November 5, 2001
Approval: 11/12/01

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 99/32

10:00 a.m., Thursday, March 25, 1999

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Executive Board Attendance

S. Fischer, Acting Chairman

Executive Directors	Alternate Executive Directors
A.A. Al-Tuwaijri	S.M. Al-Turki
A. Barro Chambrier	D. Ondo Mañe
	P. Charleton
	M. Askari-Rankouhi, Temporary
	W. Szczuka
	F. Zurbrügg, Temporary
	W.-D. Donecker
N. Eyzaguirre	P. Cabezas, Temporary
R. Faini	J. Spraos
J. Guzmán-Calafell	H. Oyarzábal
K.A. Hansen	O.-P. Lehmussaari
K.-T. Hetrakul	C. Harinowo
W. Kiekens	V. Rigász, Temporary
	M. Sobel, Temporary
	R. Fernandez
	E. Jourcin, Temporary
	M. Daïri
J.P. de Morais	C. Rustomjee
	L.J.F. Erasmus, Temporary
	S. Vtyurina, Temporary
	I. Zakharchenkov, Temporary
S. Pickford	S. Collins
	H. Mori, Temporary
A.S. Shaalan	A.F. Al-Faris
	W.F. Abdelati, Temporary
M.R. Sivaraman	A.G. Karunasena
	I. Cho, Temporary
Wei Benhua	Zhang F.
	Y.G. Yakusha
	I. Dragulin, Temporary
	M. Takeda
	D. Fujii, Temporary
	H. Ogushi, Temporary

R. Munzberg, Secretary
A. Mountford, Acting Secretary
Z. Ahmed, Assistant
P. Cirillo, Assistant
S. Djumena, Assistant
G. Nkhata, Assistant

Also Present

IBRD: S. Shetty, Africa Regional Office; G. Meyerman, Corporate Restructuring and Governance; D.F. Gray, Private Sector Development Department; S. Gooptu, East Asia and Pacific Region; R. Roulier, Special Financial Operations. African Department: G.E. Gondwe, Director; P. A. Basu, Deputy Director; G. Almekinders, J. Fajgenbaum, R.I. Harmsen, E. Harris, Y. Kawakami, P. Lopes, I. Matovu, M. Nowak, R.H. van Til. Asia and Pacific Department:Y. Horiguchi, Associate Director; A. Singh, Deputy Director; C. Browne, R.S. Krelove, K.H. Lee, K.M. Meesook, S. Nolan, I. Otani. European II Department: L.M. Valdivieso. External Relations Department: R. Brauning, R. Russell, N.V. Shastry. Fiscal Affairs Department: J. Ha, M.S. Kell. Legal Department: W.E. Holder, Deputy Genteral Counsel; B.D. Dimitrachkov, R.K. Gordon, S. Hagan, R.B. Leckow, D.E. Siegel, R.L. Weeks. Middle Eastern Department: D. Burton, Deputy Director. Monetary and Exchange Affairs Department: S. Ingves, Director; V. Sundararajan, Deputy Director; M.I. Blejer, J. Canales Kiriljenko, O.M.J. Frecaut, K.F. Habermeier, B. Johnston, A.A.Kirilenko, B.J. Laurens, J.E. Leimone, I. Otker-Robe, M. Rossi, L. Schumacher, S. Sosa, M. Swinburne, J. Vadasz. Policy Development and Review Department: T. Leddy, Deputy Director; L.J. Lipschitz, Deputy Director; N. Ishii, R. Kahn, T. Kanai, R. Kincaid, J. Lin, Y. Metzgen, J. Mongardini, G. Moser, C. Muniz, L. Nielsen, A.G. Santos. Research Department: P. Wickham. Secretary's Department: P. Gotur, B.A. Sarr. Statistics Department: R.K. Basanti. Treasurer's Department: M.G. Kuhn, Deputy Treasurer; B.V. Christensen, C. Clarke, A.B. Westphal. Western Hemisphere Department: M.D. Kaufman. Office of the Managing Director: M. Russo, Special Advisor; M. Cross, Personal Assistant; D. Citrin, J.-A. Clement, S. Tiwari. Advisors to Executive Directors: P.A. Akatu, J.A. Chelsky, B. Couillault, M.H. Elhage, S.S. Farid, E.J.P. Houtman, N. Jadhav, B. Konan, M.F. Melhem, S. N'guiamba, Nguyen Q.T., L. Palei, Y. Patel, O. Schmalzriedt. Assistants to Executive Directors: A. Abdychev, A.S. Alosaimi, N.R.F. Blancher, M. Carlens, H.W. Cocker, R. Djaafara, M.J. Fernández, K. Gobe, E. González-Sánchez, M.R. Hajian, M.S. Hililan, I.C. Ioannou, C. Josz, S.K. Keshava, B. Killen, E. Kornitch, D.H. Kranen, T.-M. Kudiwu, K. Lai, Lu A., S. Melese d'Hospital, D. Nardelli, M. Nemli, K. Ongley, Peh K.H., M. Pérez, L. Pinzani, M.M. Salvador, J.N. Santos, C.-P. Schollmeier, R.J. Singh, Siti Mariam Mohd. Yusof, Sugeng, U.Y. Tilyayev, M. Vismantas, M. Walsh, Wang X., R.P. Watal.

1. ZAMBIA—1998 ARTICLE IV CONSULTATION; AND ENHANCED STRUCTURAL ADJUSTMENT ARRANGEMENT

The Executive Directors considered Zambia's request for a three-year arrangement under the Enhanced Structural Adjustment Facility (ESAF) (EBS/99/35, 3/11/99), together with a policy framework paper for Zambia for the period 1999–2001 (EBD/99/42, 3/11/99; Cor. 1, 3/18/99; and Cor. 2, 3/24/99), and a statistical appendix (SM/99/67, 3/11/99).

The staff representative from the African Department made the following statement:

> Since the issuance of the staff report, new information has become available on economic and financial developments in Zambia, which is likely to affect the implementation of the government's program in the first quarter of 1999.
>
> As a result of weak export earnings and unforeseen, mostly administrative delays in the disbursement of donor assistance, the accumulation of international reserves has been lower than envisaged under the program. While the total amount of donor assistance during the first quarter of 1999 was initially programmed at US$119 million, only US$66 million from the World Bank has been disbursed, with most of the remaining assistance expected to be forthcoming in April. As the present shortages of foreign exchange do not allow the authorities to buy foreign exchange in the market, net international reserves at end-March—a performance criterion in the program—are likely to fall below the floor, even after taking into account the US$30 million adjuster under the program.
>
> Preliminary data for January and February show that domestic fiscal operations were broadly on track. However, reflecting the shortfall in donor assistance, net bank claims on the government have increased significantly. It will be difficult for the authorities to achieve a sufficiently large domestic fiscal surplus in March to offset the donor shortfall; thus, it is likely that the end-March ceiling on net bank claims on government—a performance criterion under the program—will be exceeded. Assuming that fiscal performance remains on track, the situation should improve significantly in the coming weeks.
>
> There are no new developments to report on the privatization of the copper parastatal (ZCCM). ZCCM has continued technical discussions with Anglo-American Corporation on the sale of the main asset packages, and Anglo-American is involved in the management of the mines. Thus far, however, the company has been unable to find a partner for the financing and development of the Konkola Deep mining project, which may lead to delays in the finalization of the agreement. Thus, the transfer of ownership of the main asset packages of ZCCM—an end-March structural performance criterion under the program—is likely to be delayed. Nonetheless, the government has made a maximum effort to expedite the transfer of the assets.

Mr. Morais made the following statement:

At the outset, let me express the appreciation of my Zambian authorities to the Fund staff for the constructive dialogue and valuable advice tendered on the occasion of the 1998 Article IV consultation and the successful negotiation of a new three-year arrangement under the Enhanced Structural Adjustment Facility. My authorities believe that the staff papers provide a balanced assessment of recent developments in the Zambian economy and the challenges that lie ahead.

Following a long period marked by stabilization gains, the Zambian economic and financial performance in 1998 was seriously affected by a combination of factors such as the effects of a sharp deterioration in the terms of trade, unfavorable climatic conditions, and shortfalls in external assistance, factors which complicated the task of the authorities to manage the economy. The inadvertent delays encountered with the complex process of the privatization of the copper parastatal (ZCCM) also impacted negatively on the outcome for 1998. Consequently, aggregate output contracted by 2 percent, inflation increased to almost 31 percent, and domestic and external imbalances worsened. However, important progress continued to be made on structural reforms, particularly in the financial sector and public service and in the privatization of nonmining public enterprises.

Recognizing the seriousness of the situation, my authorities saw no alternative other than a more vigorous course of stabilization and reform. Hence, they embarked on a strategy aimed at returning the country to a more stable macroeconomic environment, while creating the conditions for promoting long-term growth, strengthening the external position, and alleviating poverty. To this end, they have set up a vigorous medium-term economic program, comprehensively detailed in the updated and reinforced Policy Framework Paper for 1999–2001. The program appropriately focuses on further tightening of financial policies and deepening of structural reforms. To demonstrate the authorities' firm resolve, the program is essentially front-loaded in terms of policy actions. Its main macroeconomic objectives are to achieve annual GDP growth rates of about 5 percent, contain inflation to 4 percent, and strengthen external reserves to the equivalent of three months of imports by the year 2001. The program also envisages well-targeted structural reforms designed to encourage the development of the private sector. In support of this program, my Zambian authorities are hopeful that their request for Fund assistance through an ESAF arrangement meets the approval of the Board. They also trust that ESAF will continue to play its catalytic role in mobilizing additional financing from other multilaterals and bilateral donors.

Consistent with this medium-term approach, the program for 1999 is extremely ambitious, but the authorities are fully determined to achieve the economic and financial goals set therein. The economy is expected to grow by 4 percent, after declining by 2 percent in 1998; inflation is anticipated to be

reduced to 15 percent from about 31 percent in the previous year; and international reserves are envisaged to increase to the equivalent of 1.5 months of imports compared to two weeks in 1998.

Cognizant of the importance of fiscal discipline in attaining the program targets, the authorities are committed to regain control over the public finances through intensified efforts to mobilize domestic resources and contain current outlays so as to accommodate increased resources for social sectors and investment in infrastructure. As a result of these efforts the overall fiscal deficit is expected to be reduced to 3.2 percent of GDP in 1999, from 4.3 percent in 1998, while the domestic fiscal deficit will reach 0.6 percent of GDP, as a result of one-off transactions representing an exceptional allocation made to ZCCM, before shifting into surplus thereafter. Improvements in revenue performance will result essentially from a further strengthening of tax administration, as the scope for increasing tax rates and introducing new taxes is limited. Additional revenue resources will result from reduced exemptions and special regimes and stepped-up efforts to combat smuggling and customs fraud, as well as from reinforcement of the customs administration with the introduction of several administrative measures. At the same time, expenditure restraint will be maintained by limiting the wage bill increase, further retrenching public servants, and setting limits to employment levels. The ongoing efforts to reorganize the spending priorities will also enable the authorities to commit more resources to health and education, investment in infrastructure, and elimination of domestic arrears. A number of measures being implemented to strengthen the budgetary procedures and the contingency reserve mechanism imbedded in the budget process to offset unforeseen outlays or shortfalls in revenues are important steps to secure the attainment of the fiscal target.

Monetary policy will be geared toward the attainment of a substantial reduction in inflation following the reemergence of strong inflationary pressures in 1998 owing to higher food prices and the sharp depreciation of the kwacha. To this end, monetary stance will remain highly restrictive, with the Bank of Zambia (BoZ) committed to maintain a tight lid over the growth of money supply. The projected significant reduction in net bank claims on government will provided room for increased credit to the private sector. As part of the ongoing efforts to ensure the soundness of the banking system, the current prudential regulations will be strictly enforced. Furthermore, the supervisory capabilities of the central bank will be further enhanced with the envisaged amendment to the Banking and Financial Services Act, as it will provide the BoZ with the necessary legal powers to license and liquidate banks. The authorities have already submitted to parliament a legislative proposal in this respect.

The agenda of structural reforms is quite comprehensive and constitutes an important complement to the macroeconomic policies. These reforms aim at increasing the role of the private sector in economic activity. To this effect, the authorities are committed to maintain a liberal trade and exchange regime and to further reduce import tariffs in the context of regional

arrangements. Building on the progress already made, they will continue to deepen the reforms in the public service, the financial sector, and the privatization of public enterprises. Regarding the latter, the scope of divestiture has been extended to include major public utilities, parastatals in the petroleum sector, and financial institutions. Meanwhile, the authorities are actively engaged in negotiating the conditions that will set the stage for the signing of the sales agreements related to the privatization of the ZCCM's major assets.

Despite efforts made to diversify production and export bases, the economy is still highly dependent on the mining sector. The external sector continues to be vulnerable to exogenous shocks, namely, declining terms of trade and adverse climatic conditions. My Zambian authorities will continue to pursue the needed macroeconomic and structural reforms as the best means to strengthen the basis for economic growth and development. However, continued support from the international community both in terms of financial assistance and substantial debt relief will enable the reform process to proceed at a faster pace. In this regard, they hope that the implementation of the current adjustment program could pave the way for an early consideration of Zambia's eligibility under the HIPC Initiative, as the large external debt overhang continues to impose a heavy burden on the budget and to delay the achievement of external viability.

Mr. Karunasena made the following statement:

The economic situation in Zambia has deteriorated in the last year due to unfavorable external developments such as a sharp decline in terms of trade, adverse weather impact on agricultural activities, and the armed conflict in a major trading partner country. The situation has been further worsened by policy slippages, particularly in fiscal and monetary management, and implementation delays in crucial economic reforms. However, it is encouraging that the Zambian authorities are determined to improve their macroeconomic management and accelerate the implementation of long-overdue economic reforms under a new ESAF program.

The proposed program, aimed at restoring macroeconomic stability and promoting sustainable growth while containing inflation and strengthening the external assets position, is a comprehensive and ambitious one. It has correctly placed primary emphasis on the improvement of fiscal management and effectively addresses the deep-rooted structural issues with a view to improving private sector investor confidence and, hence, accelerating the country's economic growth.

On the fiscal front, it is encouraging that measures have been proposed for revenue enhancement as well as expenditure rationalization. However, given the narrow tax base, due to extensive tax exemptions granted in the recent past, and existing weaknesses in tax administration, as reflected by large tax arrears, it will not be an easy task to achieve the projected

revenue improvement in 1999. Given the negligible net revenue gain from the discretionary tax measures proposed in Box 4, the projected revenue improvement in 1999 has to be realized mainly through addressing weaknesses in tax administration, as some of the major growth contributory sectors identified in the program, such as mining, are under various tax exemptions granted in the recent past. We welcome the government's recent decision to revoke the exemptions granted to four companies as a step in the right direction.

However, it may be difficult to justify the range of tax concessions proposed for as long a period as 20 years under the privatization of ZCCM's major assets. Also it has been proposed under the present privatization agreement described in Box 2 to allow the carry-forward facilities of losses for 20 years, implying in practice that the company will not pay income tax for the foreseeable future. There is no doubt that these tax concessions will increase the attractiveness of privatization of the ZCCM, but with a huge fiscal cost over a long period. Such concessions will prove to be a drag on the finances of the government. Elsewhere in Africa, such long-term concessions to mining companies are proving to have undesirable and painful consequences. When once given, such concessions cannot be withdrawn. We strongly urge that such long-term tax concessions should not be given. Staff comments will be appreciated.

On the expenditure side of the budget, we welcome the proposals to contain the wage bill and changes in favor of spending on health and education, while maintaining capital expenditure with a view to improve essential infrastructure facilities. Successful implementation of proposed structural reforms, particularly public service reforms and acceleration of privatization programs, would further facilitate the authorities' fiscal management in the medium term even though the public service retrenchment will result in an additional short-term fiscal burden during the program period.

The proposed tight monetary policy stance is helpful not only to achieve the targeted reduction in inflation but also to minimize the pressure on the exchange rate, which depreciated sharply in 1998. However, the achievement of monetary targets will depend to a large extent on performance on the fiscal front, as the realization of reduction in the bank credit to the government is crucial in achieving the proposed monetary targets in the program without further containing the private sector credit expansion. We welcome the authorities' determination to further strengthen financial sector regulation and supervision activities, as the share of nonperforming loans in the banking sector remains high even though it has declined during the last two years from its peak in 1996. However, we are concerned about continuation of high interest spread (over 30 percentage points) in the banking system.

The authorities have correctly placed major emphasis on rebuilding of their external assets position, which deteriorated sharply in 1998. However,

we are concerned about the fragility of the external sector during the program period, because not only does the external deficit remain high even at the end of the program period (i.e., 8.3 percent of GDP), but also the expected improvements in the external sector are subjected to a number of uncertainties. Projected high growth in metal exports is highly sensitive to the expected improvements in the international metal prices as well as to successful completion of privatization of ZCCM and the performance of its new owners. Similarly, strong and consistent improvements in macroeconomic management and acceleration of economic reforms are crucial in achieving projected inflow of foreign private investments and concessional foreign assistance. Given the high external debt burden even at the end of program period, we agree with the staff that the authorities may strongly consider requesting assistance under the HIPC Initiative, after establishing a satisfactory track record under a program supported by the Fund and the World Bank.

On the structural reform front, we support the emphasis on privatization (including expansion of its scope to covering some sectors providing utilities and financial sector activities), public service reforms, and strengthening prudential banking supervision, as they are crucial in removing impediments to growth and facilitating expected improvement in macroeconomic management. However, successful implementation of the program needs the authorities' strong commitment and strengthening of the country's implementation capacity. In this context, we underscore the usefulness of providing required technical assistance and its prompt and effective use.

We support the proposed decisions on page 26, as the successful implementation of the proposed program would not only prevent further deterioration in the economic situation in Zambia, but also provide a strong basis for sustainable medium-term growth.

The staff representative from the African Department noted that, while both the authorities and staff agreed that the tax concessions to be granted to the prospective buyers of ZCCM would have undesirable effects, there was no appropriate alternative solution, in light of the urgency of arriving at an agreement. With only one potential buyer, the authorities were in a difficult bargaining position, and they were concurrently making efforts to protect the integrity of the tax system. In this regard, under the new program, the authorities had made a commitment to refrain from introducing new tax exemptions or preferential tax treatment, with the exception of the concessions made in the context of the privatization of ZCCM.

Mr. Daïri, however, considered that the Fund should not support privatization in this form, which he felt did not protect the long-term interests of Zambia or ensure the efficient exploitation of its main resource. He urged staff to consider alternative ways of dealing with the ZCCM problem, including restructuring or engaging external managerial capabilities pending successful restructuring.

The staff representative from the African Department observed that, in light of the protracted decline of ZCCM and its effects on the Zambian economy, substantial investments

would be urgently required to reinvigorate the mining sector. External management contracts would not bring in the substantial investments needed. This is why the Zambian authorities saw the long-awaited privatization as the only feasible option to get the copper sector out of the morass.

The Acting Chairman observed, in addition, additional delays would place further downward pressure on the extremely depressed value of the assets.

Mr. Daïri pointed out that investors would have more appetite for the company, and external financing would become more readily available, once the country had normalized its relations with creditors. Temporary solutions could thus be helpful in the interim period before the country's return to normalcy.

Mr. Collins made the following statement:

> I very much welcome this discussion. Let me say at the outset that I support the new three-year ESAF, and the first annual arrangement proposed by the staff. It has been a long time since we were able to consider a formal lending program for Zambia, and it has been a prolonged and difficult hiatus for the Zambians. As the staff report points out, the bottlenecks in the reform program that prevented full reengagement by the Fund, the World Bank, and bilateral donors, over the past two years, have led to substantial economic and welfare costs for Zambia. I am very pleased to see that the authorities have finally been able to reach agreement on the sale of ZCCM, as well as to meet prior actions on civil service reform and tax exemptions, thereby enabling this ESAF proposal to go forward.
>
> The program comes at a very crucial time for Zambia and, in fact, is something of a lifeline. It is worth emphasizing how much is riding on the successful adoption and implementation of this program. Zambia stands to benefit not only from the Fund's assistance, but also from substantial financing from other donors, which has been held back until now because of the authorities' inability to reach an agreement with the Fund.
>
> This package of multi-donor assistance is needed urgently. It would help the government to finance the 1999 budget without recourse to inflationary deficit financing. It would ensure that the government does not default on its debts to the World Bank and other creditors. It would facilitate the final transfer of ZCCM out of government hands by providing funds for retrenchment payments, and it would help prevent further rapid depreciation of the kwacha, which would fuel hyperinflation. For these and many other reasons, it is essential that the government secures this ESAF arrangement and sticks to it. There is no margin for error, and the costs of failure for Zambia are too great to contemplate.
>
> Looking at the details of the program, I agree with the staff's analysis of the key structural reforms for 1999. These reforms include the completion of the ZCCM privatization process; the divestiture of other

state-owned enterprises, including the telecommunications company, ZAMTEL; the petroleum distribution company, ZNOC; and Zambia Railways; and retrenchment of an additional 7,000 public servants. These measures should all be carried out as soon as possible, and I would urge the staff to incorporate performance criteria relating to ZNOC and Zambia Railways into the later years of this arrangement.

