptions amount to 1.91 percent of GDP as detailed in Appendix to the staff paper (equivalent to more than 15 percent of the country's tax revenues). We welcome the recent statement by the Peruvian Finance Minister noting his commitment to decisively address the problem of tax exemptions. To render this process politically sustainable, this process needs to be linked and coordinated with the process of decentralization. However, while such a linkage is important politically, the economics of such a linkage calls for caution, most notably with respect to the harmonization of the time horizons of the respective reforms. In particular, while we support the plans of the authorities to carry out the decentralization process in a gradual manner, we also believe that the linkage between decentralization and the elimination of tax breaks and exemptions should not engender excessive delays in removing tax exemptions and strengthening the tax base. We also

wholeheartedly support the commitment of the authorities, as expressed in Mr. Le Fort and Mr. Pereyra's statement, to abstain from introducing any tax amnesty schemes. Finally, we urge the staff and the authorities to continue to refine the debt sustainability methodology, given the importance of monitoring this indicator for the sake of Peru's economic stability.

In the monetary sphere, the confluence of high dollarization, a flexible exchange rate regime, and high indebtedness poses the single most important threat to economic stability. The decline in dollarization in recent years, while very welcome is hardly significant and given the strong inertia inherent in an orderly de-dollarization process, this vulnerability is likely to remain in the medium term. With respect to exchange rate dynamics, we welcome the policy of limiting interventions to smoothening out excessive exchange rate fluctuations. While the room for maneuver in the use of the exchange rate instrument has been somewhat expanded due to the rise in forex reserves, moves aimed at targeting any particular level of the exchange rate are likely to raise the country's vulnerability to external shocks. It thus follows that the main burden of adjustment in the short to medium term needs to be borne by fiscal policy.

Finally, the overarching need for fiscal prudence should not overshadow the importance of structural adjustment in other areas. In particular, we note the importance of the active development of financial markets, including the local bond market, as well as following up on the FSAP review recommendation pertaining to the stability of the banking sector. In conclusion, we note that fruitful collaboration between Peru's authorities and the Fund serves to improve Fund's ability to contribute to economic recovery throughout Latin America. In this respect, we are pleased that the implementation of the program has proceeded satisfactorily and we support the proposed decision.

The staff representative from the Western Hemisphere Department (Mr. Wolfe) made the following statement in response questions and comments from Directors:

There was one question about whether the investment climate in Peru had deteriorated. The staff's analysis did not uncover any significant evidence of a reduction in investment during the second half of last year. Furthermore, risk premia have come down, and the government was successful in their bond placements earlier this year. Standard & Poor's also reaffirmed its credit rating for Peru.

There was also a question about the impact of the tax audit program on revenue collection and compliance. Table 7 of the staff paper outlines compliance rates, which demonstrate that there was an increase in compliance in 2002 over previous years. While it is difficult to quantify, the auditing

program is certainly responsible for some of the 16 percent increase in revenue during the second half of 2002 over the same period the year before.

One Director asked whether the staff believes that there are problems relating to labor market and price flexibility. The issue of labor market flexibility was addressed in the context of the Article IV consultation that took place last December. Regarding the issue of labor market flexibility, several ILO-sanctioned regulations have recently been enacted in Peru, which have increased the level of protection for workers, and may in turn reduce labor market flexibility. However, it is too early to tell whether this has occurred—developments on this front will be reported in future reviews.

There was a question about whether the fiscal deficit target should be raised if revenues were to fall owing to lower than expected growth. In this case, the staff would have to examine the degree to which growth has slowed, and what the appropriate fiscal response would be given the limited scope for additional debt.

There were several questions related to the reduction in the level of dollarization. The staff agrees with the authorities that this is a longer-term process, and that it will take time for public confidence in the nuevo sol to improve. The key elements in this process are continued prudent macroeconomic policies and strong oversight of the banking system. The staff is currently working with the authorities on this issue, and an expert consultant has just been enlisted to head a task force that will study the options available to the authorities in order to promote the process of de-dollarization.

Regarding the regulatory framework for dollar-based bank liabilities, the FSAP review did not find significant fault with this system. There is a 20 percent liquidity requirement for all short-term dollar denominated assets in Peru, and the average reserve requirement for dollar deposits is now slightly above 32 percent. For many years, that reserve requirement was 45 percent, so there is a strong reserve cushion in place for dollar deposits, which exceeds 100 percent of the stock of dollar deposits in the banking system.