It will also be necessary, as we have heard from staff, to recast the criterion relating to ZCCM given that the March 31 deadline is, unfortunately, no longer feasible. In fact, it has been clear for some time that the transfer of ZCCM assets will not take place before the end of this month. I was therefore surprised that the staff did not amend this target and provide more information on the sale when the documents were distributed. It would have been preferable if the Board, and other partners involved in financing the program, had been informed earlier. It is not clear from the staff's supplementary note what the new timetable is, and I hope that they can enlighten us.

On a related point, I see from the staff's information note that external financing in the first quarter of this year has fallen below target by some $53 million. This is attributed largely to administrative delays, but lack of clear information may also have played a role. My own aid authorities, for example, were keen to disburse $10 million this month, but were unable to do so because they lacked clear information on Zambia's immediate external financing needs and the final details of the ZCCM sale. I wonder if other donors face similar problems. Perhaps this could not have been avoided in Zambia's case but, as a general principle, I would urge the staff to be more proactive in ensuring that financing partners are able to provide assistance in time to meet program targets, including by sharing necessary program information.

Moving on, I am disappointed to see that there are no performance criteria with direct relation to poverty reduction. I was, however, pleased that the document includes some discussion of the pervasive problem of poverty in Zambia and highlights the government's plans to reorient public expenditure toward the primary social sectors to assist the poorest. We are also informed that Zambia has reached an understanding with the World Bank to ensure that at least 36 percent of domestically financed discretionary expenditure is allocated to the social sectors during 1999–2001. This is an essential target for poverty reduction, and the achievement of this objective will significantly affect Zambia's ability to attract and enhance the bilateral donor support that it requires, raising growth rates. I would therefore like to propose that we incorporate this objective, which is set out in paragraph 29 of the staff report, as a performance target in the ESAF.

I am also concerned about the authorities' efforts to tackle corruption in Zambia, which are essential for rebuilding private sector confidence and raising private investment to the ambitious levels projected in the document. I note that an anticorruption authority is in place, but it

has yet to make its mark. I would therefore urge the staff to consider incorporating some governance and anticorruption measures into the program. These could be presented for consideration at the Consultative Group in May.

As I have already noted, I agree with the staff's assessment of the key structural reforms to be undertaken in 1999, but I am not convinced that these reforms can translate into the growth levels predicted in the document. Over the last 10 years, the Zambian economy has shown positive real growth in only two consecutive years: 1996 and 1997. Yet, the program envisages real growth in the region of 4.0 to 5.5 percent over the next three years. This is predicated on a near doubling of private investment from 6.7 percent of GDP in 1998 to 12 percent in 2001. I would seriously question whether this is feasible.

For example, it is not hard to envisage a situation, based on the sensitivity analysis in Appendix IV, whereby the combination of a 10 percent fall in copper prices and 5 percent fall in nonmetal export volumes would mean that gross official reserves would not rise to one month's import cover over the whole of the ESAF period, whereas the program predicts a rise to 2.8 months by 2001. This is just a back-of-the-envelope calculation—and the staff may wish to disagree with the conclusion. I make the point to illustrate how vulnerable Zambia is and how even small changes in the assumptions underlying the program could have a major impact on Zambia's external viability. Zambia's economic prospects are on a knife's edge. The global downturn in commodity prices shows no sign of reversing, and Zambia is highly likely to experience a drought over the program period. I thus hope that the staff has considered a contingency plan should export earnings and private investment not rise as projected in the document.

Finally, I must urge the authorities to carry out this program vigorously. As this chair has observed many times in the past, Zambia is a country of high potential, with rich natural resources and a potentially vibrant private sector. However, fulfillment of this potential will require concerted action by the Zambian authorities to improve economic management and follow a credible reform program. As I have already mentioned, this is an ambitious program and there is no room for wavering, particularly if Zambia is to be considered as a candidate for assistance under the HIPC Initiative. I hope that the Zambian authorities will rise to this challenge, and wish them well.

Mr. Daïri pointed out that a large part of the increase in private investment would result from the privatization of the mining company.

Mr. Charleton made the following statement:

First, let me say that I very much appreciate the clear and candid staff assessment of the situation in Zambia. They have not downplayed the scale of the problem, the inadequacies of past policies, or the risks associated with

the implementation of the 1999 program. The staff's opening remarks concerning shortfalls on performance criteria for end-March highlight further the implementation risks.

Unless this program is carried through successfully, I fear that the relatively good growth of the mid-1990s will turn out to be the aberration. This already poor country had negative growth in the first half of the 1990s and again in 1998. The objective of sustained 5 percent per annum growth is ambitious, but it has to be.

While terms of trade effects, El Niño, etc., were clearly factors in 1998, one has a sense that many of the problems facing Zambia are homegrown, have been evident for years, and that opportunities have been wasted. The result has been to make the future task even greater.

One also has a sense that, while many reforms have been undertaken, key issues have been avoided. Moreover, at times policy seems to have been deliberately perverse. For instance, the Central Bank decided to reduce interest rates and drive real rates negative at a time when inflation was clearly rising.

The ZCCM issue is critical to the whole policy package. With operational losses of $9 million per month, the country simply cannot sustain it. How much would this $9 million do for education or health? In the October 1997 Board discussion, the summing up stressed the importance of a speedy finalization of the privatization of ZCCM, noting earlier delays.

Not only have major losses been clocked up in the meantime, but the value of the assets has fallen sharply. It would now appear that the privatization of ZCCM's major assets is set to go ahead, and it is essential that this be finalized. On Mr. Karunasena's concerns about the extent of tax concessions to Anglo-American on the ZCCM privatization, I accept staff's explanation. We may not be too happy with this solution but it is the lesser of two evils.

The fiscal objectives are ambitious and will require much greater consistency in implementation than previously. In the face of clear budgetary overruns, involving both overspending and low revenue, the government was generous enough to grant discretionary exemptions from excise tax and VAT as late as September/October 1998. While most of these have been subsequently reversed, programs cannot be run on the basis of erratic and irrational policy choices.

It is still not clear that the public sector wage/pensions bill can be controlled. The reductions in numbers are to be welcomed but these seem to be conflicting payroll data, and the report notes that involuntary retrenchment of pensionable civil servants is very costly. The present civil service pension scheme is unaffordable and, I presume, cannot easily be changed. I was also somewhat alarmed by a reference to occasional erroneous payments on external debt service (p. 24). If errors can arise in this area, the system is vulnerable to fraud. Has Zambia sufficient debt management capacity?

While the staff does report on health services, there is no direct reference to HIV. Apart from the health care aspects, is the HIV problem sufficiently acute to affect the productive potential of the economy?

We would also stress the importance of addressing the full range of donor concerns, including inadequate funding of the anticorruption authority and the lack of meaningful dialogue between government and opposition parties.

While I have highlighted our concerns, the picture is not all negative. Given that the program envisages front-loaded policy actions while disbursements will be back-loaded, and given the need for Zambia to gain access to external assistance on highly concessional terms, we can support the proposed ESAF arrangement.

Mr. Daïri made the following statement:

The Zambian economy was severely affected in 1998 by the sharp decline in copper appropriation prices, the effects of El Niño, and armed conflicts in neighboring countries. Inflation rose and the fiscal and current account deficits widened. Against this backdrop, and in view of the government's strong commitment to face these problems and embark on a comprehensive reform program, we support Zambia's request for a three-year ESAF. We broadly agree with the staff's analysis and policy recommendations, and wish to make a few brief comments.

In the fiscal area, we share the staff's view on the need for strict control of the wage bill and for public sector retrenchment. In this respect, we commend the authorities' efforts to move ahead with the retrenchment and enable the planned disbursement related to the World Bank's public sector reform program, thus alleviating some constraints related to the unavailability of external financing. In view of widespread poverty and the high incidence of AIDS, changes in the structure of government outlays in favor of increased spending on health and education are also steps in the right direction.

As regards monetary policy, we welcome the authorities' intention to pursue a tight monetary policy in 1999 to reduce inflation and depreciation of the kwacha. I trust that this policy will lead to positive real interest rates, improve domestic savings, and help arrest the dollarization of the economy.

Regarding the banking system, we welcome the measures taken so far to reduce the share of nonperforming loans, which is still very high by international standards. In this regard, the improvement of banking supervision and the strengthening of loan recovery efforts will be essential.

We support the staff's view on the need to proceed with the privatization of ZCCM. However, in view of its important role in the economy, we encourage the authorities to ensure that this process does not lead to unsustainable or unwarranted revenue losses. As I indicated earlier, we were somewhat puzzled by the extent of the tax holidays granted, which contrasts with our traditional

advice against tax exemptions. We would urge the staff to seek alternative ways of dealing with the ZCCM issue that better protect the long-term interest of Zambia and ensure efficient exploitation of its main resource.

Political stability and public support are essential conditions for successful program implementation. In this regard, more attention should be paid to governance, and to the establishment of good relations with neighboring countries. We welcome the government's intention to improve political and economic governance.

Finally, given the large and rising number of refugees in Zambia, I would welcome staff's comment on the situation of refugees in the country and its implications for the Zambian economy. We support the proposed decision and hope that Zambia will soon be able to build up a satisfactory track record of program implementation for the HIPC Initiative. With these remarks, we wish the authorities every success in their adjustment efforts.

Mr. Jourcin made the following statement:

I will try to be brief. Since everyone is aware of Zambia's track record, I do not see the need to elaborate further on the mixed results registered by this country under the previous ESAF arrangement, even if I keep in mind that the amount of the support granted by the IMF in 1995 was particularly substantial and was promptly disbursed during the first year.

I think it is better to focus on how to improve the current situation, which is worrisome on many fronts. I welcome recent steps undertaken by the authorities in the structural area, as well as their willingness to restore macroeconomic stability in the framework of a new ESAF arrangement. However, I note that there are major risks and uncertainties associated with the implementation of a program for 1999. Furthermore, new information provided by staff in their preliminary statement is somewhat disturbing. I commend staff for their transparency in this regard. I prefer that this information be made available one day before the Board meeting rather than one day after. This being said, I must confess to having some reluctance about the idea to approve a new ESAF in such conditions, knowing that several criteria will not be observed in the coming weeks. I would have preferred that these criteria be revisited before the program is presented at the Board. But if there is a consensus, and in order to give the authorities a chance to realize their commitments to implement the program, I am ready to approve the proposed decision.

To conclude, I would also like to say that I share the view expressed by Mr. Karunasena in his preliminary statement and by Mr. Dairi, concerning the difficulty of justifying the range of tax concessions under the privatization of ZCCM, granted for 20 years. I can understand the explanation provided by staff, but this does not change the fact that these tax concessions are not satisfactory.

Mr. Barro Chambrier made the following statement:

It is regrettable to note that, after a promising departure in the framework of the previous ESAF, Zambia suffered some setbacks in its program implementation in 1997 and 1998. The main factors at the root of these unfavorable developments appear to be, first, the delays in the privatization of the ZCCM, and, second, external developments beyond the authorities' control, namely the shortfall in copper prices, the unfavorable weather conditions, and the armed conflict in the Democratic Republic of the Congo. These two elements, combined with the loosening of monetary policy in late 1997 and early 1998 and the weakening of the fiscal stance in the last part of 1998, have exacerbated the deterioration of the macroeconomic situation. As I am in full agreement with the staff appraisal, I will try to be brief.

In the current circumstances, it is clear that the most challenging task for the authorities is to restore macroeconomic stability and to deepen structural reform. The current program proposal is therefore welcome, and the objectives set for the macroeconomic program in 1999 remain consistent with the medium-term adjustment strategy. I also welcome the well-targeted structural reforms aimed at completing the privatization of the copper parastatal and the divestiture of large state-owned enterprises in the nonmining sector, as well as pursuing public service reform and strengthening prudential banking supervision. Nevertheless, I am of the view that the objectives of this program are very ambitious and will require strong commitment from the authorities, as well as the timely mobilization of external financial assistance from bilateral and other multilateral donors. In this regard, I am reassured by Mr. Morais's very informative preliminary statement, which highlights the authorities' recognition of the seriousness of the situation, and of the fact that there is no alternative but to pursue a more vigorous course of stabilization and reform.

With regard to fiscal consolidation, the implementation of the tax measures that are envisaged in Box 4 would be critical. It will also be essential to improve the control of spending and domestic arrears. Given the high incidence of poverty in Zambia, the authorities should be prepared to maintain the level of expenditure allocated to the social sector.

On monetary policy, I share the staff's view on the need for an appropriately tight monetary stance, including the maintenance of positive real interest rates to support the kwacha and reverse the dollarization of the economy. This would also contribute to the strengthening of the net foreign asset position of the Bank of Zambia.

With regard to structural reform, an important priority is obviously the rapid completion of the privatization of ZCCM. At this stage, the only alternative would be for the Zambian authorities to accept a lower cash payment. Given the high cost of ZCCM for the budget, it is clear that the more we wait, the more the survival of ZCCM will be at stake. I also share the concerns expressed by other Directors with regard to the tax concessions, but there is an urgent need to ensure a timely privatization process.

On the banking system, I welcome the legislative proposal to amend the Banking and Financial Services Act. This should facilitate the task of the Bank of Zambia in licensing and liquidating banks. I would insist, however, on the need for the authorities to pursue steadfastly the restructuring of the commercial banks and to reinforce banking supervision. The high level of nonperforming loans, which amount to 22 percent of total loans, is a serious cause for concern, while the number of majority state-owned banks is still high. I would be interested to hear from the staff why a bolder approach vis-à-vis the privatization of financial institutions was not contemplated. I would also be interested in further details on the contingency reserve mechanism.

Let me conclude by noting that, while we recognize the risks of this program, postponement would only add to the difficulties. It is important for the authorities to stick to the agenda of reforms so that Zambia can benefit from the external support of the international financial community and establish a strong track record for eligibility under the HIPC Initiative. I support the proposed decision and wish the Zambian authorities all the best.

Mr. Al-Turki made the following statement:

Zambia's economic situation has worsened markedly. Following the promising recovery in 1997, the outcome last year was an unfortunate mix of output drop and inflation surge in an environment of deteriorating fiscal and external payments positions. While this partly reflected the crop losses due to El Niño and the decline in export prices, responsibility also has to be shared with policy lapses. I therefore welcome assurances in Mr. Morais' helpful preliminary statement that the authorities are fully cognizant of the seriousness of the situation and committed to a vigorous course of stabilization and reform.

The program's stress on fiscal improvements is well placed. Here, the importance of better budgetary management cannot be overemphasized. The sizable scope for gains on that score are indicated in footnote 11 on page 9, where staff points out that an audit has placed domestic payments arrears at nearly three times the level estimated earlier. The authorities' priority for improved spending controls and revenue administration is therefore welcome. Full implementation of the envisaged civil service reform and containment of the public wage bill is critical. I also welcome the program's greater reliance on improved tax administration rather than on new taxes to boost budgetary revenues.

On the monetary front, staff has rightly highlighted adverse consequences of policies inconsistent with the inflation outlook. Early success in containing inflation is clearly crucial for preserving the economy's competitive edge and reserve position. The authorities' commitment to monitor the situation closely and to tighten the monetary stance as needed is therefore welcome. Given the precarious condition of the banking system, full implementation of the steps envisaged for improved management of the banks is a priority.

Macroeconomic improvements, however, can only be effective in combination with a speedup of the lagging structural reforms. Here, I welcome the commitment to maintain a liberal trade and exchange regime, to further reduce tariffs, and to speed up reforms of the public services and the financial system. Regarding the privatization drive, it is worth recalling that lack of progress in implementing plans was a major factor in the authorities' inability to go forward under the last three-year ESAF arrangement. The speedup envisaged for the privatization effort under the proposed new program is therefore crucial. That said, it is also important to ensure that progress in this regard is achieved with appropriate attention to possible long-term adverse effects on the fiscal position. Here, while I appreciate staff's response to the issues raised in Mr. Karunasena's preliminary statement, I believe the remarks of Mr. Daïri in that regard are relevant. The question here is not whether or not to privatize the ZCCM, but rather it is the timing and long-term implications of the privatization.

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

Mr. Melese-d'Hospital made the following statement:

As I find myself in broad agreement with Mr. Collins and other speakers, I can be brief.

At the outset, I would like to acknowledge the important progress that the Zambian government has made on its overall economic reform program and notably on the privatization of state enterprises, including signing the MOU with Anglo-American to complete the privatization of ZCCM. Certainly, there remains much more to be done. Nonetheless, the progress that has been made is to be commended.

We believe that the approach being taken in this ESAF is broadly appropriate. However, we remain concerned that the agreement reached between the government and Anglo is not legally binding, and there is a risk of the deal falling through if some of the preconditions are not met. In this regard, the government's past track record is not particularly reassuring. We are therefore pleased that the release of the World Bank's second tranche of its SAL is tied to the ownership and control of the remaining core ZCCM assets. We believe this is essential. We strongly urge the government and Anglo to see the deal through to its conclusion at the earliest possible date.

Reading the staff paper, I had two questions for the staff. First, in an environment of continuing armed conflicts in the region, including in neighboring DRC and in Angola, what are the prospects for increased military expenditures by the government of Zambia? Is the staff comfortable with the quality of data they are receiving in this area?

Second, in paragraph 16, I noted that the staff alludes to the deterioration in Zambia's terms of trade resulting from the sharp fall in copper prices, but also from the drop in cotton prices. In paragraph 38, I find that the projections

for 1999 are based in part on an average copper price of about $1,500 per metric ton. What are the prospects for recovery in the overall terms of trade in 1999 and what might be the ramifications?

Finally, I would urge the authorities to put their best efforts into civil service reforms, as this is a critical component of the overall reform program.

To sum up, then, although we continue to have serious concerns about the uncertainties, notably those related to the finalization of the ZCCM deal, we support this program with reservations.

Mr. Donecker made the following statement:

First, I would like to thank the staff for an excellent analysis. The report is compelling and the set of background papers, very informative. Last summer I had the opportunity to visit Zambia with a group of Executive Directors. At that time, our group stressed to the authorities the need to press ahead with the privatization of ZCCM, whose problems seem to be a millstone around the neck of the authorities. Past hesitancy on their part has had severe consequences for the whole economy, and recent developments in Zambia are not very encouraging. As the staff has pointed out, the main indicators present a picture of a weak economy with negative output growth, high inflation, and limited international reserves. What is the explanation for these unsatisfactory developments over the past year? The staff report supplies a few reasons: the depreciation of the domestic currency, the decline in copper prices, the delayed ZCCM privatization, and the effects of El Niño.

I generally support the staff's appraisal and its recommendation with regard to the financing request. However, I would appreciate additional information on two issues. First, I would have welcomed a comprehensive review of monetary policy in the report, given the alarmingly sharp acceleration of the inflation rate. In particular, I wonder whether a different use of the monetary policy instrument would have helped to avoid the impact of the depreciation on the inflation rate. In my view, the stabilization of the value of the domestic currency has to be the priority target. Without confidence in the kwacha, the chances for economic recovery are limited. I therefore welcome the authorities' announcement of improvements in the effectiveness of monetary policy.

My second question relates to the monitoring of the new adjustment program for the 1999–2001 period. As early as 1995, the Board approved an ESAF program for Zambia, which could not be put into effect because the necessary prior actions were not carried out. The new program should not have the same destiny. In this regard, I share the concerns expressed by Mr. Jourcin about our timing concerning this credit request. Given the continuing uncertainties, we would recommend closer monitoring of the implementation of the program, particularly of the planned public service reform, and the recommended banking sector reform, for which more controllable criteria could be set.

In addition to these points, I would like to underscore the importance of further improving political and economic governance. If there is no reasonable progress in this field, major conditions for financial assistance—for example, of the World Bank and the European Union—will not be met.

Finally, I would like to turn to the unsatisfactory progress in the field of privatization. In order to strengthen structural reform efforts to liberalize the economy, the authorities should speed up privatization within the next year, in particular privatization of the government-owned copper enterprises. Like Mr. Barro Chambrier and others, I see some justification for special tax concessions in order to sweeten the ZCCM deal for private investors. They will be required, after all, to invest considerable amounts to improve the efficiency and the viability of the huge loss-making copper mining sector.

The staff representative from the African Department explained that the end-March performance criterion relating to the ZCCM privatization had not been recast—despite the realization that the deadline was no longer feasible—mainly to maintain the momentum and the sense of urgency to complete the reform. The authorities now clearly recognized that any further delays in the privatization would undermine private sector confidence and efforts to revive economic growth. Shifting the timetable might suggest that there could be room for further delays. In the meantime, Anglo-American had made significant progress in finding a partner for the undertaking.

As regards the need for a bolder approach to privatization in the financial sector, the staff representative pointed out that the letter of intent expressed the authorities' willingness to privatize the state-owned financial institutions in 1999, including the Zambia State Insurance Company and the Zambia National Commercial Bank. The question was whether sufficient shares would be floated to ensure that majority assets were actually transferred from the government. The authorities also intended to complete the privatization of the Zambia National Building Society and the National Savings and Credit Bank by 2000.

The staff representative noted that the contingency reserve had been used for the past few years to offset unforeseen revenue shortfalls and expenditure overruns on domestic arrears and interest payments. It had proved to be successful in compensating for weaknesses in budget management, which continued to persist. As contingency reserves were not allocated to Ministries, they could not directly base their spending plans on those amounts.

With regard to the consequences of the armed conflict in the region on spending, the staff representative explained that while information on budget allocations was available, few details on the breakdown of expenditure were provided. The large and rising number of refugees was a major concern, particularly in the light of the continuing regional instability. The UN agencies generally coordinated aid efforts in this area and partly financed the related costs.

As regards monetary policy, the staff representative said that the acceleration of inflation had been largely due to a combination of a sharp depreciation of the kwacha and the loss of confidence in the currency. Maintaining higher real interest rates would have helped to dampen inflationary pressures. Instead, the Bank of Zambia relaxed its monetary stance by lowering interest rates and reserve requirements at the end of 1997 and in the first quarter of

1998. The staff representative further noted that Zambia would be the first case for which the new intensified monitoring guidelines would be applied.

The prospects for the recovery of overall terms of trade remained unfavorable, the staff representative stated. The *World Economic Outlook* projected that the price of copper would remain depressed in the medium term and, in 2001, would be at its 1996 levels.

Mr. Daïri observed that if the tax concessions accorded to ZCCM were deemed necessary to attract foreign investment, then there was perhaps a need to reconsider the Fund's position on tax exemptions and tax holidays in other countries.

While recognizing that for a low-income country, resorting to the Compensatory and Contingency Financing Facility (CCFF) was probably not the best solution, Mr. Daïri wondered if this option had been considered for Zambia, in view of the substantial shortfalls in metal exports in 1998. He felt that as long as the CCFF resources were used to strengthen reserves, and not to replace concessional financing, then the lending could reinforce the authorities' resolve and enhance the country's attractiveness to foreign investment.

Mr. Donecker stressed the need to consider the case of ZCCM as unique. While the authorities were now keen to press ahead with the privatization, the process had been fraught with difficulties and delays, and there was now little room for maneuver. ZCCM was the centerpiece of the economy, and many Zambians regarded it as a national treasure, which should not be easily given up to foreign investors. At the same time, ZCCM had substantial payment arrears to the local suppliers, and copper prices were likely to remain depressed for some time. Two years ago, potential investors had withdrawn their offer at the last minute, because after closer inspection of the assets, and of the viability of the mineral production, they had not been entirely satisfied with the proposed deal. Under these specific circumstances, and given the huge investments required, providing investors with a sweetener was appropriate.

Mr. Collins observed that, in an ideal world, the authorities would not have to forgo tax revenue in exchange for releasing this hemorrhaging asset, but this was the price the authorities had to pay to ensure that privatization went ahead. The opportunity costs of the tax losses were difficult to ascertain. Selling off the assets with a sweetener would introduce a degree of certainty into the government's finances that would otherwise be lacking. While recognizing the need to avoid amending the performance criterion on ZCCM and sending the wrong signals on the urgency of completing the transaction, Mr. Collins wondered if it would not be appropriate to set a new date now.

The Deputy Director of the Policy Development and Review Department noted that the CCFF had indeed been considered as an option for Zambia. However, in light of the country's limited repayment capacity, ESAF financing had been deemed more appropriate. Presumably for the same reasons, the authorities themselves had expressed no interest in a CCFF.

The Deputy Director felt that additional structural benchmarks on issues such as privatization and poverty reduction could be useful. He noted that such structural benchmarks would be part of the ESAF's proposed new architecture, as would be the more intense quarterly monitoring.

The staff representative from the African Department, noting that the World Bank had clear benchmarks or performance criteria on social spending, stressed the need to avoid duplication, especially in view of the difficulty of operationalizating such benchmarks. He also referred to the continuing efforts of bilateral donors to address conditionality on governance and poverty reduction in the context of Consultative Group meetings. Nevertheless, the policy framework paper included the authorities' explicit commitments to improve political and economic governance and to continue implementing their own action plan to strengthen and make procurement more transparent and accountable, as well as to pursue donor-supported activities to build up the capacity of financial institutions and of the judiciary.

As regards ZNOC, the staff representative commented that the government would determine its approach towards privatization in the oil sector following completion of a fuel options study and the review of the institutional framework for the petroleum sector to be completed by December 1999. The government planned to adopt an action plan by 2000, establishing a liberalized pricing and retail distribution for petroleum products.

Mr. Collins stressed that, while he agreed that the staff should avoid duplicating the World Bank's work, it would be helpful to the authorities if, at least ex ante, there was adequate coordination between the two institutions to ensure consistency of their objectives.

The Acting Chairman, while recognizing the importance of structural benchmarks to monitor performance on social issues, emphasized the need to observe the normal division of responsibilities. Social issues were clearly the responsibility of the World Bank and, during a recent discussion on the design of Fund programs, many Directors had cautioned against multiplying performance criteria and benchmarks. This underscored the need for an early Board decision on this issue.

The Deputy Director of the Policy Development and Review Department pointed out that some of the benchmarks would be amenable to the World Bank's monitoring system, but not to the Fund's quarterly monitoring.

The staff representative from the African Department noted that it was not necessary to establish a new date for the completion of the ZCCM privatization in the program as such. If the privatization took place after March 30, but within a period deemed to be reasonable, the staff would request disbursement, with a waiver of the structural performance criterion.

The Acting Chairman indicated that the staff and management would continue to press for an early transfer of the assets.

Mr. Donecker said that, rather than modernize ZCCM's operations and raise production and employment, the new owners might decide, in the light of the unfavorable market conditions, to slow down operations and lay off more workers. The preferential tax treatment would be an appropriate incentive to keep the mine operating and sustain employment.

The Acting Chairman stated that one of the reasons why the paper had been submitted to the Board at this time was to maintain the pressure for successful conclusion of the deal and to prevent it from unraveling, which would be disastrous for the country.

Ms. Pinzani made the following statement:

Zambia's performance in 1998 suffered from the effects of both adverse external developments and policy weaknesses. In particular, the country experienced a contraction of real GDP, due mainly to the impact of the El Niño phenomenon on agricultural production, while the external position deteriorated, partly as a consequence of the conflict in DRC. At the same time, the 1998 budget deviated from plans because of the sizable accumulation of tax arrears, the weak performance in import value-added and excise taxes, due in its turn to ad hoc exemptions, and the disappointing collection of nontax revenues.

In the monetary area, the increase in the annual rate of consumer price inflation was due not only to higher food prices, but also to a relaxation of the monetary stance decided upon by the authorities in early 1998.

Despite the corrections introduced by the authorities in both fiscal and monetary policies in the second quarter of 1998, the uncertain orientation of the authorities' management of the economy does not bode well for the new program under discussion today. Results achieved through more disciplined economic policy were jeopardized by sudden and unexpected government decisions. In addition, further delays in privatizing the main asset package of the ZCCM are not reassuring. The staff report on the 1998 Article IV consultation for Zambia and the request for a second three-year ESAF arrangement put the Board in a very delicate position, namely that of choosing between giving more relevance to the catalytic role of its resources, or focusing more on the use of its resources according to a program that is deliverable on the basis of the country's track record. Our task would have been facilitated considerably had the discussion been postponed until after the conclusion of the ZCCM privatization. Some Fund monitoring could have been envisaged in order to guarantee due diligence for the conclusion of the deal. I understand, however, that the Board prefers to focus more on the Fund's catalytic role at this juncture, and can therefore support the consensus. However, I hope that the timing of such Board discussions will be better assessed in future so that similar situations can be avoided.

Mr. Zakharchenkov made the following statement:

In 1998, Zambia's overall economic performance suffered several setbacks. On the one hand, the country has been affected by the terms of trade shock and by El Niño, which have led to a contraction in both the industrial and the agricultural sectors. On the other hand, the government remained reluctant to undertake adequate corrective measures to reverse the situation through a subsequent tightening of monetary and fiscal policies. As a result, inflation accelerated to above 30 percent on an annual basis and the overall fiscal deficit widened to 4 percent of GDP. At the same time, relaxed monetary policies have led to a depletion of international reserves, a weakening of the national currency, and a deterioration of the country's external position. Also, there was a delay in privatization of the parastatal entity, ZCCM, which, in light of its sizeable operational losses, exerted even stronger pressure on the government's

weak finances. At the same time, some progress has been achieved in the areas of trade liberalization and civil service reform.

The program for 1999 is aimed at restoring prospects for future growth through maintaining adequately tight monetary and fiscal policies, enhancing the role of the private sector, and implementing structural measures to remove existing rigidities in the public and financial sectors. Here, we agree with the macroeconomic framework as proposed in the authorities' Memorandum of Economic and Financial Policies. As for the proposed ESAF-supported program, it features a well-balanced policy mix which, once implemented, will help to reveal the country's potential and its clear growth prospects. Its objectives are ambitious, but within reach. However, there are major risks associated with the implementation of the ESAF because of the uncertainty of copper price movements and the availability of external financing. With respect to the latter, we would urge the authorities to implement all the envisaged actions timely and properly and not to undermine the integrity of the program, as it is essential for building a foundation for bringing the economy back on a sustainable path.

I agree with the main conclusion of the debt sustainability analysis that the Zambian external financing situation is very difficult. Taking into account that Zambia's debt to Russia is substantial, our authorities are prepared to go beyond the framework of Russia's agreement with the Paris Club and to provide the rescheduling of sizeable post–cutoff date arrears. I want to mention that the Zambian authorities have been conducting debt negotiations with Russia in good faith and that many important points have been agreed. However, there still remain unresolved issues and I urge the Zambian authorities not to delay their regularization. It is our intention to approach the staff shortly for technical consultations on this matter.

With these remarks we support the proposed decision and wish the Zambian authorities well.

Mr. Dragulin made the following statement:

In 1998, the main economic indicators in Zambia went into the alert zone. As acknowledged by Mr. Morais in his informative preliminary statement, the deterioration was a consequence of the insufficient policy response during the previous years, combined with adverse external developments. The shortfall in external assistance compounded the problems, while the delays in the privatization of the copper parastatal ZCCM blurred the economic landscape and instilled reticence among external donors and investors.

The three-year program prepared by the authorities and proposed for support under an ESAF arrangement aims at restoring equilibrium by maintaining sustained growth of approximately 5 percent per year, achieving a significant decline in inflation to 4 percent by the end of the program, and ensuring a strong recovery of the international reserves, which would rise to the equivalent of three months of imports. However, the most recent data made

available by the staff suggest that important risks confront the program. Staff comments are welcome.

The program assumes a 10 percent increase in copper production, a 7–8 percent increase in agricultural production, and an improvement in the investment and savings ratios. These assumptions appear to be over-optimistic. Crops depend heavily on rains, and the results under the ASIP program have, up to now, not been encouraging. Similarly, the projected increase in the domestic savings ratio by 3 percentage points in the first year seems again challenging, considering the declining past trends of that ratio and the negative deposit interest rates in real terms.

The policy package prepared by the Zambian authorities combines strong financial policies, fiscal consolidation, and monetary tightening with a broad structural reform program. However, alongside this effort, a positive contribution from the multilateral organizations and bilateral donors will also be necessary. In view of the importance of donor assistance for the program, it is of utmost importance that the authorities have a realistic assessment of the context in which these resources would effectively be made available.

It seems that the program is well conceived and appropriately linked to ESAF conditionality, which is set on a quarterly basis—a welcome approach to prevent temporary slippages. The program for 1999 sets a target of half of a percentage point for the domestic fiscal deficit. Let me make a few comments.

First, the budget will be affected by huge one-off expenditure in connection with the copper parastatal privatization. If these transactions are of a stock nature, I consider them less dangerous. Second, and this is indeed more preoccupying, the broad set of fiscal facilities extended over 20 years offered to the announced buyer of the major assets of ZCCM creates inequality in fiscal policy, which could be accepted as the price for stemming the tremendous potential losses. I am, however, concerned about the direct and indirect impact on the budget, via moral hazard. In this regard, I fully share the excellent point made by Mr. Karunasena in his preliminary statement. Third, I agree with the intended measures to strengthen tax administration, reduce tax exemptions, and discontinue the import declaration fee. Fourth, on the expenditure side, critical problems seem to be, on the one hand, restructuring expenditure by containing the wage bill and increasing the allocations for health, education, and public investment, and, on the other, how to properly monitor such targets. Here the track record is less encouraging. The World Bank's public sector reform program (PSRP) has progressed too slowly, attesting to a weak commitment of the government. The implementation of the revised action program, which is currently under preparation, is therefore an area of concern and needs to be placed on top of the agenda. For the health and education allocations, new, upward trends have been registered, but they are still insufficient in relation to the basic needs social indicators.

Turning to privatization, there are indications that ZCCM will be privatized soon. However, I share the concerns expressed by Mr. Newman in his memo to the Secretary regarding the sequencing of the Board meeting to discuss

the approval of the ESAF today, and the announced signing of MOU/ZCCM privatization at the end of March.

Regarding other privatization plans, there is a need for more rapid action. Numerous studies have been initiated and various proposals submitted to the Cabinet, which should already have resulted in official reaction and initiatives. I welcome the integration into the new ESAF of structural benchmarks for privatization. Finally, I would like to comment briefly on the banking system reform. The improved regulatory and supervisory capabilities of the authorities, as well as the initiatives taken so far, are welcome. However, obstacles remain. For example, the Development Bank of Zambia's restructuring program proposes the same practices of direct lending after it has finished its activities to loan recovery.

Finally, despite the uncertainties surrounding the proposed program, I agree with the staff's recommendation to approve a three-year ESAF arrangement.

Mr. Rigász made the following statement:

It is regrettable that the authorities did not seize the opportunity of Zambia's two years of economic growth and fiscal consolidation to get its economy on a sustained growth path. As a result, the economy shrank overall in 1998. While certain exogenous factors played a role, it was the missed opportunity for effective policy action that contributed most to this unfortunate result. For Zambia, as for other impoverished countries, sustained growth is the only way of improving the living standards of the population. World Bank data showed that a stunning 86 percent of the population was living below the poverty line in 1993.

The data on trends are even more revealing. Per capita private consumption recorded an average annual decline of 4 percent over the last two decades. This is certainly not very promising in terms of the quality of human capital, which is crucial for any country's long-term growth. While we appreciate the authorities' desire to bring more of Zambia's poorest under the umbrella of social services—which is a very necessary short-term measure—what the population needs are jobs that provide a living wage.

The employment statistics for the last 20 years show practically no change in the structure of employment, with about 75 percent of the total labor force engaged in agriculture, and accounting for the majority of persons living below the poverty line. In this connection, we are encouraged by the government's determination to create a vigorous private sector, beginning by accelerating the privatization of state assets, but it will take time for these actions to bear fruit in the form of new jobs. In addition, the number of jobs will decrease before beginning to increase. This will make it harder for the government to maintain the social consensus that is indispensable for the program's success.

The extremely low turnout during last December's elections may already signal serious popular disillusionment, which will quickly worsen if growth does not resume. Growth could soon pick up if the government's expectations that the mining sector will revive in 1999 actually came to pass, but this seems unlikely. Even if the privatization of Zambia's copper mines is successful, it will take time for production to get up to its full potential. The possibility that Zambia's mining sector can lead a revival of growth is also threatened by the impending labor troubles, the continuing world copper surplus, and low copper prices, which are expected to decline further in most of 1999.

As regards other major threats to successful program implementation, the budget's reliance on external grants is particularly striking. Grants account for one-third of total budgetary revenues. More significantly, 40 percent of these grants are not linked to projects. This means that in case they do not materialize, the government will be forced to make budget cuts, even beyond the present difficult target, or resort to central bank financing again, which, as the staff statement indicates, has already begun. Perhaps the staff could comment on the quality of assurances the authorities have received about the status of grants which have been included in the budget assumptions.

With these remarks, we support the proposed decision and wish the authorities all the best.

Mr. Carlens made the following statement:

It is unfortunate to note that the Zambian economy, after a period of welcome stabilization gains, has suffered significant setbacks in the past year. External forces, such as adverse climatic conditions, have indeed contributed to this. More importantly, though, policy implementation has faltered in several crucial areas. Yesterday's staff update unfortunately reflected that recent performance continues on the same path. This is regrettable.

I broadly share staff's assessment and policy recommendations. I also share Mr. Collins's and Mr. Charleton's view that growth assumptions might be somewhat overly optimistic. Let me therefore just add two short comments.

First, I am satisfied to note that the authorities are recognizing the seriousness of the current situation, as reassured in Mr. Morais' preliminary statement, and that their medium term economic program is indeed comprehensive and ambitious. Hence, full implementation will be the crucial issue in the time ahead. Here, I agree with Mr. Collins that there will be no margin for error. Furthermore, staff notes that Zambia's capacity for program implementation needs strengthening in several areas. Hopefully, the authorities will work closely with the Fund's resident experts and technical assistance teams to strengthen this capacity. In this light, however, and bearing in mind Zambia's large outstanding obligations to the Fund, I very much welcome the design of the ESAF program, in that it has front-loaded policy actions and back-loaded disbursements.

Second, on the issue of privatization, like several previous speakers, I believe it is imperative to press ahead with privatization of the ZCCM as soon as possible, since the privatization will have far-reaching effects on the whole economy. Moreover, I welcome the privatization plans for large state-owned enterprises outlined in the medium-term program and encourage the authorities to implement these plans vigorously.

With these remarks, Mr. Chairman, and especially in light of the back-loaded disbursement schedule, I can support the proposed decision.

Mr. Fujii made the following statement:

The economic situation in 1998 was disappointing, although exogenous shocks, such as bad weather and the situation in the DRC, had significant implications. It is also unfortunate that the ESAF arrangement approved in June 1995 finally expired without getting back on track.

While an agreement reached at the beginning of the year with regard to the long-awaited privatization of the ZCCM is encouraging, the report on the end-March performance criteria is very unfortunate. This chair really hopes that the sale of the ZCCM will be completed as soon as possible, as this is a critical step for overall economic recovery. In addition, the mining sector will remain the main engine of the economy, and the revitalization of that sector is essential for medium-term economic development. Following the completion of the sale of the ZCCM, a large investment will be necessary to enhance the efficiency and productivity of the mining sector. Further efforts by the authorities are encouraged on this front.

The first and utmost policy challenge facing the Zambian authorities is to stabilize the economy and promote the basis for sustainable growth. Disciplined macroeconomic policies are critical in order to strengthen the fiscal and external position and to reduce inflation. In addition, Zambia is a HIPC country and needs large external financing. In order to ensure debt relief and attract donor assistance, credible and decisive policy management will be required and needs to be sustained. Policy credibility, which has been lost due to excessively expansionary macroeconomic policy and the protracted delay in the privatization of the ZCCM, must be restored.

In this connection, in terms of facilitating the authorities' policy efforts, it is reasonable that the new ESAF program envisages front-loaded policy actions with back-loaded disbursements. It is also appropriate that the program incorporates quarterly monitoring with a view to ensure the authorities' commitment to it.

On the fiscal front, the staff argues that the projected increase in tax revenues by 0.5 percent of GDP is ambitious, and that strengthening of the tax administration and recovery of economic activity are the main sources for revenue enhancement. However, I wonder whether this tax revenue target can be achieved without taking any other measures such as increasing tax rates and introducing new taxes. It seems reasonable to set a contingency reserve that will

be used to offset unforeseen revenue shortfalls or expenditure overruns, but I wonder whether the size of the contingency reserve is enough.

On the expenditure side, the composition of expenditures should be reexamined, and more resources need to be allocated to investment and social spending in order to ensure sustainable growth over the medium term. To this end, expenditure controls should be strengthened to avoid expenditure overruns and the accumulation of domestic payment arrears. In this regard, I strongly encourage the authorities to take the decisive measures spelled out in paragraph 19 of the MEFP to enhance budget management.

Regarding structural issues, of course, completion of the ZCCM privatization is the key to reform in 1999. In addition, I support expansion and acceleration of the divestiture of other major state-owned enterprises such as telecommunications, oil, and railroads.

With these remarks, and with the hope and understanding that the Zambian authorities will double their efforts in both macroeconomic and structural areas in order to maintain the program on track, I can go along with the proposed decision. I wish the authorities every success in their endeavors.

Mr. Elhage made the following statement:

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

We agree with the staff analysis and recommendations and support the proposed decision. It is our hope that the authorities will seize this opportunity to push forward with their reform agenda.