Regarding the reasons for the decline in FDI flows in 2003 over 2002, much of the investment that we foresaw for 2003 actually came in 2002. The actual combined FDI flows into Peru for 2002 and 2003 are equal to the sum of the original program projections for the total amount of foreign direct investment in those two years. Furthermore, the mining sector and the natural gas sector—where a major project is currently underway—have received the most FDI flows. There is also foreign investment flowing to many other sectors, including the banking and manufacturing sectors.

There was a question about strategies for poverty reduction and increased social spending in Peru. I would like to note that the authorities' poverty reduction strategy focuses on medium- and long-term progress in the areas of education and health, which should result in continued growth and increased spending. There are also short-term needs that the authorities are attempting to address through poverty alleviation programs, which have been growing as a share of budgetary outlays since 2000. These programs receive special protection and guaranteed financing every year, and they are subsequently insulated from any expenditure reductions.

Finally, there was a question about the timing of tax reform, and if the delay in the phasing out of tax incentives was indicative of a weakening of the program. The decision to approach these reforms gradually reflects the political realities in Peru. The elimination of these exemptions has a significant potential impact on the population. Furthermore, the decentralization process requires significant political consensus, which might be jeopardized by the impact of another major reform such as the elimination of exemptions. Thus, the authorities decided to delay such reforms until the political conditions were more conducive. In any case, this dimension of the tax reform plan is most important for medium-term fiscal sustainability. In this light, the gradual elimination of these tax exemptions does not pose a threat to the program.

Mrs. Amador made the following statement:

The staff presented a comprehensive and balanced report that highlighted the important steps already made and the challenges ahead. Credit should be given to the authorities for putting in place a credible strategy to sustain the gains under the program and for making considerable headway in addressing macroeconomic imbalances. As a result, the momentum of growth has continued, inflation has remained low, external vulnerability has been kept manageable, and the banking system kept fundamentally stable in spite of challenging global and regional economic conditions.

On monetary policy, it is noteworthy that, after past episodes of hyperinflation, credibility under the inflation targeting framework has been established. Progress in the fiscal front and stability in the banking system have helped ensure that there was no pressure on the central bank to unduly expand credit.

On fiscal policy, the reform agenda is rightly focused on medium-term fiscal consolidation. It is prudent that the targeted decline in the public sector deficit is largely based on tax reform measures already taken in 2002, and is not dependent on prospective measures in the current year. Looking ahead, we welcome the envisaged strengthening of the Law on Fiscal Prudence and

Transparency, which would underpin the institutional aspects of fiscal adjustment.

A key element of tax reform is the planned elimination of regional and sectoral tax exemptions, which is integrally related to fiscal decentralization. While it was expected that this measure should garner support given that the increased tax collections will be channeled to regional infrastructure programs, it has been reported by staff that political considerations has led to a delay in the plan. It would be useful if staff can elaborate on this point.

On the rationalization of public spending, it is noteworthy that improvements will be made in the effectiveness of social spending to ensure that the most vulnerable segments of the population are well protected. This is especially important given Peru's dual economy. The success of this strategy should provide a solid ground for popular support for the reform measures.

We are encouraged by the continued commitment of the authorities to pursue a market-friendly structural reform agenda. On measures to strengthen bank supervision, we welcome draft legislation that would provide the necessary statutory protection to the staff of the Superintendency of Banks as well as regulations to apply prudential requirements on a consolidated basis.

Like the staff, however, we see a number of risks that could challenge the momentum of growth, if not the sustainability of the program.

The impact of the high level of dollarization of the economy has been muted by prudent management of the external sector, with the central bank keeping a comfortable cushion of international reserves. While we also acknowledge that the resilience shown by the banking sector has helped keep the pitfalls of dollarization at bay, it would do well to emphasize the importance of vigilantly monitoring the financial system and adapting the prudential supervisory framework to take into account the more risky environment. This would include putting in place appropriate systems to minimize the adverse effects on banks' balance sheets of exchange rate changes. We therefore find it commendable that the Superintendency of Banks has issued norms requiring banks to strengthen their exchange rate risk management by better identifying currency mismatches and including these considerations in banks' credit risk calculation. We also welcome authorities' commitment to maintain reserve requirements on dollar deposits at their current level. It is also noteworthy—as Mr. Le Fort and Mr. Pereyra pointed out in their statement—that the development of a fixed-income market in domestic currency will favor a process of financial de-dollarization. On a separate but related point, it would be useful if staff could elaborate on whether dollarization has complicated the task of the central bank in using interest rate changes to influence the demand for money.

It could well be that sustained economic growth would give the administration much-needed political capital. Nevertheless, there is concern that political resistance from the opposition could pose a drag on the administration's ability to deliver decisive action needed to sustain the reform agenda. It would be useful if staff can elaborate on what the authorities are doing to gain broad public and congressional support.

In closing, we support the staff's recommendation for the completion of the second review. We note that the authorities have made appreciable headway in pursuing good macroeconomic discipline centered on medium-term fiscal consolidation, inflation targeting and a floating exchange rate. We wish the authorities continued success in their task of reforming the Peruvian economy.

Mr. Al-Nassar made the following statement:

I thank the staff for a well-written paper and Mr. Le Fort and Mr. Pereyra for their helpful statement. The authorities are to be commended for Peru's strong economic performance despite the difficult external environment. This is evidenced by the high growth, low inflation, and the robust external position. That said, the economy is still highly vulnerable in view of the high dollarization and uncertain external environment. The authorities' commitment to continued prudent macroeconomic policies and structural reform is therefore reassuring.

I broadly agree with the staff's appraisal, and will limit myself to a few remarks for emphasis.

First, the moderate fiscal consolidation in 2003 is appropriate as it strikes a balance between supporting the recovery and reducing the deficit. In this regard, I welcome the steps to strengthen the tax administration, expand the VAT, and refrain from any tax amnesty schemes. While directing any revenue over-performance to further fiscal consolidation is desirable, I share the authorities' concern of its potential impact on the recovery. The commitment to keep current spending under strict control with no generalized wage increase and the readiness to take additional measures if needed are encouraging. Here, I welcome the ongoing work to redirect social expenditures to ensure that the most vulnerable segments of the population are protected.

Second, regarding fiscal reforms, I welcome the reform of the pension system and the progress toward strengthening the law on fiscal prudence and transparency. The plan to rationalize current spending and reverse the decline in the share of capital expenditure in total outlays is also encouraging. I endorse the authorities' strategy to carry out fiscal decentralization in a gradual manner. I agree with the staff on the importance of phasing out the

regional and sectoral tax exemptions for public finances over the medium term. Here, the authorities' approach for integrating this plan into the ongoing fiscal decentralization process is appropriate. To this end, early adoption of the fiscal decentralization law is critical.

Third, I welcome the steps taken to strengthen risk management relating to the exchange rate, and to monitor foreign-currency lending. The authorities are encouraged to implement the remaining FSAP review recommendations. Their commitment to reversing dollarization in the banking system is welcome. Here, maintaining reserve requirements on U.S. dollar deposits at their current level is essential. In this regard, the recent measures taken to improve the functioning of the domestic market for government securities should help restore confidence in the local currency. Continued prudent management of monetary policy under the inflation-targeting framework is also essential for achieving financial de-dollarization.

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

Mr. Prasad made the following statement:

We would like to thank the staff for their candid paper, and Messrs. Le Fort and Pereyra for their helpful statement. Despite regional turbulence and the global slowdown, the Peruvian economy has performed well, displaying low and stable rates of inflation, a stable exchange rate, and a sound banking system. Economic stability stemming from sound policies has been reflected in the country's relatively high economic growth rate, encouraging employment trends, strong progress toward fiscal consolidation, and increasing investor confidence.

Peru's high levels of international reserves could help to insulate the country from regional contagion. Fiscal reforms have also progressed solidly, and all program criteria for 2002 have been met. The authorities' track record bodes well for the program, and points to their commitment to genuine reform.