Mr. Hililan said that he agreed with the proposed decision.

The staff representative from the African Department noted that the disbursement of donor financing programmed for 1999 would depend very much on the implementation of the program and the specific conditionality attached by donors.

Mr. Morais made the following concluding remarks statement:

I thank Directors for their candid comments and support for Zambia's program. As most of the questions have been addressed by the staff, I would like just to make some additional remarks.

Over the past year, my Zambian authorities have made significant efforts to advance the process of adjustment and reform. They have tried to maintain a strong revenue effort and have made further progress in liberalizing the trade regime. In fact, Zambia now has one of the most liberal trade regimes in Africa. The authorities have also made efforts to advance the process of privatization.

On ZCCM, steps taken thus far toward privatization leave no doubt about the government's intentions. First, to make the deal more attractive, the government has relieved the would-be investor of ZCCM's liabilities in relation

to the cost of retrenchment of workers following privatization, and of its social obligations. The government has thus decided to take over former mine schools, hospitals, and workers' accommodation. Around 4,000 workers have already been laid off. Second, the government has laid out a clear plan for servicing ZCCM's debt after the privatization. Third, a decision has been taken to grant the privatized company one of the most generous tax concessions witnessed in the African mining industry.

The delays in completing the sale that are now expected are technical in nature and fall outside the government's purview. Anglo-American is currently carrying out technical assessments of each mine, as well as drafting the legal documents related to the transactions for presentation to the Anglo-American Board of Directors. There is no government involvement in this process. In light of the urgency of concluding the sale, the Ministry of Finance has requested that a new timetable be formally agreed and signed by both negotiating teams. The authorities will surely provide the donors with this information as soon as it becomes available.

Finally, I strongly support Mr. Collins's concerns on poverty reduction. In a country where 70 percent of the population lives below the poverty line, poverty reduction should clearly be a key parameter of the policy framework. However, I agree that this issue correctly falls under World Bank monitoring. With these remarks, I thank Directors for their comments.

The Acting Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They noted that Zambia's economic performance had been affected by adverse external developments in 1998, including the decline in world copper prices and a weather-induced fall in agricultural production. The slowdown in economic activity was compounded by the protracted delay in the privatization of the copper parastatal Zambia Consolidated Copper Mines (ZCCM).

Directors regretted that economic and financial policies in 1998 had been only partially successful in arresting the deterioration in economic conditions. In particular, the loosening of the monetary policy stance in early 1998 had contributed to an accelerated depreciation of the currency and loss of international reserves, while expansionary fiscal policies during the last quarter had exerted strong upward pressure on inflation.

In this regard, Directors welcomed the government's adjustment program for 1999, which aims at restoring macroeconomic stability and promoting sustainable growth by reducing inflation, strengthening the external position, and emphasizing the critical role of private sector development. However, given the uncertainties associated with Zambia's heavy dependence on copper exports, and the budgetary risks emanating from the financial problems of the ZCCM, they urged the authorities to tighten their financial policies and deepen their program of structural reforms, so as to restore private sector confidence and lay the basis for sustained economic growth over the medium term. They also stressed the importance of firm and effective

implementation of the program and avoidance of a repetition of the policy slippages that had undermined Zambia's performance in recent years.

Directors welcomed recent progress made in the sale of the major assets of the ZCCM to a prominent international mining house, which was crucial for macroeconomic stability and would lay the basis for the restoration of the financial health and development of Zambia's mining sector. They noted, however, that the sales agreement had not yet been finalized, and strongly urged the authorities to do everything in their power to expedite the transfer of the assets.

Directors emphasized the need for a strong fiscal adjustment effort that would have to be supported by supplementary expenditure restraint to offset the effects of any adverse shocks. In this context, they urged the authorities to take firm action to address the serious existing weaknesses in expenditure controls and to avoid the accumulation of domestic payments arrears. Moreover, it was imperative to limit the increase in the wage bill and implement additional public sector retrenchment in order to bring current expenditures to a more sustainable level and allow a reorientation of expenditure toward health, education, and poverty reduction. In addition, Directors stressed the need to strengthen revenue performance by improving tax administration and refraining from introducing new tax exemptions or preferential tax treatment. In this regard, some Directors expressed concern about the generosity of the tax concessions granted in the context of the privatization of ZCCM, which would entail significant fiscal costs in the long term, while other Directors agreed that these concessions were important for the recovery of the copper sector in Zambia.

As regards monetary policy, Directors noted that the rise in interest rates in 1998 was appropriate in light of the mounting inflationary pressures, and urged the authorities to maintain positive real interest rates to promote savings and restore confidence in the kwacha. They expressed concern about the weaknesses in the commercial banking system and noted that the current high share of nonperforming loans in total loans was not sustainable. Accordingly, they urged the authorities to strengthen loan repayment efforts, to strictly apply minimum liquidity and capital requirements, and to strengthen prudential supervision.

Directors regretted that limited progress had been made in privatizing state enterprises in the nonmining sector in 1998. They welcomed the high priority accorded in the government's medium-term adjustment program to the divestment of public enterprises, including public utilities, parastatals in the petroleum sector, and financial institutions.

Directors commended the authorities for the trade liberalization measures taken in 1998 and emphasized that trade liberalization should remain one of the key elements of the authorities' medium-term adjustment program.

Directors noted that Zambia's external current account deficit would remain large, and that the external position would be subject to a number of uncertainties, in particular the availability of external financing and the timing

of the completion of the privatization of the ZCCM. In this connection, they stressed the critical importance of sustained program implementation and further progress on fighting corruption so as to improve the prospects for timely and adequate mobilization of external support, including through the HIPC Initiative. Directors encouraged the authorities to take the necessary steps toward accepting the obligations of Article VIII of the Fund's Articles of Agreement.

Directors noted with concern the weaknesses in economic and financial statistics, including the recent deterioration in the reliability of external debt service statistics. They urged the authorities to improve the quality of economic and financial statistics, as a matter of urgency.

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

The Executive Board took the following decision:

1. The government of Zambia has requested a three–year arrangement under the Enhanced Structural Adjustment Facility in a total amount equivalent to SDR 254.45 million.

2. The Fund notes the policy framework paper for Zambia (EBD/99/42).

3. The Fund approves the arrangement set forth in EBS/99/35, Supplement 1.

Decision No. 11925--(99/32), adopted
March 25, 1999

2. PORTUGAL—MACAU—1998 ARTICLE IV CONSULTATION DISCUSSIONS

The Executive Directors considered the staff report for the 1998 Article IV consultation discussions with Portugal—Macau (SM/99/56, 3/3/99; and Sup. 1, 3/23/99). They also had before them a background paper on recent economic developments (SM/99/64, 3/11/99) in Portugal—Macau.

The staff representative from the Asia and Pacific Department stated that although the staff report had recommended that consultation discussions with Macau take place on a 24-month cycle, the Chinese authorities had not yet decided whether to hold discussions.

Mr. Faini made the following statement:

I would like to begin by stating my authorities' appreciation for management's and staff's prompt response to the request for Macau to join the Fund's consultation process. It is my authorities' conviction that, as long as its economic autonomy will warrant it, the participation of Macau in the Article IV process will provide a very useful framework for an exchange of views on

economic policies and prospects. In this respect, the timing of the first Article IV mission to Macau, in the aftermath of a major financial crisis in neighboring economies and about one year before the transfer of sovereignty to China, was particularly fortunate.

Despite its strong fundamentals and the prospects of a smooth transition to Chinese sovereignty, the economy of Macau was hit hard by the financial crisis in the region, as evidenced by a sharp slowdown in economic activity and an increase in unemployment. The negative effect in the real economy was also magnified by the unavailability of the exchange rate as a buffer to the external shock. Yet, despite the difficult economic environment, the authorities view the exchange rate link as a key ingredient of financial stability, hence the priority given to maintaining adequate supporting monetary and fiscal policies.

In addition to sound public finances, it is worth noting the priority attached to maintaining a lean government, where revenues and expenditures account for a relatively low percentage of GDP, considering the level of per capita income in Macau. More important, however, the goal of a low tax environment has been achieved while safeguarding an adequate provision of public services, particularly in social sectors. Indeed, sufficient funds have been made available to education, which is now free, and health, which is highly subsidized. This policy is consistent with the authorities' goal of upgrading skills, which should be instrumental in improving labor productivity and promoting economic diversification.

Looking ahead, we share staff's cautious optimism with regard to economic prospects in Macau. Most important, we believe that the flexible nature of markets, well reflected in a remarkable deceleration in prices and wages during the past year, should help the economy's ability to adjust to changing circumstances and offset somewhat the unavailability of the exchange rate as a buffer to exogenous shocks. Moreover, a number of factors should come into play and contribute to minimizing the output cost of adjustment in Macau. The unwinding of the devaluation in other regional currencies, coupled with the above-mentioned wage and price flexibility, should be instrumental in strengthening the competitive position of the economy. Also, external demand for exports should be stronger, reflecting the improved growth outlook in neighboring economies.

Yet, there is a considerable downside risk to a recovery in 1999, mostly related to the uncertainty still surrounding the growth outlook in the region, including in Hong Kong SAR. In particular, if a devaluation of the renminbi materializes, it should have significant consequences for the growth and financial stability of the Macanese economy.

With regard to the policy discussions, my authorities agree with the thrust of the staff's advice, namely with the need to improve productivity and diversify the economy and with the desirability of including any fiscal stimulus in the context of a budgetary framework that incorporates the medium-term goal of fiscal balance. However, while the challenges of the

current situation are obvious, it is equally clear that the handover of sovereignty to China in a short period of time constrains the authorities' leeway to address those challenges. On fiscal policy, for instance, while the comfortable fiscal position would normally provide some scope to implement countercyclical fiscal policy, the authorities do not want to initiate any projects that cannot be completed before the future administration takes over.

In view of the exchange rate arrangement in place, another priority is to increase factor productivity and diversify domestic production and exports, including tourism, in order to safeguard the competitiveness of the Macanese economy. For that purpose, in addition to measures aiming at upgrading labor force skills, the authorities have concentrated efforts towards strengthening tourism and promoting foreign direct investment. They believe these efforts will be instrumental in achieving a higher growth of exports and output.

Finally, my authorities would like to express their appreciation for the Fund's consideration of their request for technical assistance in the area of balance of payments statistics. In their view this is an area where data are particularly weak and that needs to be addressed promptly if Fund surveillance is to be effective.

Mr. Wei made the following statement:

As is well known, the Chinese government will resume its exercise of sovereignty over Macau on December 20, 1999. In this context, we see the importance and benefits for Macau in its participation of the Fund's consultation process. This chair would like to commend the staff for their diligent work, providing us with a well-written and balanced report, and a comprehensive picture of Macau's economy. While we basically concur with the thrust of the staff appraisal, we would like to highlight the following points for emphasis.

Although there have been slight drops in the GDP in recent years, Macau, as a free harbor, has its own advantages—low tax rates, a simple tax system, sufficient financing facilities, modernized transportation systems, simple customs procedures, the rapid transit of merchandise, the swift transfer of capital or funds, and a special relationship with the EU countries. At the same time, given its location at the west bank of the Pearl River delta, Macau hosts great potential for its economic development with the support of the mainland of China. It cannot be doubted that the sustained, stable, and rapid economic growth of the mainland of China will have a strong impact on Macau and help boost its economy. China's resumption of sovereignty over Macau at the end of this year will provide new opportunities for its further economic development. It is expected that Macau's economy will bottom out with the gradual recovery of its neighboring crisis-hit regions. We are confident that the prospects for Macau are brilliant. In this context we welcome the authorities' efforts to introduce foreign capital and stimulate economic development, including the offshore proposal to integrate the service sector (particularly the banking sector) with the offshore business, and the draft regulations on tax holidays.

We encourage the authorities to continue their prudent fiscal policy to budget expenditure according to its revenue generation in maintaining the balance between revenue and expenditure. As mentioned above, the prospects for Macau's economy are expected to improve. We are of the view that the cumulative fiscal surplus should not be utilized at the current stage in order to ensure that the necessary conditions are in place for the transitional period as well as for Macau's future development.

The pegged exchange rate regime, which is well suited to the small open economy and conducive to the soundness of the banking system, has worked well and should continue to serve as an important vehicle in preserving financing and economic stability in Macau. We concur with the staff that there is no viable alternative to a firm commitment to the pegged exchange rate. As Hong Kong SAR is able to defend its linked exchange rate regime, it is our firm belief that so will Macau SAR. In this connection, we fully endorse the staff view that Macau, now and in the future, should be able to defend the regime, given flexibility in the labor market and in product prices, as well as the strong external payments position and the virtual absence of official external debt.

The banking system in Macau is conservative and sound. The high risk-weighted capital adequacy ratio ranged between 10 percent and 70 percent for most financial institutions—much higher than the level mandated by the BIS—providing an important cushion to back up the nonperforming loans. Therefore, the risks of nonperforming loans to the banking system liquidity insolvency are limited. We welcome the authorities' policy measures to improve banking supervision. We would also like to associate with the staff in encouraging the authorities to intensify the monitoring of financial institutions' activities. We are particularly concerned about the tendency of some banks to become involved in the insurance business.

Although the number of tourists has declined with the onset of the Asian financial crisis, the external competitiveness of Macau's export sector as a whole has not been adversely affected, as reported by the staff. Given the economic recovery of the EU countries, the buoyant economy in the United States, and the signs of recovery in Asian crisis–hit countries, external demand in Macau is expected to rebound and, thus, the export prospects are optimistic. Meanwhile, since a number of international conferences are to be held in Macau this year, and with the prospect of activities related to China's resumption of sovereignty over Macau, tourism is expected to increase. Therefore, Macau's BOP performance is expected to improve.

We would like to reiterate my authorities' commitment to keeping Macau's current economic system unchanged as depicted in the Sino-Portugal Joint Declaration and the Basic Law of Macau SAR. The Chinese government will continue to make every effort to achieve a smooth transition and to maintain prosperity and stability in Macau.

Mr. Ogushi made the following statement:

I very much welcome the first Article IV discussion on Macau before the historical transfer of sovereignty to China in December of this year. Macau has benefited from an open and liberal economic system and enjoyed high economic growth during the past decade.

It is very important for Macau to maintain its economic autonomy after the transfer of sovereignty, as this will serve as a basis for its economic stability. Mr. Wei's statement, in which he says that the Chinese authorities are determined to maintain Macau's current economic system, is very reassuring.

I generally concur with the thrust of staff's appraisal, but would like to offer a few comments.

First, Macau was not an exception among the victims of the regional crisis; indeed, it has experienced a severe contraction of the economy over the past year. While the outlook for 1999 is promising, there still remains a downside risk. In this connection, while I agree that Macau should maintain its medium-term policy objective of balancing the budget, I wonder whether there might be a need to provide some stimulus through fiscal policy if economic activity remains weak this year. But I certainly understand the constraints that the authorities face, which Mr. Faini referred to in his statement.

Second, as in the case of Hong Kong SAR, Macau's currency board arrangements served very well as an anchor in the economy. I do not see any reason to change this arrangement now as I believe it will continue to serve the economy well in the future.

Third, Macau has to continue to make its utmost effort to improve productivity and the diversity of the economic base. There is no easy solution to these challenges, but I hope the authorities will continue to pursue this long-term objective vigorously under the new sovereignty.

With these remarks, I wish the authorities the best in their future endeavors and hope that Macau will continue to make an important contribution to the world economy.

The staff representative from the Asia and Pacific Department remarked that there was some room for stimulating domestic demand through additional government spending. In contrast to Mr. Wei, the staff representative thought that Macau's overall fiscal position was sound, especially when taking into account the land fund, which amounted to 15 percent of GDP, and the accumulated budget surpluses, amounting to 5 percent of GDP.

The Chinese authorities had repeatedly stated that the renminbi would not be devalued, the staff representative observed, but if it were devalued, Macau's exports, imports, tourism, and capital flows would be affected, but only slightly. Overall, the balance of payments situation would not deteriorate much.

On Mr. Wei's concern about the increasing tendency of commercial banks to become engaged in the insurance business, the staff representative noted that those banks had started to set up subsidiary companies dealing in the insurance business or had started to sell other insurance companies' products. Those activities had been approved by the monetary and foreign exchange authorities of Macau and were fully consistent with the insurance law. The monetary authorities' department of insurance supervision was keeping the activities of both the banking sector and the insurance companies under surveillance.

Mr. Faini stated that he was more concerned about the systemic effect of a devaluation of the Chinese currency on the region as a whole than on the specific effect stemming from the links between China and Macau.

The Acting Chairman made the following summing up:

> Executive Directors, taking note of the statements made by Messrs. Faini, Wei, and Ogushi, agreed with the thrust of the staff appraisal in the report for the 1998 Article IV consultation discussions with Portugal-Macau.

3. INDONESIA—1999 ARTICLE IV CONSULTATION; EXTENDED ARRANGEMENT—REVIEW, AUGMENTATION, MODIFICATION, AND WAIVER OF PERFORMANCE CRITERION

The Executive Directors considered the staff report for the 1999 Article IV consultation with Indonesia, the fourth review under the Extended Arrangement for Indonesia, and its request for augmentation of the arrangement, modification, and waiver of a performance criterion (EBS/99/41, 3/16/99; Sup. 1, 3/16/99; and Sup. 1, Cor. 1, 3/23/99). They also had before them a statistical appendix (SM/99/75, 3/15/99) and a World Bank brief on corporate restructuring in Indonesia (EBD/99/46, 3/22/99).

The staff representative from the Asia and Pacific Department the made the following statement:

> This statement updates the progress made by the authorities in bringing reserve money in line with the modified program and implementing financial and corporate restructuring measures targeted for completion by end-March in the Memorandum of Economic and Financial Policies (EBS/99/41, 3/16/99, especially Boxes 1 and 3). Most of the required policy actions are being completed broadly as envisaged although, in some cases, implementation might slip into early April from end-March.
>
> Our main concern is in one area related to the creation of the state-owned Bank Mandiri, namely, the transfer of assets from the component banks of Bank Mandiri to the Asset Management Unit (AMU) of IBRA, which was to have been completed by end-March. Issues related to the transfer are under discussion, and we will continue to press the authorities strongly for early implementation.
>
> On this basis, and given the substantial progress achieved in all other areas, the staff continues to recommend completion of the fourth review under the extended arrangement.

Base money control was temporarily interrupted by uncertainties created by the delays in resolving the private banks. After intensified efforts, base money has now declined from a peak of Rp 81 trillion on March 4 to Rp 75.3 billion on March 23, only Rp 0.8 trillion higher than the target for March 31. Bank Indonesia has successfully mopped up liquidity through conventional open market operations—increased sales of central bank certificates (SBIs)—and special sales of bonds to two nationalized banks that were seen as safe havens and benefitted from substantially increased deposits in the run-up to the March 13 bank closures. The central bank expects to be able to absorb additional liquidity in the coming days, as uncertainty diminishes and temporarily inflated currency holdings return to the banking system.

Progress in implementing corporate restructuring measures listed in Box 3 of the MEFP is basically on track, as assessed below.

A presidential decree has been issued appointing four ad hoc judges to the Commercial Court.

The decree establishing the regulatory facilitation group ("one-stop shop") was issued by the Chairman of the Indonesia Private Sector Debt Team on March 22. The first meeting with representatives of all the concerned ministries is scheduled for March 26.

The Project Implementation Unit of the Jakarta Initiative Task Force is set to become operational from April 1 and begin drawing down the government funds in its accounts.

A consolidated decree will be issued by the Minister of Finance in early April to eliminate stamp duty and consolidate other tax-related aspects of corporate restructurings, as anticipated in the MEFP.

A law has been drafted to provide for the registration of security interests and is currently being reviewed by Fund and Bank staff, with submission to Parliament expected shortly.

The bank restructuring program continues to be implemented broadly as envisaged except that, as pointed out below, issues related to the asset transfers from Bank Mandiri to the Asset Management Unit of IBRA require further discussion, and the timetable for the transfers will be slightly delayed beyond end-March.

The one bank (Bank Ganesha) whose resolution was awaiting final decision has been approved to remain open as a Category A bank, after a review of its new ownership.

All 4 of the 10 banks frozen in April and August 1998 whose shares were traded on the stock exchange have now been de-listed.

Plans have been developed for the restructuring of the four remaining functioning banks taken over by IBRA in 1998—BCA, Danamon, Tiara Asia

and PDFCI; final decisions will be taken, as anticipated, after discussions with the IFIs.

The Finance Minister has informed us that the terms and conditions for the issuance of government bonds for its share of the recapitalization of approved banks are expected to be approved this week.

Restructuring plans for three state banks (BNI, BRI, and BTN) are expected to be completed by the contracted international accounting firm on schedule by end-March, for discussion with the IFIs.