In this light, we support the completion of the present review. However, we would like to make a few comments on the economy's vulnerabilities for emphasis. Regarding the issue of dollarization, as noted by Mr. Dohlman and other Directors, we believe that the vulnerabilities associated with dollar denominated debt persist, although we acknowledge the authorities' significant efforts to address the issue. Such measures include work toward the creation of a vibrant domestic bond market, which should help to alleviate the problem. We encourage the authorities to continue to monitor the situation closely, and to be prepared to take additional measures to tighten monetary policy if necessary.

Regarding the fiscal issues, we commend the authorities for the progress that they have made in promoting strong revenue performance, and hope that the decentralization process will be ratified by congress in the near future. In conclusion, we wish the authorities success.

Mr. Fabig made the following statement:

We are pleased that Peru has performed well under the program. With growth at 5.2 percent in 2002, inflation subdued, moderate fiscal and external current account deficits, and growing reserves, the Peruvian economy is in good shape, as many of my colleagues have already pointed out.

Skillful economic management deserves a substantial part of the credit for these positive developments. We would like to stress, however, that there is no room for complacency. In this regard, I fully agree with Mr. Bennett's points from his excellent statement. Let me briefly comment on four points that I consider particularly important.

First, the completion of the tax reforms, particularly the elimination of regional tax exemptions and the implementation of fiscally-neutral decentralization, is crucial for fiscal sustainability as many have already stated. I have nothing to add to Mr. Bennett's remarks in this regard. However, we have a question for the staff—why is the program's fiscal conditionality relatively weak? Progress on tax reform and fiscally neutral decentralization are only defined as structural benchmarks for 2003, while no structural PCs exist. I would be interested in the staff's comments on the related point that Mr. Bennett makes in paragraph 7 of his statement.

Second, reserves seem to be quite high by standard measures. However, this stems from the large share of foreign currency deposits. According to the standard measures presented by the staff, the level of reserves looks high because it covers over 200 percent of short-term external debt and over 11 months of imports in 2002. However, about one-third of these gross reserves are required by the high minimum reserve requirements of foreign currency deposits, which are a necessity owing to the high overall level of dollarization. This part of reserves should be considered as a type of safeguard against rapid withdrawals from the domestic banking system, and not as "reserves" in the traditional sense.

Third, we endorse the staff's view that reducing dollarization—which remains a key source of vulnerability—will take time and should be achieved by restoring confidence in the local currency rather than by direct measures to limit dollarization. This is because the latter course of action would shift part of the dollarized financial system either off-shore or underground.

Fourth, we acknowledge Peru's successful return to international private capital markets, but would like to point out that the authorities should also improve the domestic capital market in the local currency. As mentioned in the staff paper, investors lost confidence in the domestic bond market because the auction system was no longer transparent. The revitalization of the domestic bond market is not only crucial for covering the residual financing needs of the public sector in 2003, but also for making the Peruvian financial system more resilient to exchange rate shocks. We gladly took notice that first steps have already been taken in this regard, as reported by the staff as well as Messrs. Le Fort's and Pereyra.

In conclusion, let me join Mr. Bennett in emphasizing the urgent need to increase ownership of the program, to enhance the government's capacity to implement it, and, more generally, to improve governance, strengthen institutions, and fight corruption. With these remarks, we support the proposed decision and wish the authorities success.

Mr. Yakusha made the following statement:

The authorities' appropriate macroeconomic policies and commitment to prudence has allowed the economy to prosper in the midst of global and regional uncertainty, and they deserve the Fund's continued support. In this light, we support the proposed decision.

Nevertheless, Peru has had problems addressing several critical reform issues of late. For instance, the complex tax administration should be modernized, and greater emphasis should be placed on greater fiscal transparency. Government enterprises should also be made more efficient, and the elimination of tax exemptions should be accelerated, as they tend to distort economic incentives.

By the time of the final program review, we would like to encourage the staff to undertake an extensive assessment of how the recommendations that resulted from recent FSAP reviews have been addressed by the authorities. Like other Directors, we encourage the authorities to implement the remaining recommendations.

Furthermore, the key financial sector challenges outlined in the latest FSSA recommendations are addressed by the authorities' reform agenda, although they do not seem to be among their top priorities. In particular, the authorities should make a commitment not to use public funds to support consumer lending. A continuation of such policies may send undesirable signals about their commitment to the program.

Most of the banking sector has shown improvement recently. Nevertheless, remaining issues must be addressed by the authorities, including

the high degree of dollarization, which underscores the need for additional measures aimed at strengthening the financial sector in order to create a cushion against unforeseen events. I would appreciate it if the staff could focus on the issue of additional precautionary measures in their future discussions with the authorities.

With respect to the program itself, the list of conditions and benchmarks is not particularly impressive. Mr. Pereyra's helpful statement outlined the authorities' plans to pass the remaining reform legislation. Nevertheless, risks remain. However, in spite of these risks, I am somewhat reluctant to endorse conditionality being applied to the passage of legislation in cases like this. In this light, it might be helpful if PDR could undertake an examination of the practices that have been followed by various area departments that have faced similar cases.

In conclusion, I would like to note my agreement with the thrust of the staff appraisal, and my support for the proposed decision. I wish the authorities success.

The staff representative from the Western Hemisphere Department (Mr. Wolfe) made the following additional statement in response to questions and comments from Directors:

There was one question about the reasons for the delay of the phasing out of regional tax exemptions. This strategy was the result of a political decision. Although it might have been preferable to eliminate these exemptions immediately, such a strategy could have created a political backlash that would have impeded the final implementation of the reform. In this light, the authorities' decision to delay the elimination of these exemptions seems appropriate.

Another Director asked about the rationale behind the use of structural benchmarks in the program, and the reasons why no structural performance criteria were used. Structural performance criteria contain language that is perhaps too specific to promote the tax reforms that are required in this case, involving a series of 10 to 15 measures, which are outlined in the appendix to the staff paper—it would be extremely difficult to develop performance criteria for each of them. Furthermore, given the Peruvian authorities' track record of good performance and compliance with the tenets of the program, the imposition of such conditions was not deemed necessary.

The staff representative from the Policy Development and Review Department (Mr. Fetherston), in response to Mr. Yakusha's request for an examination of the application of structural conditionality by the various area departments, noted that this was continually being assessed by PDR as part of its review function.

The Acting Chair (Mr. Aninat) said that he could provide the Board with some perspective on the issue of program ownership in Peru by sharing some of his own insights. He had been a direct participant in the Fund's discussions with the authorities in the context of program and surveillance missions, and could attest to the fact that there was strong ownership of the program. Furthermore, it was important to keep in mind that the prevailing global and regional economic situation had not been conducive to the authorities' successes in the context of the current program, which was a further testament to their efforts. In this light, he would personally agree with the staff that the authorities had, and continued to demonstrate, a strong commitment to reform and ownership of the program.

In January of 2003, he had traveled to Peru to visit the new congress, which had only been in place for slightly over a year, the Acting Chair continued. At that time, he had the opportunity to meet with two congressional committees—the Finance and Foreign Affairs Committees. The discussions had been quite straightforward and candid, and he had been extremely encouraged by their views on the pending reform measures and the program. He had also been invited to a plenary session involving representatives of the opposition party by the Congressional Chairman, and when the Fund delegation arrived at the session, there had been unanimous applause. He had rarely seen such a positive reaction during his official travel, so that was encouraging. Although this episode was somewhat anecdotal, it did provide some indication of the authorities' commitment to the program.

Mr. Vermaeten made the following statement:

> I wanted to thank the staff and Messrs. Pereyra and Mirakhor for their comments regarding ownership. I would like to reiterate our support for Peru, and note that we believe that strong program ownership exists at the highest levels of the government. Box 1 of the staff paper is very useful in pointing out the type of political support that exists for the government's agenda, which is a reflection of the degree of domestic ownership in Peru. However, ownership invariably involves more than a particular group's willingness carry out reforms. We must also consider their capacity to carry out said reforms. In this light, questions regarding the degree of congressional, public, and even legislative support also become important for our assessment of ownership and risks to the program.
>
> The staff's analysis was extremely useful because it provides critical information to Directors, which allows for a more informed judgment of the risks to the program. As the staff representative noted earlier, the government requires sufficient latitude with respect to the sequencing of specific reforms to generate and maintain public support for the program, particularly in the context of the planned elimination of tax exemptions, in order to avoid undermining the broader reform agenda. This is obviously a prudent approach. Nevertheless, we must remain conscious of the political dimensions of the program, as well as the possible limitations that these impose on the proposed reform agenda. In this light, it is essential that the staff continue to assess the

options available in the context of program design, in order to ensure the maximum probability of success.