Some delay is expected in the transfer or sale to the Asset Management Unit of the loans of Bank Mandiri and the other state banks that was scheduled for March 31. The Minister of Finance has decided that these measures require a state bank restructuring decree which has not yet been finalized, in part because a consensus has not been reached on the framework for the pricing of nonloss, nonperforming loans that are to be sold to the AMU. The authorities are aiming to resolve these issues in the first half of April in consultation with MAE staff. State bank restructuring will be an important element of the next review of the extended arrangement.

Bank Indonesia has finalized implementing regulations removing restrictions on foreign investment in the banking system, which are expected to be issued shortly.

Parliamentary approval of the Central Bank Law is expected by mid-April.

The Asian Development Bank approved a $400 million power sector loan on March 23; the first tranche of $200 million has been disbursed. The AsDB is expected to approve on March 25 a $300 million health and nutrition loan (with a quick-disbursing component of $100 million, of which the first tranche of $50 million is to be disbursed shortly after approval) and a $320 million commodity and local government support loan (with a quick-disbursing component of $200 million, of which the first tranche of $70 million is to be disbursed shortly after approval).

The World Bank Board will consider a $31.5 million corporate restructuring technical assistance loan on March 26.

The Steering Committee of Indonesia's creditor banks is meeting in London to discuss a second interbank exchange offer for the period through the year 2001.

Finalization of plans for a specialized trade finance institution is broadly on track. A presidential decree is expected to be issued shortly.

Mr. Harinowo, speaking on behalf of Mrs. Hetrakul, made the following statement:

The Indonesian authorities wish to convey to the Board the latest developments and measures undertaken to expeditiously bring the economy back on the road to recovery.

The recent volatility of the rupiah during 1998 has underscored the fragility of the economic situation and the imperative of adapting the program to consolidate the stabilization gains already achieved. The monetary authority's strict discipline and support from the IMF played an important role, pushing up the rate to a range of Rp 7,500–8,000 at the end of 1998. Stronger yen against the U.S. dollar also affected the grand picture. Further confidence from the international market took place along with the successful negotiations for the rescheduling of private debt, pushing up the rupiah further. In January 1999, the rupiah again went to a new level: Rp 9,300/US$, breaking the relatively calm months at the end of 1998. The Brazilian real devaluation, combined with rumors of China's yuan devaluation and yen depreciation, created a negative sentiment for the rupiah. In February 1999, the rupiah reversed to a level below Rp 9,000/US$, even though it was no longer persistent. The turbulence of delaying bank liquidation and other factors affected the rupiah's depreciation to the level of Rp 9,450/US$ on March 12, and then appreciated to Rp 8,790/US$ on March 16 after the government announced sweeping reforms in the banking system.

Due to the volatility of the rupiah, the inflation rate that was subdued at the last quarter of 1998 began to rise in the first two months of 1999. By the end of 1998 year-on-year inflation rate reached 77.63 percent. Then the January 1999 monthly CPI registered a 2.97 percent increase following a 1.42 percent increase in December 1998, owing to the cyclical higher food prices during the New Year and the Idul Fitri. However, year-on-year inflation in January dropped to 70.6 percent. Low consumer purchasing power, together with low production capacity utilization, prevented inflationary pressures from developing further after the holiday was over. In February 1999, the inflation rate moderated to 1.26 percent, owing to the smaller increases in prices of raw and processed food, beverages, and cigarettes and tobacco, which contributed nearly 79 percent of the February drop in inflation. The only probable factor for pushing the inflation higher is the supply shortage. Thus, the key factor in phasing out the inflationary pressure in the few months ahead is to smooth out the basic need supplies.

On the monetary front, the authorities, through monetary policy, have played a central role in restoring confidence in the national currency, marked by a falling rate of inflation and a rising external value of the rupiah during 1998. A strict and disciplined monetary stance was adopted to fend off a further downward depreciation-inflation spiral. All sources of central bank money creation had to be monitored and brought under control, and excess liquidity already injected into the banking system had to be absorbed. Weekly Open Market Operations were conducted to absorb excess liquidity for longer tenure through a new "quantity target" SBI auction system. Daily operations called rupiah intervention are used to both subtract and add liquidity from

interbank market for shorter tenure. The overall performance of Bank Indonesia's monetary policy has been positive. The introduction of a new auction allowed interest rates to be determined in the market. Interest rates declined smartly on a further easing of inflation and continued a strong performance under the monetary program. By the end of December 1998, the rate of one-month SBIs declined to 35.52 percent from 70 percent when the first auction started in July 1998. The downward interest rate move toward the end of 1998 began to decelerate by early 1999. The February one-month SBI rate increased to 37.32 percent while the three-month SBI rate was 1.8 percent lower, reaching 36.15 percent. Prior to the sweeping reforms of the banking system on March 10, the one-month SBI rate went up to 37.64 percent. Thereafter, on March 17 the SBI led to a lower interest rate. The latter indicates the market expectation toward a further downward trend on the interest rate in the long run.

As regards the capital market, the Jakarta composite stock price index has risen to a 411 level in January from the level of around 398 at end-December 1998. The improvement of foreign investor expectations in the Indonesian economy, owing to the inflation rate at below target and economic contraction at a lower level, promotes huge amounts of stock purchased by foreign investors in the first week of January. The fragility of the rupiah and a stable trend of interest rates in the domestic market and in some industrial countries were major factors affecting the composite stock price index fluctuation in January 1999. This index has been suppressed to below the 400 level in late February and downturned further to below the 380 level in the first half of March 1999.

On the fiscal front, fiscal policy became expansionary in the second half of 1998/99, primarily because of higher social expenditures. To mitigate the social impact on the poor, the social safety net program was extended through subsidies, ensuring the availability of food and other basic needs at affordable prices throughout the country. Around Rp 18 trillion, equivalent to 6.8 percent of the total budget, was spent on the social safety net program. However, the overall growth in spending is much less than expected, slowed by efforts to strengthen monitoring, limit leakages, and ensure accountability. This brought about an overall fiscal deficit of 4 percent of GDP, well below the target of 8.5 percent of GDP. The authorities feel that the speed of the fiscal stimulus in the second half of 1998/99 will be sufficient to stimulate the economic activity.

On the external front, in 1998 the country's overall balance of payments position strengthened to a surplus of US$689 million, as compared to a deficit of US$4.1 billion in 1997. The surplus stemmed from a surplus in the current account, although the capital account was still in deficit. For the first time since 1980, the current account recorded a surplus of US$4.4 billion (4.5 percent of GDP). However, the current account surplus is expected to be temporary, since it was brought about by a substantial drop in imports rather than by higher exports. In addition, during 1998, the capital account remained in deficit. This was mainly attributed to huge private capital outflows, which offset official capital inflows originating from foreign assistance. The net

private capital outflows (excluding FDI) recorded a deficit of US$12.4 billion. Foreign direct investment (FDI) flows also decreased in 1998, reflecting the deteriorated investment climate, including political and economic uncertainty. Total private capital outflows reached US$13.7 billion in 1998. The overall balance for 1998/99 is expected to show a surplus of over US$7 billion. On February 23, net international reserves stood at US$14.75 billion, surpassing the adjusted target of US$11.2 billion for February 1999.

With respect to the foreign exchange monitoring system, Bank Indonesia is making progress toward establishing an improved monitoring system for foreign exchange flows. In this case, the Fund will provide further technical assistance over the next three months, and the monitoring system is expected to be in place by June 1999.

As regards the privatization of state enterprises, this program has fallen behind schedule this year, mainly because market conditions remain unfavorable. In the current fiscal year, the government has sold shares in a cement producer and food processing company amounting to $200 million. Nevertheless, the government has made intensive efforts to divest, by end-March 1999, majority interests in the Jakarta container terminal concession company and minority interests in the Jakarta airport concession company, the largest palm plantation company in Indonesia, and further shares in international telecommunication concerns. Moreover, policies concerning future market structure, cross-ownership, and regulation are planned for completion in the next one to two months.

On banking reforms, the resolution strategy has been elaborated in all the four major areas as follows. First, on the basis of principles for state bank resolution, the capitalization of Bank Mandiri and the recapitalization of the other state banks will follow operational restructuring. Clear deadlines are also set for key elements of restructuring and asset recovery so that capitalization or recapitalization can proceed in step with compliance with the deadlines. Moreover, actions for asset recovery are being intensified against the largest delinquent borrowers.

Second, in line with private bank restructuring, on March 13, the government announced sweeping reforms of the private domestic banking system, falling into five main groups. First, banks of category A (capital adequacy ratio (CAR) above 4 percent), comprising 73 private domestic banks, or about 5 percent of bank deposits, have no need to participate in the recapitalization program. Second, based on review of business plans of all 38 banks of category B (CAR below 4 percent but above minus 25 percent), nine banks, comprising about 12 percent of bank deposits, have been determined as eligible for recapitalization. Third, seven banks of category B have been taken over by the government (IBRA) and will be restructured quickly to minimize the public cost of their resolution, in light of their large depositor base (over 80,000 accounts, amounting to 2½ percent of bank deposits). Fourth, 21 banks of category B and all 17 banks of category C with a total of about 5 percent of bank deposits, which did not qualify for participation in the recapitalization program or meet the public interest need for takeover, have been closed, effective March 13, 1999.

Third, in the case of IBRA-related restructuring, the government has resolved the obstacles that have delayed the liquidation process for the 10 banks frozen in April and August 1998 by issuing necessary bonds to Bank Indonesia relating to previous Bank Indonesia liquidity support to these banks, promulgating the regulations to implement the banking law, and completing the transfer of the assets of the 10 banks to the AMU. Moreover, the restructuring of the four remaining functioning banks taken over by IBRA in 1998—BCA, Danamon, Tiara Asia, and PDFCI—will be prepared by March 31, 1999, with the assistance of international banks or international financial advisors, for discussion with the World Bank and the Fund. In addition, the holding company structure for receiving assets from the former owners of the 10 banks which were closed or taken over by IBRA, in settlement of their obligations to the government arising out of liquidity support and related lending, has been established. This process will be completed by June 30, 1999.

Fourth, in accordance with legal, regulatory, and supervisory frameworks, the Central Bank Law has been submitted to Parliament and is expected to pass by mid-April 1999. In addition, eight prudential regulations have been issued as previously envisaged. All of these have been reviewed by the Fund, the World Bank, and the Asian Development Bank. Moreover, the regulations on the implementation of the banking law amendments clarifying that all legal and administrative restrictions to the entry of foreign investment into the banking system have been removed. It[[what?]] will be issued by March 25, 1999. Finally, in light of experience, the government prepared additional modifications that may be needed, especially to ensure the full effective functions of IBRA to which the government is firmly committed and to modify the present confiscatory provisions in the banking law.

In order to strengthen the corporate sector, the authorities have made further progress in implementing the Jakarta Initiative and the INDRA scheme, enhancing the corporate restructuring framework, and creating a consistently applied bankruptcy system. Under the Jakarta Initiative, 15 companies have reached some form of arrangement with their creditors, addressing about $2.0 billion in foreign currency debt and Rp 600 billion in domestic currency debt. Other deals are expected in the coming months as a wide range of companies try to benefit from the INDRA scheme. With regard to the enhancement of the corporate restructuring framework, the government is establishing a regulatory facilitation group; a more effective regulation removing company law limitations on debt-to-equity conversion; a supplementary decree providing more favorable treatment of cancellation of indebtedness income in restructuring; more accessible information to the public; legislation for the registration of security interests; improvements in governance through strengthening securities regulation, stock exchange listing requirements, and company and accounting laws; and guidance to consolidate the legal materials related to tax aspects of restructuring. Moreover, to provide the appropriate incentives for corporate restructuring, the government is committed to the creation of a consistently applied bankruptcy system, through anticorruption legislation that has been submitted to Parliament and immediate bankruptcy filings initiated by all state banks against debtors who failed to cooperate within the context of the Jakarta Initiative.

Furthermore, other structural initiatives are also issued by the government to promote the "people's economy," to protect the environment, and to alleviate difficulties that importers and exporters continue to face in accessing trade and working capital credit. In November 1998, a decree was enacted to broaden ownership and participation in the economy, especially the development of small and medium-sized enterprises and cooperatives, with the support of the AsDB, the World Bank, and the Fund. The government will also create a firm, PT Madani, which will initially provide venture capital funds and later increase economic opportunities, especially for small and medium enterprises. In the field of environment and forestry, major reforms are ongoing to protect the environment by signing a new forestry regulation on January 27, 1999; observing a moratorium on the award of new permits for forest land concession; reviewing or revising the formula for the forest resource rent tax that was introduced in 1998; and implementing regulations for the Environmental Management Law. Moreover, with support for the Japan Export-Import Bank and other institutions, such as the World Bank, in order to alleviate difficulties that importers and exporters continue to face in accessing trade and working capital credit, the government will review and restructure the Trade and Working Capital Credit Guarantee Facility; establish a specialized trade finance institution with full details of the proposal; facilitate the use of the guarantee facility to channel import and working capital lines of credit; and identify domestic banking institutions that will be sufficiently sound intermediaries to channel funds for trade finance.

Finally, my authorities would like to convey to the Board their sincere appreciation to the Board and the mission, not only for their unwavering support and advice, but also for their tireless coordinating efforts. The Indonesian authorities will maintain close contact with the Fund and will consult on the adoption of any measures that may be needed in accordance with the Fund's practices on such consultations. The government will also provide the Fund with such information as it requests on policy implementation and achievement of program objectives.

Mr. Harinowo, extending his remarks, thanked the Board for agreeing to waive the circulation period. The meeting was crucial for Indonesia, because disbursement of assistance from the Export-Import Bank of Japan was linked to the completion of the review. It was hoped that the completion of the review would allow the loan disbursement process to be expedited. The authorities were grateful for the Japanese government's continued support through the Export-Import Bank of Japan, and for Mr. Takeda's assistance in facilitating the process.

There had been mixed progress to date regarding corporate restructuring, Mr. Harinowo noted. The lack of transparency in the formal court resolution process had impeded progress. However, the authorities had quickly identified the problem and sought a remedy. Several decisions had already been made, as elaborated in the annex of the staff report.

Progress had been recorded on the less formal proceedings through the Jakarta Initiative, Mr. Harinowo continued. Significant advances had been made in 15 cases worth more than US$2 billion, and some had even been restructured. More than 125 cases had been registered so far, worth US$17.5 billion, and progress was expected to be made on them as

well. There was currently an intense negotiation taking place with creditors concerning up to US$1 billion worth of private debt. A source involved in that process had reported that progress had been more expeditious than expected. Many cases of corporate restructuring had also been undertaken outside of the Jakarta Initiative. Two of the largest corporations had successfully restructured their debt into a more sound financial position. Thus, there was much optimism vis-à-vis the overall progress on corporate restructuring.

Transparent and credible steps had been made in the area of bank restructuring on March 13, 1999, Mr. Harinowo reported. Those steps marked the culmination of concerted efforts made over several months by many institutions and the authorities to close down a series of banks. Such decisions were always painful, involving not only the banks, but also thousands of people who would lose their jobs at a time of relatively high unemployment. However, that step was considered necessary in order to bring the country out of the crisis, and as a result there seemed to be better prospects for the banking system. For example, the nine private banks that were to be recapitalized were well-known institutions with good reputations. The money invested in those banks would help them recover more quickly, and there was the potential that they would produce good returns. There had been intensive negotiations regarding one of the nine banks to be recapitalized. That negotiation was reported to be at an advanced stage, and it was hoped that progress would be made expeditiously.

The legal reform program supported by the Fund constituted a window of opportunity for individuals who had long aspired to a better and more modern legal system, Mr. Harinowo commented. It was fortunate that several key positions were held by such people. As a result, the authorities claimed full ownership of that program and were fully committed to it.

Mr. Collins and Ms. Brownlee submitted the following statement:

> Over the last few months Indonesia has made important progress: targets for output and inflation look to be within reach, and the decline in GDP is moderating. In particular, the next steps of the private bank restructuring process announced on March 13 represent an important milestone.
>
> However, the challenge that lies ahead is a daunting one: the bankruptcy process and corporate debt restructuring are faltering, and the rupiah has started to slide back somewhat following gains in the last quarter of 1998. The deepening social unrest is deterring export orders as well as foreign capital, and this is likely to worsen in the run-up to the parliamentary elections in June and beyond.
>
> As the staff report notes, significant downside risks to the program remain. The report is right to highlight the path for export volumes—the further deterioration in exports in the fourth quarter is attributed partly to the falloff in orders following the May riots, and similar effects might be expected to persist throughout the forthcoming tricky period. Moreover, larger private capital (including human capital) outflows could also be expected if the social unrest persists and/or deepens. Therefore, both current and capital accounts could well turn out worse than expected. Given the volatility of the situation,

we would be interested in a comment from the staff on the potential for more comprehensive sensitivity analyses in future papers.

Regarding augmentation of the program, we would have preferred a clearer and more comprehensive rationale in the staff report, which fails to explain fully the reason for the financing gap. Section C (paragraphs 21–23) and Table 7 simply identify the gap and explain it on account of a weaker capital account and net international reserves. The report does not give a comprehensive explanation for these developments or outline the potential consequences if the Fund program were not augmented.

That said, we are prepared to support the augmentation. As far as we can tell, the financing gap of $5 billion reflects the desirable further relaxation of fiscal policy, the costs of bank recapitalization, and the need to maintain financial stability throughout this particularly difficult election year. Indonesia will be seeking further rescheduling of interbank obligations—indicating a significant private sector involvement.

The announcement on the private bank recapitalization and closure program was welcome, and the compromise regarding bank nationalizations appears justifiable on account of maintaining social and financial stability, while ensuring that the authorities act credibly and transparently over insolvent banks. However, despite passing this milestone, there is still a long way to go. The private banking sector is only 25 percent of the total. We note that progress on the state banks is dependent on prior "operational stability," i.e., downsizing and asset recovery. The latter is likely to prove very difficult given the particular conditions in Indonesia. It is therefore important to make determined efforts in this area: as well as clear deadlines for recovery, it would be helpful to have clear targets also.

Moreover, it is important that the Asset Management Unit remains fully independent and properly resourced. Responsibilities between Bank Indonesia, IBRA, and the Ministry of Finance might be clarified further—at present there is the appearance of a blurring of responsibilities with regard to bank supervision, which could cause some confusion.

The lack of significant progress on the corporate debt restructuring side remains a concern, and an important element in this is the problems experienced with the functioning of the bankruptcy court. The Fund's efforts in this regard are therefore clearly welcome, as is the authorities' proposed independent judicial subcommission. We were also grateful for the World Bank brief, which illustrates clearly the complexity of the problem. We think more use should be made in future of Bank material in this way. Also regarding corporate restructuring, given the slow progress and the rupiah's weakness, should we assume the INDRA scheme regarding the exchange rate guarantee will be extended into the second half of the year?

On the fiscal side, last year's large underspending (of over 3 percent of GDP) is a significant cause for concern. Not only did this prevent policy from giving the desired support to economic activity, but also the significant

underspending on social programs may have exacerbated the social impact of the crisis (although it appears in aggregate terms that the impact of the crisis on poverty is smaller than originally feared). We therefore stress the need for the authorities to ensure that the full fiscal stimulus is delivered over the coming year. Moreover, we would hope that the increasing evidence on the social effects of the crisis will allow better targeting of programs (and withdrawal of subsidies).

On the revenue side, we welcome the Fund's forward thinking regarding its efforts to preserve future revenues. But it is possible that the expected receipts from privatization in the coming fiscal year are over-optimistic. Progress with privatization has been slow so far owing to weak market sentiment, and this is likely to persist throughout the year.

The rupiah currently stands just above 9000 to the dollar, significantly weaker than the 7,500 assumed in the program. Its path is bound to be uncertain, but it would be useful to have a comment from the staff on when they expect to see it appreciating and why such appreciation should persist over the course of the program. Indeed, should the stronger currency not materialize over the course of this year, confidence in the program could well be undermined.

Paragraph 40 of the staff report suggests that indicative targets are being set on a quarterly basis between September 1999 and March 2000. Given the electoral timetable, this period is most likely to be subject to a policy vacuum, and the risks of the program going off course then must be significant. We would be grateful for a comment from the staff on whether Indonesia should remain on at least a bimonthly review schedule throughout this period.

Finally, the paper notes that all main opposition parties have given support to the Fund program. We would like to encourage the staff to maintain, and perhaps intensify, dialogue with the opposition to minimize the risk of the program going off course over the coming months and beyond.

Mr. Collins, extending his remarks, commended the staff for its frank and candid report, with the staff appraisal being particularly to the point.

Mr. Mori made the following statement:

Indonesia's economic performance remains weak. In addition, despite the significant depreciation of the rupiah, there was a sharp decline of 20 percent year-to-year in exports during the fourth quarter of 1998, with reduced strength in volumes adding to the impact of lower dollar prices. A positive development, however, is that agriculture has proved resilient to the crisis, and has had the role of a buffer sector by absorbing significant surplus labor from other sectors. Indeed, the informative Box 5 prepared by the staff notes that some crop-producing regions have experienced minimal negative impact. The crisis has hit urban areas particularly, but poverty rates may have risen less than expected.