Mr. Pereyra noted his authorities' appreciation for the comments made by Directors, and the efforts of Management and the staff. Furthermore, the Acting Chairman's comments regarding his recent trip to Peru were greatly appreciated.

The Acting Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They observed that the Peruvian economy had performed well in 2002 and had shown remarkable resilience to a difficult external environment, reflecting the authorities' continued commitment to sound economic policies. The country had achieved the highest growth rate in the region, with increasing employment, low inflation, and a strengthened external position. Directors added that the economic outlook remains favorable, although it is not without risks. They considered the authorities' macroeconomic policy stance and structural reform agenda for 2003 as appropriate in laying the basis for sustained high growth and managing the risks associated with the highly dollarized banking system and the relatively large public debt. To ensure effective program implementation, Directors underscored that continued efforts will be crucial to ensure broad political support for the envisaged fiscal and structural reforms, and that economic performance would benefit from continued improvements in governance.

Directors supported the fiscal program for 2003, which aims at moderate fiscal consolidation in line with the authorities' medium-term fiscal goals. Directors recommended that, in case revenue collections exceed program projections owing to stronger growth, part of the additional revenue should be used to lower the deficit further. Directors supported the plans to rationalize public expenditure and to improve the quality of social spending and ensure that vulnerable groups are protected, with the assistance of the World Bank and the Inter-American Development Bank. Directors welcomed the recent issuance of regulations to reactivate the domestic bond market, which should serve to diversify fiscal financing sources. Directors urged the authorities to ensure that the recently introduced petroleum price stabilization mechanism remains, as intended, a temporary and limited scheme without adverse impact on the fiscal program.

Directors urged timely implementation of the authorities' fiscal reform agenda for 2003, covering the areas of tax policy, decentralization, and fiscal rules. These reforms are key signals of the authorities' commitment to follow sound fiscal policies over the medium-term. In particular, Directors considered that swift passage of the strengthened law on fiscal prudence and transparency would reinforce the authorities' commitment to fiscal

sustainability. Directors encouraged the authorities to work with congress to obtain early approval of the pending legal initiatives in these areas.

Directors stressed the importance of implementing decentralization in a fiscally-neutral manner, and with appropriate sequencing and strong institutions, to ensure sustainable public finances. Adoption of an appropriate fiscal decentralization law will be crucial to this end. Most Directors supported the authorities' strategy to broaden support for the phasing out of regional and sectoral tax exemptions, a key element of tax reform, by linking it to the process of decentralization. Directors emphasized that, since this reform is to be implemented over the next two years, it will need to be pursued vigorously and consistently in order not to lose momentum.

Directors supported the authorities' commitment to continue improving prudential oversight of the banking system. They welcomed recent steps taken to improve banks' foreign-currency risk management, and encouraged early adoption of draft legislation to provide adequate legal protection to bank supervisors. Some Directors questioned the recent extension of the consumer-lending program of the Banco de la Nación, and Directors urged the authorities to manage prudently existing sectoral support programs and to refrain from creating new ones. Directors welcomed the progress in implementing a number of the main FSAP review recommendations, and urged the authorities to take action on the remaining ones identified by the FSAP review.

Directors endorsed the authorities' inflation targeting framework and the current stance of monetary policy. They expressed satisfaction with the transparency of monetary policy under the inflation-targeting framework. Directors considered that the high level of dollarization, in addition to being a source of banking sector vulnerability, reduces the flexibility and effectiveness of monetary policy. Therefore, the authorities should give priority to efforts to reduce dollarization. This goal, while taking time, would require continued prudent macro policies, supported by a further strengthening in bank supervision and a deepening of domestic capital markets.

Directors noted that the floating exchange rate system has served Peru well in adjusting to external shocks, and observed that the high level of official reserves has been a key factor in protecting Peru from the effects of regional turbulence. They supported the authorities' policy of not intervening directly in the forward exchange market, and recommended that exchange rate-indexed certificates of deposit be used only in situations of unusual spot market volatility and in relatively low amounts.