The weakening export performance adds to the concern that, in the absence of necessary financing, domestic demand needs to contract even more to reduce imports in order to compensate deficits in the capital account. A larger trade surplus would not represent a positive signal, as this is achieved basically by drastically containing domestic demand. The staff correctly points out that adequate official financing is essential to maintain overall confidence, prevent another spiral of depreciation, and keep the budget on course. In this regard, we welcome Japan's initiative to provide financial resources to support Indonesian authorities' adjustment efforts, which will certainly mitigate the hardship of economic adjustment.

To restore foreign private capital flows, the authorities need to persevere in their difficult task of reorganizing the economy, with special interest on the structural area, as corporate and financial sectors have been severely affected by the crisis. Delays should be avoided in the process of corporate debt restructuring, but the difficulties the authorities have faced in the current unfavorable environment need to be given due consideration, as the helpful World Bank brief on "Corporate Restructuring in Indonesia" notes. We encourage the authorities to move decisively in this area.

We welcome the important progress made in implementing the private bank recapitalization program. The restructuring of state banks in turn requires special consideration because of the relevance of these banks in the market. Firm actions are essential to recover assets in view of the need to minimize the fiscal costs of restructuring. On the Central Bank Law, we share the view that separation of bank supervision from Bank Indonesia is not appropriate at this stage.

Fiscal policy continues to be an important instrument to stimulate the economy. External resources are an essential component and need to be disbursed timely in order to fill the budget financing gap. The staff is concerned with the reduction in revenue. In general, this is essential to maintain a prudent fiscal approach, especially in view of the expected high cost of restructuring the banking sector. The case for further efforts on the revenue side is also reasonable in view of increasing needs to finance social programs. We observe with interest the ongoing assessment regarding the efficacy of existing tax incentives. On fiscal decentralization, we are of the view that care should be taken in designing a well-balanced framework which contemplates appropriate allocation of responsibilities between central and local governments, on both revenue and expenditure sides, to avoid loss of fiscal control in the future.

We support the proposed decision and the waiver requested by the Indonesian authorities for nonobservance of the structural performance criterion.

Mr. Sivaraman made the following statement:

The staff report for Indonesia's 1999 Article IV consultation and fourth review under the extended arrangement shows that the projections for

the 1999/2000 macroeconomic framework could foster a growth outcome between minus 2 to plus 1 percent and possibility of single-digit inflation. The situation is therefore still very fragile, as the market sentiment has been relatively more volatile as seen in the behavior of the rupiah since the last review. Uncertain political factors continue to dominate the risk to the program. However, the authorities are to be congratulated for making significant achievements since the last review.

The authorities have to address the problem of low capacity utilization and keep up the level of higher social expenditures. The overall deficit of 4 percent of GDP as compared to the target range of 8.5 percent indicates that the much-needed fiscal stimulus was falling short of expectations. The staff had anticipated this earlier. I am a bit disappointed that the deficit target for 1999/2000 has now been projected at 6 percent of GDP. I also see the measure that the authorities have taken to encourage activity in 22 industrial sectors by giving tax holidays as something necessary at this juncture. I continue to believe that if Indonesia has to see a turnaround in economic activity this year, the combination of fiscal and monetary policies will have to be highly stimulative, even if it means overshooting the programmed target for the year 1999/2000. We welcome the fiscal decentralization legislation and the Competition Law approved by Parliament.

Mrs. Hetrakul's lucid statement indicates that the recent volatility of the rupiah had an adverse effect on the inflation rate during the last quarter of 1998 and the beginning of 1999. While there have been signs of moderation, the supply of basic needs is still seen by her as a constraint in the coming months. I believe that the subsidy program for food continues to be implemented in a satisfactory manner, but I would appreciate the staff comments on the current status of this very important social safety net program.

As regards monetary policy, I am glad to note that the Bank of Indonesia's policies have been flexible and forward looking. The market expectation of a downward trend in interest rates in the long run augurs well for the Indonesian economy. I would support the approach that monetary policy should be tightened only if inflation goes out of hand or on account of extreme market volatility; otherwise, the policy should support the much-needed fiscal stimulus which would give the Indonesian economy the necessary impetus to reverse the negative trend in GDP growth in the coming months.

Coming to corporate debt restructuring, the dismissals by the judiciary of bankruptcy petitions and the adverse comments on it would have a negative market impact. It is not clear as to whether there are appellate procedures under the law. From the staff report it seems that the government is moving a bill for an independent judicial subcommission to evaluate judicial officers' integrity. While these measures would help in improving integrity, there is a need to have proper appellate procedures with access to higher courts available to the aggrieved parties.

The problem of Indonesian corporations is indeed grave, as nearly all of them are finding it difficult to meet their debt service obligations with half the debt denominated in foreign currency. There seems to be no easy way out, as it depends on how quickly these companies can revive. The Jakarta Initiative has offered a window of opportunity which would be helpful in the short term, but eventually the repaying capacity of the corporations has to be assured. The World Bank brief on the corporate restructuring issues is very useful. I would only reiterate the view expressed earlier that intervention of the government in the field of corporate debt workouts is going to be crucial in bridging the needs of the debtors and creditors. I welcome the measures that have been mentioned in Mrs. Hetrakul's statement.

As regards the banking system restrictions, it is understandable that it is painful and somewhat slow. Nevertheless, there is measurable progress. But Box 3 presents a rather alarming picture of the health of banks. It gives an impression that NPAs are mounting vigorously. We hope the effort of the authorities is not a labor of Sisyphus. The staff appraisal does not throw light on the health of the banking system. Could we have some comments? Unless the health of the state banks improves, we would advise the staff not to push for privatization as they could be sold for less than their potential value.

I congratulate the staff for the excellent work they are doing for Indonesia's recovery. It was a good idea to link this review with the Article IV consultation. The Indonesian economy has come a long way from the time when uncertainty had become the order of the day. The authorities have made significant progress and established a good track record. Therefore, I support the completion of this review and the request for augmentation under the Extended Arrangement. I wish the authorities success in their future policy endeavors.

Mr. Sivaraman, extending his remarks, pointed out that during the period of corporate restructuring, substantial amounts had to be falling due. The World Bank report had indicated that thousands of debtors were involved. What was happening to those repayments? Was there some kind of standstill or freeze?

Mr. Barro Chambrier made the following statement:

The staff papers and Mrs. Hetrakul's statement have been very helpful in facilitating our understanding of recent developments and immediate prospects of the Indonesian economy. The Indonesian authorities deserve to be commended for having pursued the implementation of their economic program in a very difficult environment. They have achieved some progress toward macroeconomic stability and should make efforts to safeguard these gains. To that end, we welcome their adoption of strong bank resolution and corporate restructuring policies and the development of a macroeconomic framework for 1999/2000. To achieve the growth objective expected during that period the authorities will have to implement some fiscal measures and accelerate the pace of their structural reforms.

In the fiscal area, an expansionary stance is appropriate as it will enable the authorities to continue to implement their social programs. We note that the fiscal target may be difficult to achieve without additional measures. In that context, we support the staff's view that the granting of tax holdings for up to eight years to newly established corporations in 22 industrial sectors should be reviewed. In addition, actions will be needed to strengthen tax and customs administrations.

On the expenditure side, the emphasis placed by the authorities on efficient safety net programs is well placed. We would like to encourage them to take actions that will facilitate the implementation of these programs, including a reduction of the remaining untargeted subsidies to less than 2 percent of GDP and the rationalization of other expenditures. In that regard, the adoption of a five-point program to improve the design, implementation, and monitoring of the social safety net represents a positive step.

On monetary policy, to avoid excessively high real interest rates, we support the view that if the rate of inflation was to fall close to a single-digit level by the end of the next 12 months, further cuts in nominal interest rates should be envisaged. We also agree with the Central Bank that if inflation does not subside as expected in the program, a tightening of monetary policy will be required. As regards the exchange rate, we support the maintenance of a flexible regime. In addition, the intervention policy of Bank Indonesia should continue to be directed primarily at offsetting the monetary impact of the fiscal deficit.

Bank restructuring remains a key aspect of Indonesia's economic program. It is therefore very encouraging to note that the authorities have recently taken steps to accelerate the process. In that regard, the progress achieved in implementing the private bank recapitalization is encouraging. We wonder, however, what will be the impact of this recapitalization on the budgetary operations. In addition, we would like to know what is the social cost expected from the closures of 38 banks mentioned on page 11 of the staff report? Concerning the state-owned banks, the authorities are encouraged to speed up the process of their restructuring. To that end, we believe that it would be important to adequately fund IBRA and allow it to operate with full independence.

On the privatization of state-owned enterprises, it should be recognized that the authorities have already made some progress with the divesture of majority interests in a Jakarta container terminal concession company and minority interests in Jakarta airport concession company, the largest palm plantation company in Indonesia, and further shares in international telecommunications and mining companies. Nonetheless, additional efforts are needed to accelerate the process. In that context, we welcome the authorities' intention to sell stakes in 11 enterprises during 1999/2000. The restructuring of the power sector is also to be encouraged, as it will improve efficiency and reduce the fiscal burden. We therefore urge the authorities to accelerate actions that are necessary in that regard.

Finally, we would like to encourage the authorities to pursue the restructuring of the corporate sector under the Jakarta Initiative. In that regard, it is important to apply the bankruptcy law as envisaged. It is encouraging to note that the legislation aimed at improving governance, including in the judiciary, has already been sent to Parliament and the commercial court is being strengthened.

We support the proposed decision to complete the fourth review of the Extended Arrangement for Indonesia and wish the authorities full success in the future implementation of their economic program.

Mr. Daïri made the following statement:

As the staff report and Mrs. Hetrakul's statement clearly bring out, Indonesia's economic conditions continue to be very difficult. Despite discernable progress since the last review, which is quite remarkable given the extraordinarily difficult domestic and external circumstances, the situation remains fragile. The economy shows no signs of bottoming out, inflation has recently turned up, exports have faltered, and the fiscal stimulus—which was required to cushion the economic downturn—has been slow to materialize. More worrisome are outbreaks of social unrest and uncertainties ahead of the upcoming elections, which have sapped confidence, weighed heavily on the stock market, deterred private capital inflows, and contributed to renewed volatility of the exchange rate. Delays in the implementation of important structural reforms have also added to the economic difficulties.

While this may add up to a rather somber picture, there are some encouraging signs. According to the staff's assessment, real GDP could turn up around the second half of 1999, although this judgment is qualified with many downside risks, with political uncertainties being a major consideration. Other factors include the authorities' ability to press ahead with the task of macroeconomic stabilization, including, in particular, bearing down anew on inflation. Much also depends on meaningful progress with the difficult and complex task of financial and corporate restructuring.

We note that the budget for 1999/2000 incorporates a stimulus equivalent to about 1 percent of GDP. This is the appropriate stance that fiscal policy should assume under the circumstances, although one may question whether the size of the stimulus will be adequate. Moreover, recent experience has shown that generating a strong fiscal impulse will not be easy and it will be important to ensure that expenditure implementation capacity be strengthened and sustained at a high level. We attach particular importance to the implementation of the social safety net in the context of the expanded development budget and the work of the World Bank in helping to implement improved health, education, and employment creation programs.

The staff and the Indonesian authorities are right in their concern about the weakness of fiscal revenue and the importance of taking measures to reverse this trend. Against this background, we are also concerned about the recent decree that granted generous income tax holidays in 22 industrial

sectors. While we are sympathetic to the government's claim that Indonesia needs to retain its attractiveness to foreign investors, experience shows that such fiscal incentives have generally proven to be inefficient. We are, however, pleased to note that an interdepartmental committee will carefully study the matter with FAD's technical assistance. In the meantime, we strongly support efforts to strengthen tax and customs administration, including tax audits and improved collection from large taxpayers. We note the contingency measures that have been identified by the authorities in case fiscal risks materialize; however, we fully agree with the view that, given the role of fiscal policy as a cushion to the deep recession, every effort must be made to secure larger financing rather than resort to new taxation and/or expenditure cuts.

Monetary policy has been assigned an appropriately cautious role. If inflation should come down as planned, there would seem to be scope for a gradual decline in interest rates without compromising the authorities' exchange rate policy. Vigilance will be required to prevent a premature lowering of interest rates, given that market confidence remains fragile in the run-up to the elections.

Indonesia's external position remains worrisome. While the trade surplus is large, it is almost entirely a reflection of the severity and depth of the economic recession. Exports, which had previously grown well in volume and were the only stimulus to demand, have dropped sharply. It is troubling to learn that this was due in part to the reluctance by banks to extend credit despite a government guarantee scheme. As mentioned by Mrs. Hetrakul, however, the actions now taken to alleviate the financing difficulties of exporters seem promising. On the capital account, despite official debt relief and the prospects of a rescheduling of interbank obligations, the absence of new official financing and significant private capital inflows means that the capital account will show a net outflow. Although the staff considers that the financing gap has been closed, including through the proposed Fund augmentation and Japanese cofinancing, there remains a risk that the program could be underfinanced. The implications of this risk materializing, for confidence and program implementation, are well known. It will be essential to maintain an adequate level of official financing in this difficult period preceding the presidential election.

We agree with the staff that bank and corporate restructuring presents "formidable obstacles and interdependent risks to the program." However, success in these fields promises rich dividends and is absolutely critical for Indonesia to regain economic strength. Private bank recapitalization has proceeded well, and the authorities' efforts in preparing the public for closures have been successful. IBRA's success in restructuring of private and, more importantly, public banks, especially as it relates to asset recovery, will serve as a litmus test of market credibility and public acceptability. Corporate restructuring has proved less tractable, with implementation at a less satisfactory pace. While the problems in the application of the bankruptcy law are unfortunate, the authorities are to be commended for their efforts in devising and implementing a corrective strategy. With new legislation having

been sent to Parliament, it is our hope that the situation improves significantly. In this context, we concur with the view expressed in the World Bank brief on "Corporate Restructuring in Indonesia" (EBD/99/46) that a willingness on the part of some foreign banks to accept debt write-downs would also be helpful to the process.

In conclusion, while the Indonesian authorities should do their utmost to fully implement the program despite difficult and uncertain domestic conditions, the adequate and timely support of the international community remains crucial. We concur with the requested augmentation that will not only give confidence to the authorities and markets, but also help catalyze additional financial support.

Mr. Taylor made the following statement:

We would like to express our appreciation to the staff in putting together a useful set of papers and also for their ongoing efforts in Indonesia.

After pleasing progress and more stability in the second half of 1998, the recent signs of volatility—despite the broad progress in implementing the program—are of some concern. Furthermore, the risks posed by the recent volatility are heightened by slower progress and uncertainties in some areas. While not wanting to detract from the significant progress that has been made on a number of fronts—in particular, we would draw attention to the bank restructuring announcement of March 13—our remarks will focus on those areas that we consider present the greatest risks. We would also note that these risks have generally been identified well in the staff paper.

Paragraph 29 and elsewhere alerts us to "significant risks" that the fiscal cost of banking restructuring could be higher. We agree with these risks, and note that underestimating the fiscal costs now could lead to much higher banking recapitalization costs in the future. While the total cost of recapitalization was estimated at about 30 percent of GDP at end-December 1998, the interest costs in 1999/2000 are estimated at about 3 percent of GDP (as bond issues to banks are being phased in over the year to ease the short-run fiscal cost). This means that by the end of 1999 the negative net worth of banks will be higher as banks continue to make losses. We therefore consider it important for the authorities to act quickly to stem the losses of the banking sector.

The average interest rate assumed in 1999/2000 is 21.2 percent (Annex II, Table A.3). However, Indonesia will be starting the fiscal year with a one-month SBI rate of just under 40 percent after it was driven up by exchange rate weakness. Moreover, even though inflation should come down, the political and social risks posed in the next six months may mean it is unlikely to see interest rates fall by this much. Good political progress could see interest rates fall in the second half of the financial year, but it may be difficult to achieve an average interest rate of 21.2 percent without posing a risk to the exchange rate.

With runs on banks leading up to and following the bank restructuring announcement on March 13, we had some concerns about the level of liquidity support and base money. In this regard, we welcome the news in the staff's statement that the authorities have absorbed the excess liquidity and base money has declined to a level approaching the March 31 target. We commend the authorities for these efforts and encourage them to seek to achieve the end-March base money target.

We recognize that important background work has been done in support of the privatization process. However, we are disappointed by the outcome for last year, and would like to stress the importance of meeting next year's target. This should be made easier now that an appropriate framework is in place.

Unfavorable market conditions have been cited as one reason for slower-than-hoped-for progress on privatization, yet we have not seen this backed up by the evidence. The market is down, but it reflects current conditions and the outlook for the next few years. There has been quite a bit of interest by major international players, in the likes of Semen Gresik and telecommunications companies, etc. In addition, the government is also the owner of the major Indonesian corporate assets held by IBRA that also need to be sold. If these are not sold, this will significantly reduce the funds available to cover the costs of bank recapitalization. As the stock of assets to be sold is growing, this reinforces the need to push ahead quickly on this front, while there is real interest by a number of competing buyers.

The paper highlights the problems with bankruptcy and the slow pace of corporate restructuring. The critical and worsening nonperforming loan problem has been damaging to the banking system. As we have said before, progress on bankruptcy and corporate restructuring is essential given its implications for other reforms—we are concerned about the ability of the budget to bear an even larger bailout package for the banks.

We therefore urge the authorities to take the action necessary to get the system moving quickly and to maintain pressure on borrowers. In this regard, there is some indication that when extreme pressure was put on bad banks, some owners came up with the capital. In cases where borrowers are found to have the means to service loans but are electing not to do so, does the staff see any options (beyond what is outlined in the paper) for a more radical pursuit of debt reduction? For example, the streamlined confiscation of assets under certain objective circumstances. We also have some concerns that the system of restructuring may currently be shielding bad borrowers, which would seem to be a poorly targeted form of subsidization.

Finally, on augmentation and program monitoring, we would like to support the positions raised in Mr. Collins' statement.

Mr. Cabezas made the following statement:

Economic and social developments in Indonesia clearly indicate the difficulties experienced by the economy in the last two years. The social and economic realities of the country are quite dramatic: while the rate of absolute poverty doubled in one year, real wages fell nearly 35 percent until August 1998; last year the economy contracted almost 16 percent, and this year it is expected to continue to contract an extra 0.5 percent. In order to improve the country's future economic prospects, critical advances are expected to be materialized, specially in the corporate and banking sector, sectors that have been devastated by the lack of prudence in their former management strategies.

The solution to the banking and corporate sector debt problem is clear but not easy to materialize in the present times of international financial stress. Indonesia needs to urgently mobilize sufficient external financing in order to recapitalize and restructure the banking sector and to bring about the corporate debt restructuring process. A key element of this recapitalization effort rests on the implementation by the government of a credible and enforceable bankruptcy law. In this regard, there are serious setbacks to the restructuring process arising from recent dismissals of bankruptcy petitions, a fact that might give the impression to the international community that the amended bankruptcy law is not being enforced as envisaged, exacerbating further the problem of debtor resistance in the economy. It is to be expected, hence, that progress in some new initiatives like the creation of a judiciary and a commercial court will help put the process back on track.

On corporate debt restructuring there is still a long way to go, as only 15 out of 125 private firms have been able to reprogram their debts. In this respect, I would like to commend the government's decisive involvement in the Jakarta Initiative Task Force. Nevertheless, the government should invigorate its efforts to ensure the operation of the crucial bankruptcy law, as this will provide the appropriate incentives for corporate restructuring.

On other banking issues, there is an urgent need to accelerate the restructuring of the banking sector, including through a higher rate of loan recuperation from the newly intervened and state-owned banks. It is important to bear in mind the need for transparency in the restructuring process in order to set sound bases for the future evolution of the banking industry, where the lack of transparency exhibited in the past is the basis of its current "malaise."

On fiscal issues, we encourage the authorities to make all efforts to promptly deliver the expected fiscal stimulus to the economy. Even though it is understandable that some delays arise from slower-than-expected financing disbursements, evidence suggests that expenditure implementation capacity is not fully satisfactory. Although we commend the government for the improvements made on the targeting of subsidies and expenditures—a critical development that will ensure further protection towards the most needed—we encourage the authorities to improve the social expenditure deliverance

record, giving special attention to expand the targeted programs while rationalizing other expenditures and reducing leakages.

Overall this Chair supports the augmentation of the program for Indonesia on the conviction that it is necessary to boost confidence in the markets and that it represents a much-needed additional external financial support for the country. We also support the waiver requested for nonobservance of the structural performance criteria.