The Executive Board took the following decision:

1. Peru has consulted with the Fund in accordance with paragraph 3(c) of the Stand-By Arrangement for Peru (EBS/02/12, Sup. 2, 2/7/02) and paragraphs 27 and 14 of the letters from the Minister of Economy and Finance and President of the Central Reserve Bank of Peru dated January 18, 2002 and November 26, 2002, respectively, in order to review program implementation and establish conditions for the second year under the Stand-By Arrangement.

2. The letter from the Minister of Economy and Finance and President of the Central Reserve Bank of Peru dated March 17, 2003 (the "Letter"), together with its Technical Memorandum of Understanding (the "TMU"), shall be attached to the Stand-By Arrangement for Peru, and the letters from the Minister of Economy and Finance and President of the Central Reserve Bank of Peru dated January 18, 2002 and November 26, 2002, with their respective attachments, shall be read as supplemented and modified by the Letter and the TMU.

3. Accordingly, the Stand-By Arrangement for Peru shall be modified as follows:

(a) Paragraphs 3(a)(ii) and 3(a)(v) shall be deleted;

(b) A new paragraph 3(e) shall be added to read as follows:

"(e) if, at any time during the period of the Stand-By Arrangement, a request for purchases would not be consistent with the inflation consultation mechanism specified in Table 1 attached to the Letter and in the TMU";

(c) The quantitative performance criteria for March 31, 2003, June 30, 2003, September 30, 2003, and December 31, 2003 referred to in paragraphs 3(a)(i) through 3(a)(vii) shall be as set forth in Table 1 attached to the Letter and in the TMU:

(d) Paragraph 3(c) shall be amended to read as follows:

"(c) after August 30, 2002, March 15, 2003, and August 30, 2003, until the reviews contemplated in paragraph 27 of the letter dated January 18, 2002 and paragraph 21 of the Letter are completed; or".

4. The Fund decides that the second review contemplated in paragraph 3(c) of the Stand-By Arrangement for Peru is completed. (EBS/03/34, 3/17/03)

Decision No. 12974-(03/30), adopted
March 28, 2003

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/03/29 (3/26/03) and EBM/03/30 (3/28/03).

5. SIERRA LEONE—ENHANCED INITIATIVE FOR HEAVILY INDEBTED POOR COUNTRIES—ADDITIONAL INTERIM ASSISTANCE

The Fund as Trustee (the "Trustee") of the Trust for Special PRGF Operations for the Heavily Indebted Poor Countries and Interim PRGF Subsidy Operations (the "Trust") decides that:

(a) satisfactory assurances regarding the exceptional assistance to be provided under the enhanced HIPC Initiative by Sierra Leone's other creditors continue to be in place,

(b) the Trustee shall disburse to Sierra Leone as additional interim assistance the equivalent of SDR 23.64 million, which shall be made available by the Trustee to Sierra Leone in the form of a grant that shall be paid no later than three business days after the adoption of this decision to the account for the benefit of Sierra Leone established and administered by the Trustee in accordance with Section III, paragraph 5 of the Trust Instrument, the proceeds of the grant shall be used by the Trustee to meet Sierra Leone debt service payments on its existing debt to the Fund as they fall due, in accordance with the following schedule: 95.4 percent of each repayment of principal obligation falling due to the Fund during the twelve month period from March 21, 2003; and

(c) for the purposes of Section III, paragraph 3(d) of the PRGF-HIPC Trust Instrument, the conditions for the disbursement under (b) above are that Sierra Leone has met (i) all of the performance criteria applicable to the third and fourth disbursements under the three-year Poverty Reduction and Growth Facility ("PRGF") arrangement for Sierra Leone (EBS/01/118, Sup. 3, 8/26/01), as amended, that, based on the information provided by Sierra Leone, have been found to have been met, and (ii) all of the conditions specified in the decision completing the second review under the PRGF arrangement. (EBS/03/36, 3/20/03)

Decision No. 12975-(03/30), adopted
March 26, 2003

6. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 03/1 and 03/5 are approved.

7. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors, by Advisors to Executive Director, and by Assistants to Executive Directors as set forth in EBAM/03/22, Sup. 1 (2/26/03), and EBAM/03/34 (3/26/03) is approved.

APPROVAL: June 16, 2003

SHAILENDRA J. ANJARIA
Secretary