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

Mr. Kiekens made the following statement:

The weakening of market confidence in Indonesia since the last review is worrisome. The renewed volatility of the rupiah, rising inflation, and falling stock markets were in part caused by the episodes of social unrest and the devaluation in Brazil. Policy implementation should have been strengthened in response to these negative events. Certainly the authorities have made good progress with the program, but not enough to sufficiently restore the confidence of the markets. In particular, delays in the restructuring of corporations and banks undermined confidence in the authorities' commitment to the program. This made Indonesia's situation substantially worse.

I can give only reluctant support to the proposed decision to augment the extended arrangement by $1 billion. The authorities and the staff point out that in order to maintain overall confidence during the period of political uncertainty preceding the presidential election, it is essential that adequate official financing be available. I would suggest that what is essential for maintaining confidence is determined adherence to the program and clear evidence of the political will to carry out reforms. The reality is that the need to augment the extended arrangement is partly owing to the recent delays in implementing bank and corporate restructuring measures. Any similar mixed signals during the period ahead, particularly after the elections, are sure to be taken as an indication of deficient commitment to the program. No amount of external assistance will remedy the resulting loss of confidence.

I am sure that management has carefully balanced all the arguments before recommending the increase in the Fund's financing by $1 billion "to catalyze the additional financing support." I would like to observe that despite the Fund's strong financial support last year, the World Bank's loan disbursements declined 37 percent from their average annual disbursements of the four preceding years. Admittedly the Asian Development Bank's disbursements in 1998 were $350 million higher than the average for the four preceding years. On a consolidated basis, loan disbursements from the multilateral development banks declined from the average level of the four preceding years. I would like to learn from the World Bank representative the reasons for this disappointing decline in World Bank lending to Indonesia, and what disbursements are planned for this year. Furthermore, there is no

accounting in the staff report on the disbursement of the almost $40 billion package for Indonesia announced in November 1997. Of the package, the Fund has already disbursed $8.8 billion, or almost 80 percent of its commitment. The World Bank delivered only $1 billion for balance-of-payments support, 20 percent of its commitment. The Asian Development Bank paid $1.5 billion, about 30 percent of its commitment. I further noted $1.5 billion in trade financing by the Japanese EXIM bank and a $4 billion debt rescheduling by the Paris Club. The $18 billion second line of defense has not been activated. I agree that the mandate of the multilateral development banks is not primarily to provide balance-of-payments financing, but I must observe that even though the Fund has provided the lion's share of the financial support for Indonesia, it only catalyzed marginal additional foreign financing.

I will now comment on fiscal policies and on bank and corporate restructuring. I will close with some remarks on the so-called "people's economy" and on labor policy.

Indonesia's fiscal policy is appropriately aimed at cushioning the recession. The most important task in the short run is to make sure Indonesia is able to increase its expenditures for development and the social safety net. Last year, current and development expenditures fell more than 5.6 percent of GDP short of the program's spending targets. Improving the transparency of administration and the monitoring of social expenditures would alleviate donor concerns and enable the authorities to make use of more of the donor's financing commitments.

The interest cost of the bank restructuring will probably exceed the amount provided in this year's budget. This is not the right way of reaching this year's higher budget deficit target. The needed budgetary stimulus should be channeled into the economy through social and development expenditures. Every effort should be made to keep higher-than-expected interest costs or lower-than- expected external financing from crowding out social and development expenditures.

A medium-term concern in the fiscal area is the worrisome decline in budgetary revenues. Measures that would provide short-term gains at the medium-term cost of eroding the tax base should be avoided. Accordingly, I urge the authorities to consider revoking the recent presidential decree granting, to new corporations in certain sectors, remission of income taxes for up to eight years.

The privatization performance is disappointing. No doubt unfavorable market conditions represent an important obstacle to progress with privatization. But market conditions cannot account for a total lack of progress in designing the regulatory framework and legislation needed to go forward with the sale of international telecommunications shares. But there is little evidence of any kind that privatization enjoys strong political support.

The restructuring of banks and corporations is still the most important challenge facing the Indonesian authorities. The success of Indonesia's program and sustained medium-term recovery depend critically on making good progress in addressing the two related problems of bank and corporate restructuring.

The decision on the recapitalization of the private banks, announced March 13, is an important breakthrough even though it comes much later than expected. The authorities have produced transparent and objective evaluations of the financial health of banks. The restructuring of the state banks is the next step. This will likewise be a challenge, because these banks dominate the banking system and have many politically potent debtors in their portfolios. I agree with the staff that recapitalization should be resisted until the restructuring is credibly advanced. Success in recovering assets and connected loans have important implications for the magnitude of the cost of bank restructuring and public acceptance of it. Ensuring the full independence of the operations of IBRA will be another important test of the government's ability to make and carry out politically difficult but necessary decisions.

Progress till now with corporate debt restructuring has not been encouraging. The bankruptcy law is well drafted but cannot be effective as long as it is systematically misapplied. Its sham implementation is obstructing progress with corporate debt restructuring and contributing to the perception that the entire economy is riddled with corruption. Recent decisions, such as establishing independent judicial subcommissions and appointing ad hoc judges to the Commercial Court, with a view to improving governance and the functioning of the judiciary system, seem appropriate. These measures must be implemented with care to avoid violating the principles of judicial independence and the rule of law.

On the question of the "people's economy," I urge the authorities to consult with the IMF, the World Bank, and the Asian Development Bank when elaborating and implementing this strategy, as they promise to do in the MEFP. Care should be taken to prevent the strategy from becoming a populist policy catch-all that will unduly burden the budget and the already weak public banks. In addition, it must be borne in mind that such nonmarket based strategies that involve directed allocation of resources always involve the risk of encouraging rent-seeking activities and corruption. Given that Indonesia's troubles are largely corruption-related, the authorities have all the more reason to implement such a strategy with great caution.

Lastly, I commend the staff for the attention they have given to the social impact of the crisis and to labor issues. The Fund's dialogue with the authorities on the core labor standards of the ILO was effective in persuading the government to subscribe to four of the seven standards. I urge the authorities to subscribe to the standards on discrimination, forced labor, and child labor as well and, even more important, to comply with them. The reports of the International Federation of Free Trade Unions about violations in Indonesia of all core standards, including instances of child labor and forced

labor, are very worrisome. I ask the staff to maintain a firm stance on these issues in its continuing discussions with the authorities.

Mr. Al-Tuwaijri made the following statement:

Developments over the past 12 months highlight the progress made in resolving the economic crisis in Indonesia as well as the continued fragility of the situation. Indeed, developments since December underscore the magnitude of the challenges still facing the authorities. Here, I agree with the staff that rising social tensions and political uncertainties pose significant risks. Steadfast implementation of the agreed policies should accelerate the recovery and boost confidence, thus helping in containing those risks.

On fiscal policy, I endorse the 1999/2000 budget. Providing a fiscal stimulus is appropriate at the current phase of the economic cycle. Indeed, given the ongoing contraction in the economy and the growing social tensions, the importance of increased spending to strengthen the social safety net cannot be overemphasized.

Turning to monetary and credit policies, I welcome the reduction in interest rates as it could facilitate economic recovery. I am also encouraged by the staff's assessment that the expected drop in inflation should allow for further interest rate reductions in the period ahead. To achieve the full benefits of those reductions, it is critical that viable firms, especially those in the export sector, are able to obtain adequate credit.

The continued credit crunch facing exporters has contributed to the weakness in exports in the fourth quarter and negatively impacted growth. Therefore, addressing the corporate debt problem remains a priority. Here, while welcoming the progress made in restructuring under the Jakarta Initiative, accelerating the process is essential. This requires streamlining the commercial courts, applying the bankruptcy law as envisaged, and expediting regulatory approvals for restructuring. The authorities' ongoing efforts to address these issues are encouraging.

On the ongoing restructuring of the financial system, I endorse the authorities' efforts to retain confidence in the banking system. In this connection, I welcome the progress made in recapitalization of viable private banks and in the merger of four state banks. While some delays in merging the state banks are understandable given the complexity of the issue on both legal and political grounds, it is essential for the authorities to speed up their efforts. The continued deterioration in the financial health of the banking sector underscores the urgency of this issue. It is also essential that every effort be made to collect on nonperforming loans.

The timing of the turnaround in Indonesia also depends on continued external financial support and on a recovery in the region. In this regard, I endorse the authorities' request for augmentation. As the staff notes, such augmentation should catalyze additional resources from Japan, the World Bank, and the Asian Development Bank.

With these remarks, I support the completion of the review and wish the authorities well.

Mr. Sobel made the following statement:

Since the last Article IV consultation we have learned much about Indonesia. The staffs of the Asia and Pacific Department, Monetary and Exchange Affairs Department, Legal Department, Fiscal Affairs Department, and the World Bank have shuttled between Jakarta and headquarters, which is hardly a short distance, and have done a great job. Everybody deserves tremendous praise. Indonesia's transformation is occurring at a time of great fragility. The authorities have kept the macroeconomic framework ontrack and undertaken sweeping structural reforms. On top of the fragility, and despite what has been done, there is a perception that there has been political interference in key economic decisions. This adds to the burden of restoring confidence. We hope that the authorities will do their utmost to pursue reforms in a decisive, transparent, and technocratic manner.

On fiscal matters, we support the principle that the deficit should be externally financed, providing for stimulus and helping to support an efficient social safety net. We welcome Japan's contribution in this regard. We had understood that the elasticity of non-oil revenues to GDP was uniform and are now concerned that the recent declines point to weaknesses in tax administration as well as policy shortcomings. The authorities should make maximum efforts to restructure the banking system and ensure repayment of past liquidity support in order to limit fiscal appreciation. We agree with the staff's caution in this area and welcome the efforts to review Indonesia's fiscal transparency in light of the Code of Good Practices on Fiscal Transparency. Can the World Bank staff, on the basis of last year's PER, tell us how much military spending was financed off-budget, and will such spending come to light in the audits of off-budget accounts? Regarding contingency measures, we are troubled by the 5 percent temporary import duty.

On monetary policy, stabilization took hold when a simple transparent framework was adopted, which targeted a tight NDA path and allowed for the rupiah to float. That strategy was operationalized by the mopping up of the liquidity extended to banks or SBIs in the past month and the efforts of the monetary monitoring committee, which we hope is still running. Nevertheless, monetary policy remains burdened as uncertainties weaken the rupiah, put pressure on inflation, and limit the central bank's ability to lower interest rates.

Indonesia's experience raises the issue of the intervention policy noted in paragraph 20 of the staff report. If a key to restoring monetary credibility is a largely transparent rules-based approach, such intervention—defined as a discrete effort to influence the exchange rate—could weaken the basic strategy and create uncertainty. Intervening to influence the exchange rate is rather different than transparently auctioning a known, preannounced amount of foreign exchange. Perhaps we need to work on our nomenclature.

Financial and corporate restructuring are interdependent processes, which are crucial to reviving economic activity. Unless these are pursued with vigor, recovery will be delayed and fiscal dynamics will weaken. We welcome the announcement of the private recapitalization program, although financial reforms have been controversial in the past, with delays owing to last-minute political intrusion. Unfortunately, this chapter appears not to have been an exception. The staff did a good job of facilitating a compromise while adhering to sound criteria. However, it is a concern that certain category B banks became category A banks after the initial deadline. This action remains controversial, and we expect that the authorities will vigorously adhere to a 21-day deadline. The private banks have received no more attention than state banks, and the latter hold the bulk of assets. The staff is paying appropriate attention to the design of Bank Mandiri's restructuring, but we are disappointed that the transfer of assets to the AMU will not take place by March 31, 1999. That development also raises the question of whether Bank Mandiri will be recapitalized by May 31, in line with the program's structural benchmarks. Implementation delays can only add to the fiscal costs, and loan collection on nonperforming loans appears to be creating a serious moral hazard with systemic ramifications. The restructuring of the state banks is the next major challenge. We hope that the authorities will intensify their efforts with the support of MAE and the World Bank.

The staff thinks that Indonesia is still likely to meet the May 31 deadline to recapitalize Bank Mandiri. We have heard that IBRA has publicly said that it does not have sufficient personnel for this task. Is the government planning to provide IBRA with adequate resources to obtain maximum recovery on nonperforming loans? The planned capitalization will bring banks to a 4 percent capital adequacy ratio, compared with the 8 percent international standard. Given the current climate of weak activity and negative spreads, is another round of recapitalization likely? With negative spreads, presumably banks do not have an incentive to lend, so what activities are they likely to pursue?

Indonesia has made important headway in designing a framework for corporate restructuring. Nonetheless, progress has been slow and the framework is vulnerable. Perhaps most worrisome are the bankruptcy developments. The staff of LEG is to be commended for its work. While the recent adoption of remedial measures is welcome, these must be implemented vigorously to dispel the perception that the bankruptcy proceedings are plagued by governance problems.

The Jakarta Initiative Task Force (JITF) has recorded some success, although, to be effective, it must have the institutional and legal capacity to facilitate restructuring on a larger scale. Despite what we read in paragraph 38 of the letter of intent, we have heard that there are staffing problems at the JITF and implementation problems with the World Bank's technical assistance loan. We assume that creditors and debtors are free to avail themselves of the benefits of either or both initiatives. The regulatory facilitation group ("one-stop shop") will help reduce the delays related to restructuring, and the decree providing tax neutrality for restructuring has been implemented and provides

the institutional structure to make one-stop shopping a reality in the near future. Could the Bank staff address these issues? While I still regret that the audits were delayed for six months, at this point I want to know if the audit results will be published.

I concur with Mr. Kiekens on the "people's economy" and welcome as well as agree with his remarks on core labor standards. We commend the staff for including in the staff report Box 4 on labor issues and core labor standards, and thank Mr. Neiss for his personal efforts on the labor front. We hope that management will urge the staff to replicate this kind of analysis widely in staff reports.

Could the World Bank representative also inform us about the government's deliberation with the IPPs?

Finally, we support the staff's efforts to catalyze and leverage reforms as well as international support.

Mr. Takeda submitted the following statement:

Given the long list of lead speakers, I will submit my statement for the record and I will just focus on major points I would like to make. Trying to avoid repeating the points made by earlier speakers is not easy, but allow me to make some repetition.

It is unfortunate that market sentiment for Indonesia has become volatile since December of last year and that the Indonesian economy is yet to bottom out. This, however, is due to political uncertainty that is expected to continue in the future, as well as to some external factors, and I highly appreciate that the authorities have maintained an appropriate macroeconomic policy stance in accordance with the Fund program.

I believe that the most effective way to stabilize the market sentiment is for the authorities to strongly commit to and implement the Fund program, as our Belgian and Saudi colleagues have pointed out. I share the authorities' view that in order to facilitate this process, maintaining foreign financing regardless of the election schedule will be crucial. In this sense, I welcome the staff's proposal that the Fund continue to make disbursements to Indonesia and augment its contribution.

It is regrettable, however, that the World Bank and the Asian Development Bank are not making matching efforts, a point made by Mr. Kiekens in great detail. Not only should their loans that were supposed to be made during fiscal 1998 be made immediately, but also additional contributions should be forthcoming from them. We would like to ask other chairs around this table to put pressure on these institutions to make additional resources available for Indonesia. Japan announced last month that it will offer Indonesia yen credit equivalent to 2.4 billion dollars under the new Miazawa initiative, part of which will be made available in the form of a parallel loan to the augmentation. I hope other countries will follow suit in helping Indonesia.

In this regard, I have to point out that the staff paper's paragraph 23, which refers to Japan's contribution, contains some inaccurate descriptions. From now on, when the staff writes about the contribution in the staff paper, I would like them to carefully consult with us in advance to avoid any misunderstanding between us.

Let me comment on some specific issues. Under the current situation, it is clear that financial sector reform and corporate debt restructuring are the most important issues to be dealt with in order for the Indonesian economy to move back to a medium-term growth path. We share the concern raised by the Chilean chair on bankruptcy law, and regarding the banking sector reform, it is encouraging that the authorities have announced their decision with respect to 128 private banks on March 13. It seems that banks to be closed were chosen impartially, which was appreciated by the market. It is critical for the authorities to make every effort to stabilize the financial system by steadily implementing their decision.

State bank reform is also essential, as pointed out by some previous speakers. According to the staff report, the moral hazard problem has been seen in the state banks' asset collection efforts since they expected to be either recapitalized or closed by the government. As the size of assets held by the state banks is significantly larger than that of private banks, the negative effects of this moral hazard will be enormous. I agree with the staff that operational restructuring is important and believe that this should be a precondition for recapitalization.

With these remarks, I support the proposed decision.

Mr. Askari-Rankouhi made the following statement:

We agree with the general thrust of the staff's analysis and recommendations. Developments since the third review in December underscore the continued fragility of the Indonesian economy and the importance of fully implementing the adjustment program. The authorities' foot-dragging in a number of areas, including bank restructuring, has hampered confidence and exacerbated the effects of volatility in the global economy as well as in Indonesia.

While we generally support the recently announced bank restructuring plan, the delay in the announcement suggests that politics was at play and that the government was searching for ways to help its friends. Many questions have been raised about the selection of the seven banks taken over by the government. The official announcement of the takeovers justifies the selection of those banks on the basis of their large number of accounts and the fact that their closure would have disrupted the payments system. However, the threshold of 80,000 accounts is arbitrary, and there is no explanation as to how that level was chosen. In our view, other factors seem to be more important than the number of accounts—for example, the composition and the size of the banks' loan portfolios and their branch networks. The unanswered question is whether all seven banks would have been selected on the basis of these other

criteria. Some elaboration by the staff would be appreciated. Regardless of the validity of the bank restructuring, the government's credibility has been further damaged. This underscores the need to deepen governance reform, including efforts to combat corruption at all levels.

On corporate restructuring, efforts should be made to encourage more companies to make use of the Jakarta Initiative and the INDRA scheme in order to avoid further deterioration of their financial health. That is also important for mitigating the social impact, much of which has been in the formal sector. Given that only a few companies have used INDRA so far, I wonder whether consideration should be given to extending the June 1999 deadline for joining it.

On the "people's economy," I am somewhat uncertain about the government's intention, and am also concerned that such a plan may lead to directed lending and misallocation of resources. We do not have enough information about the government's plans, and the staff report does not provide any details, probably because the staff does not know either. I welcome any further information that the staff can provide, now or in future meetings.

On the tax exemptions granted to foreign investors, I share the concerns expressed by others, and agree with the staff that the Fund is being asked to finance a budget deficit. Actions that directly affect the budget deficit should be done in consultation with the Fund.

On the augmentation of the program, I share the concerns expressed by Mr. Collins and Ms. Brownlee. There is no good explanation for such an augmentation. If there was a concern for the financing of the budget in the coming fiscal year, perhaps that could have been done by rephasing the current program and bringing forward some of the scheduled disbursements.

Mr. Lehmussaari made the following statement:

The Article IV report on Indonesia in front of us today clearly paints a gloomier picture on economic prospects in Indonesia than has been the case at our earlier reviews. Although progress has been made in many areas, and the sharp decline in economic activity is moderating, it appears that little progress can be expected on the economic front before the question of political leadership is settled. Moreover, the recent decline in exports is weakening our hopes for an export-led growth and has already started to erode the current account surplus. One might have hoped for more positive developments in some areas of the economy, but the growing social unrest in the country is taking its toll here too.

In the following, I have a few remarks on fiscal policies and then on the restructuring of the banking sector. Before that, however, I would like to say that I fully agree with Mr. Collins and Ms. Brownlee that the staff report is rather weak in explaining the emergence of the $5 billion financing gap. The augmentation of the extended arrangement by $1 billion would have called for more detailed discussion on the factors behind the financing gap.

On fiscal policies, let me first state that I support the more expansionary fiscal stance visible since the second half of the past budget year. In the recently approved budget, higher spending on development, including social safety net issues, is a particularly welcome feature.

This being said, I am concerned over the deterioration of the revenue side of the budget. It seems as if the authorities remain to be convinced of the gravity of the situation. According to the Letter of Intent, however, the new budget has as a main objective to rebuild the revenue base. I had some difficulties, though, with identifying what the specific actions in this regard would be.

Instead, I was struck, like other speakers, by the recently issued presidential decree granting income tax holidays to newly established corporations. Like the staff, I find this a matter of great concern, and I do not see how such a measure can be compatible with the spirit of the Fund program.

In light of the staff's concern that fiscal revenue, at only 11 percent of GDP, has become a major problem, I am puzzled that the staff did not insist on the actual implementation of the various tax-related measures suggested by the recent technical assistance mission by the Fiscal Affairs Department. These measures could raise revenues in the medium term and would reduce the risk of further financing gaps in the future. A more relaxed stance in fiscal policy could have been guaranteed by transitory measures in the expenditure side. Obviously, the authorities have instead decided to only use additional tax measures as contingency measures. I regret this and would appreciate the staff's views on this issue.

Let me now turn to the restructuring of the banking sector. Here, I very much welcome the recent announcement on the private bank recapitalization and closure program. This marks a positive step towards the reconstruction of a viable banking system. The state of the banking sector, however, remains extremely risky, something that is very well illustrated in Box 3 of the paper.

I note, in particular, that loan collection is a growing problem, and that the problem is concentrated in the state-owned banks. I believe that strong efforts must be made to set up proper structures for collecting loans, and bank managers must act with authority if they are to succeed in this task. If the loans are not collected, the restructuring process of the banking sector will, of course, become more costly—something that will further burden the government's future budgets and perhaps even give rise to a new financing gap in the future. This would be a very unfortunate development.

It is also crucial to make loan collection in the state banks more successful in order to maintain the general public's confidence in the government's capacities. Failure in this area could also risk leading to a more lax attitude towards tax compliance in general.

Further on this point, I agree with the staff that it is crucial to restructure the state-owned banks on an operational level before proceeding with recapitalization. There have been some doubts raised about the government's ability to successfully finance the recapitalization through bond issues. I note that the Finance Minister has assured that the terms and conditions for the issuance of the bonds will be approved this week. I wonder whether it is realistic to find buyers for all these bonds, and at what price. I would appreciate the staff's views on this matter.

Finally, Mr. Chairman, I support the proposed decision and the completion of the fourth review under the extended arrangement.

The Deputy Director of the Asia and Pacific Department said that the health of the banking system had recently deteriorated significantly, which was a source of concern. There was evidence of increasing debtor resistance to make payments, causing loan collection efforts to decline markedly in the past one or two quarters. As a result, nonperforming loans on average were well above 50 percent. The problem of negative spreads had also continued, especially in the state banks. That needed to be curbed swiftly, as the resulting fiscal cost was mounting every month.

The impact on the budget of the private bank recapitalization was small, the Deputy Director noted. The bulk of those costs had arisen from the state banks. The nine banks that had been identified for recapitalization constituted only 11 percent of the banking system, and their recapitalization need had been estimated at about 5 percent of the total need for the system. However, as market-linked bonds were involved, the interest costs would be about 10 percent of the amount provided in the budget, or about 4 trillion rupiah. Those bonds would be government bonds placed in the banks, and would not be used for more borrowing. The financing for the budget was expected to come principally from foreign sources and domestic asset recovery.

The social cost of closing the 38 banks was small in relation to the total size of the banking sector, the Deputy Director reported. Those banks employed about 17,000 workers out of a total banking system labor force of over 200,000 people. The workers in those banks would not all lose their jobs immediately, as at least half of them would be employed on a contractual basis to help wind up the banks and assist the Indonesian Bank Restructuring Agency (IBRA). There were also clear legal provisions for severance pay. However, there had been controversy about severance payments in some of the closed banks, as on previous occasions some of the workers had successfully negotiated more than the legal maximum for severance pay, and they wanted to do the same thing again. However, the government clearly wanted to resist that, because of the precedent it could have on other cases.

The functioning, adequate financing, and future role of IBRA were fundamental to the bank restructuring debate in Indonesia, the Deputy Director commented. The Fund and the World Bank were committed to ensuring that IBRA remained fully financed, and steps had been taken to ensure that it would be. However, there was currently a renewed debate on IBRA's role and whether the asset disposal process should remain entirely with it. The staff had urged the government to make no change in that area at the present time. The authorities had agreed to invite international experts to advise them on that issue in the coming weeks. It had been stressed that any change in IBRA's role and functioning should be decided in

consultation with the IFIs and should not smack of cronyism or any reversal of strict discipline.

There was expected to be a second round of bank restructuring, the Deputy Director noted. A total of 74 banks had been approved as category A banks to remain open, although they represented only 5 percent of the banking system. However, after the current reviews were completed, it would most likely be found that not all of those 74 banks had been adequately recapitalized, and it also might be found that their owners did not meet the fit and proper test. The tests of capital adequacy, the injection of funds and where they came from, and the fit and proper test would be complete by April 21, 1999, and there might be more closures, takeovers, or other remedial actions. The authorities had prudently laid the groundwork for further remedial actions by making it clear to banks that there would be consequences if they failed those tests.

Seven banks had been selected to remain open under state ownership, the Deputy Director continued. There had been much interest in and criticism of the criterion for those takeovers. However, while it could be debated whether that criterion was correct, it was transparent: the scheme would apply only to banks with more than 80,000 depositor accounts. The objective of that criterion had been to try to prevent systemic problems in terms of the payments system and size. The banks had now been taken over, their owners removed, and in virtually every case their management had already been changed.

Regarding INDRA, there had recently been a meeting in London of the steering committee of private bank creditors, the Deputy Director noted. The issue was quite advanced, and an agreement in principle was emerging. At the meeting, the authorities announced, after consultation with the staff, that INDRA would be extended until the end of 1999. There would be other modifications to INDRA to make it more attractive while containing and balancing its financial risks.

Regarding the question of whether the corporate debt restructuring shielded bad borrowers, there was no doubt that the problem of bad borrowers had grown, the Deputy Director remarked. More than half of the portfolio of Bank Mandiri, for example, was on account of the 20 largest connected borrowers in Indonesia. There was a serious and growing problem of debtor resistance. It would have to be determined whether the corporate debt restructuring framework had failed to stimulate restructuring or the problem related to the entire central structure. Political uncertainty was one primary reason for debtor resistance. Debtors believed that the government could not and would not take strong actions against recalcitrant debtors in the next few months, even though in the Letter of Intent the authorities had declared that debtors would be taken to bankruptcy court if there had not been genuine efforts toward some kind of negotiation in that period. It was not clear in those cases where debt payments were not taking place whether there was a standstill or some other form of arrangement. While there were some standstills, in the majority of cases the debtors were simply in arrears.

The coordination committee on monetary policy worked well, met frequently, had substantial input from the Fund's resident office, and had been responsible for keeping firm control on base money, the Deputy Director reported. In the past few weeks, that committee had steered base money control close to the target for end-March 1999.

Regarding burden sharing, there was no doubt that there had been delays in disbursements from other IFIs, the Deputy Director noted. Augmentation would have a catalytic role. Less than half of the programmed financing had been disbursed in 1998–99, and there was a period of particular political uncertainty ahead, where private capital inflows could not be expected. There was, therefore, the clear risk that much of the progress achieved in the past six to nine months could be reversed if markets sensed that Bank Indonesia was not strong enough in terms of its foreign exchange situation and if foreign financing adopted a wait-and-see attitude. For that reason, it was crucial to have a budget deficit with a sufficiently strong stimulus, and that there be a further restoration of reserves, which were still low, even with the improvement in net reserves. With the augmentation, the usable gross reserves of Bank Indonesia would be about $23 billion. That would be much less than other Asian countries and was below the precrisis level of $28 billion. Faced with that situation, the judgment had been made that augmentation was necessary not just to catalyze the necessary financing, including that from bilateral sources, but also to bring it forward over the next few months, the period of maximum need. The strategy had so far been successful, and commitments had been made. The AsDB had made a substantial disbursement already that week. If all went according to plan, the Fund's financing would go entirely to build up reserves. However, Fund financing, including augmentation, would give a good degree of assurance that, were there to be renewed shortfalls or delays in official financing, there was room in the program for reserves to be used with the help of the Fund.

In rephasing the arrangement, the staff had tried to strike a balance among different factors, the Deputy Director commented. The issue was to make sure that adequate resources were available in the next five or six months, a period of great uncertainty, while at the same time to ensure that the bulk of the augmentation would be available after the new government was formed, following the November 1999 presidential election.

Because of the delays in the past year, the Fund's share of the official financing was about 40 percent, the Deputy Director reported. In 1999–2000, the Fund's share would fall to about 15 percent, which was a distinct improvement. Those numbers were even better if one took account of the role of the private sector, through the second exchange offer currently being discussed in London, and the rescheduling of the corporate arrears.

The staff representative from the Asia and Pacific Department said that the latest survey data, while preliminary, indicated that the increase in the poverty rate since the start of the crisis was substantially less than the doubling that had earlier been estimated. The latest data showed that 13 to 14 percent of the population was currently below the poverty line, compared with about 11 percent at the start of the Asian economic crisis, and well below the earlier figures that had suggested that as much as 30 percent of the population was below the poverty line.

The spread of poverty was much more uneven than had been expected earlier, the staff representative continued. Certain geographical regions were more affected than others, and urban areas had suffered much more than agricultural or rural areas. In light of those new data, the social safety net for 1999–2000 was being retargeted to reflect the needs of particular areas and groups, including sharply focusing on urban employment-generating projects.

The data showed that about 9 or 10 million families were currently covered by the targeted rice program, the staff representative reported. The increase in the subsidized

amount, from 10 kilograms to 20 kilograms per month, that had been made effective December 1, 1998, had spread to virtually all of those families within a matter of days or weeks. That program was probably close to its capacity of 10 to 12 million families. Furthermore, the authorities no longer saw a need to expand it to as many as 17 million families as earlier suggested.

The staff shared Directors' concerns about the sharp fall in the revenue to GDP ratio over the previous two years, the staff representative noted. There was considerable scope for reversing that trend over the medium term, especially if FAD's recommendation to reduce or eliminate tax incentives and to improve the tax and customs administration were accepted. However, it would be difficult to raise substantial revenue in the short term, given the weak state of the economy and low world oil prices. The measures that Mr. Lehmussaari had mentioned as a means of raising revenue were designed as contingency measures rather than immediate measures that could be invoked quickly if the external financing gap had not been filled.

The staff representative from the World Bank said that the Bank had recently disbursed a second tranche of the policy reform support loan, the PRSL-1. That second tranche had been delayed by four months, primarily because of the delays regarding two conditionalities, those dealing with the palm oil tax and the forestry regulation changes. The Bank Board that day had approved a corporate restructuring technical assistance loan of $30 million and had also discussed two IDA credits in the education and health sectors. The Bank was preparing two further operations: the core adjustment operations loan (PRSL-2) of about $500 million and the social safety net operation, which were parallel operations.

Regarding the PRSL-2, three of the main conditionalities were still outstanding, the staff representative continued. Those included the transfer of assets to the AMU, the enactment of an anticorruption law, which was currently before Parliament, and the issuance of certain regulations concerning forestry concession management. It was understood that there were no major obstacles preventing the PRSL-2 from moving forward. There would be negotiations in the second week of April, and the Bank staff would go to the Bank Board with the PRSL-2 in the first week of May.

The social safety net operation was lagging somewhat behind the PRSL-2, as it was more complicated in terms of the groups involved in the discussions and because of the small social safety net programs, the staff representative noted. Certain conditions also remained to be addressed, revolving around expenditure monitoring and targeting. In that regard, an oversight group had been established, with government and civil society participation, and there had been tremendous progress in the past week in finalizing the group's terms of reference, staffing, and budget plans. Draft monitoring plans for each social safety net program had been formulated and adequate budgets were being allocated. The Bank's new poverty estimates were playing a part in formulating the plans. There had been a tremendous improvement in the budgetary transparency at the local level; the Bank staff was currently piloting the monitoring system in more than 300 jurisdictions. In addition, the civil society consultation was under way and the independent monitoring group was being formed, composed of a coalition of civil society and NGO groups. It was anticipated that both the social safety net and the PRSL-2 could be discussed by the Bank Board at the same time, in the first week of May.

The Bank staff had recently agreed with the government on the composition of the overall development budget for 1999–2000, the staff representative noted. As a result, it was expected that the status of the Bank staff's operations and the Bank's disbursements would be accelerated.

The part of military spending that was off-budget was a complicated issue, the staff representative commented. During the public expenditure review, the Bank staff had determined which off-budget items related to military expenditure. It was found that the military had revenues from its operations in a range of businesses, with each branch of the military having its own foundation. Exactly how much revenue was derived from each of those foundations was difficult to estimate, but it was clear that the off-budget money was essentially used for maintenance, salary supplements, and buying military equipment. Given that the business environment had been adversely affected in Indonesia, those off-budget components had also been adversely affected. According to the media, the off-budget amount represented about 2.2 percent of GDP, but the staff was in the process of carefully looking into the issue.

The second staff representative from the World Bank said that the issue of the depositor standstill could be looked at from both an official and an unofficial level. At the official level, there had been a significant shift in policy away from the standstill. Initially, the authorities had announced a standstill in repayments. That had been officially terminated by the Minister of Finance, and the coordinating Minister of Economy had stated in August 1998 that a standstill no longer existed. Corporations were told to resume the restructuring and repayment of their debts, and to make every attempt to service them at that time. At the unofficial level, corporations could be divided into two groups. The first group came under the Jakarta Initiative, through which they could enter into a formal standstill agreement with creditors. Many of the 15 corporations that had reached some form of agreement under the JITF were operating under such a formal standstill agreement. In those cases, there were bilateral agreements between debtors and creditors to stop payments or reduce payments while negotiations were proceeding. The second group of corporations had declared some type of a strategic standstill of their own, taking the approach that until they were forced to pay, they would not pay. They could be forced to pay only by the bankruptcy court, through significant pressure from creditors, or by the willingness of creditors to come to agreeable terms. As there were difficulties associated with the bankruptcy court and little pressure from creditors, a larger group than normal was allowed to take the strategic approach of waiting.

The corporate restructuring would take place with or without the Jakarta Initiative or other policy actions, the staff representative continued. The question was how fast it would take place and at what cost to the economy, as it was believed that the strategic defaulters would eventually come to terms with their creditors. The only problem was that the creditors might be surprised to find that there was little left in terms of assets. In the past several months, many of the firms in default had been operating reasonably efficiently, with recovering cash flows, and were building up some assets in order to come to terms with their creditors at some convenient time. The transaction mentioned by Mr. Harinowo was coming close to a resolution, for example. In that case, the debtor had built up significant assets to eventually come to terms with its creditors. That example underlined the need to move forward and not let up with the restructuring process.

The Jakarta Initiative had to address thousands of firms, the staff representative commented. The 125 firms currently under the Jakarta Initiative represented about 24 percent

of the external foreign debt. About 40 percent of the total corporate debt was domestic and 60 percent was foreign. A third of that 60 percent involved debt between joint venture companies and parent companies as well as other forms of indebtedness that might not make some companies eligible to participate in the Jakarta Initiative, as they did not need the facilitation. There were many deals being made outside of the Jakarta Initiative that periodically needed help on a specific issue.

There had been significant progress on the portion of the debt that was foreign currency, the staff representative continued. Indonesia was different from some of the other countries in the region in that as much as 74 percent of its corporate debt was foreign exchange–denominated. Thus, there was a huge portion of debt that could be handled by offshore creditors, but it would be subject to tremendous currency fluctuations, such as those of the past 16 months. That was both good and bad. On the downside, if the rupiah again lost value, it would be much more difficult for those corporations to service their debt. On the upside, the fact that so much of the debt was held by foreign banks meant that those banks could apply a market mechanism in terms of seeking resolutions and be able to discount or write off the political instability that Indonesia would face, probably for the rest of 1999.

The staffing of the Jakarta Initiative was important in light of the political uncertainty in Indonesia, the staff representative noted. It was difficult in most of the crisis countries, and especially in Indonesia, to find enough capable senior people to take on all of the challenges that the IFIs were imposing. The staff had met with a number of officials who were playing more than one role. The chairman of the Jakarta Initiative held a number of senior positions, for example. He was therefore subject to the country's political instability and was hesitant to make commitments that had not been fully backed by his government, the World Bank, and the IMF.

With the World Bank's approval of the technical assistance loan that same day, there would likely be immediate steps on the part of the Jakarta Initiative to complete the staffing and hiring of facilitators, the staff representative remarked. Until that approval, it had not been clear whether that funding would be available. In that sense, progress had been made.

The civil law decree had put into place the structure for the Jakarta Initiative's one-stop shop, but it contained virtually no details, the staff representative reported. It left it up to the JITF to implement that decree, which was similar to past practices. Both the Fund and the Bank could be expected to expand on that decree and make it work. In that regard, the cooperation between the Fund and Bank staffs in corporate restructuring had worked extremely well. There had also been a high level of cooperation from others, such as the Japanese government and the U.S. Treasury Department. The staff was confident that the one-stop shop would soon be up and running, with the decree and funding in place. Significant progress had been made, and would continue to be made, notwithstanding the difficult economic and political environment.

The staff representative from the World Bank said that the Bank staff had been informed that the PLN had completed preparations for the 10 key IPPs. Negotiations with the developers of one of the two IPPs already in commercial operation were to have begun that week. The Minister of State Enterprises, heading the GOI, had established an interagency working group. The Minister of Mines and Energy would be responsible for the parallel working group on PLL corporate restructuring, while the Minister of Finance would be responsible for the working group on PLL financial restructuring. On the whole, the financial

restructuring was being conducted within the framework of the government's Power Sector Restructuring Policy, which had been publicly announced in August 1998, with the implementation plan announced in December 1998. The Bank and the AsDB would finance technical assistance for the PLN and the government to support the implementation.

The Acting Chairman said that it had been difficult to restructure banks properly and the joint effort by the Bank and the Fund staffs had been exemplary.

Mr. Sobel said that it was agreed that the recapitalization of Bank Mandiri should proceed in line with the overall restructuring process. However, what could be expected over the following two months, what would be the key checkpoints, and was the staff satisfied that adequate progress was currently being made to meet the May 31 structural benchmarks?

The Deputy Director of the Asia and Pacific Department pointed out that some of the dates on the right-hand side of Box 1 of the Letter of Intent had been misaligned. Bank Mandiri should and would be recapitalized only after it had met the benchmarks for restructuring. Thus, the restructuring and recapitalization would be phased in over a long period. It would begin now and likely be completed by the end of 1999 or by March 2000. The restructuring and recapitalization of Bank Mandiri was probably the most important aspect of Indonesia's entire bank restructuring, so it was critical that it be handled properly. It was critical that the bank not be recapitalized before being restructured, as had been proposed a couple of months ago. The government had agreed that the two steps would be done in sequence, and that process would be carefully monitored over the next 12 months.

Mr. Zurbrügg made the following statement:

> The developments in Indonesia over the last three months have revealed the inherent fragility of the economic situation. A cumulation of negative factors has led to a deterioration of market confidence. Domestic problems, such as the poor security situation and delays in program implementation in the area of bank restructuring, have been exacerbated by spillovers from the devaluation of the real. The weakening of the rupiah, the upward pressure on prices, and the bleak growth outlook are putting strong pressure on the authorities. These economic uncertainties are compounded by the upcoming parliamentary and presidential elections. I commend the authorities for the steadfast implementation of the broad reform program and urge them to continue, notwithstanding this difficult situation.
>
> Turning to the program, like Mr. Collins, I found the staff's explanation of the necessary augmentation of Fund resources unconvincing. The financing gap has not changed since our last review and the program is on track. It strikes me as somewhat surprising that the Fund has to participate in new rounds of additional financing to ensure its catalytic role. Let us not forget, this is the second augmentation of the Indonesian program. Given the—hopefully—high "multiplier" of the Fund's additional effort and the strengthening of the program, I can reluctantly go along with this augmentation. However, like Mr. Kiekens, I would like to underscore once more that the success of the program is not ensured by increasing external official financing, but by a forceful implementation of the reforms.

In this context, bank and corporate restructuring are crucial. Progress in this area will determine how fast private external financing will again become available to the Indonesian economy. While I welcome the authorities' recent decision to close 38 nonviable private banks, the process was more than bumpy. I share the staff's view that full transparency and consistency in decision making is necessary to retain the public's confidence in the banking sector. To enhance public acceptability of the fiscal restructuring costs, it is imperative that an independent and strong IBRA minimize these costs by making all the efforts to maximize proceeds from asset recovery.

Like other speakers, I am very worried by the deterioration of the loan portfolios of the banking system, which is not only a threat to fiscal stability, but also hinders economic recovery. The deterioration is partly owing to the fact that collection efforts of banks seem to have slackened because of the imminent restructuring. However, it is not sufficient that banks have incentives to collect their debt; it is also indispensable that the legal and judiciary framework gives them the power to enforce their claims vis-à-vis the corporate sector. In this respect, the uneven application of the bankruptcy law is extremely worrying. I therefore highly welcome measures to improve practice under the law such as the intensified training and supervision of the judges as well as the strengthening of the anticorruption law. However, some critics consider flaws in the bankruptcy law itself to contribute to the current problems. The World Bank brief mentions that the government is reviewing the law. I would appreciate the staff's comments on this issue.

On monetary policy, I can be brief. After the expansion of the monetary base owing to the liquidity support of ailing banks, it is now necessary to return to a firm monetary stance as designed in the program. The initial remarks by the staff were very encouraging in this respect. I strongly support the staff's view that monetary policy should remain cautious and welcome the central bank's commitment to tighten monetary policy if inflation does not subside in accordance with the program.

Regarding fiscal policy, the targeted expansionary fiscal stance with a deficit at just under 6 percent of GDP will continue to be difficult to achieve, as many social expenditure programs have to be set up. This will take time, as attention must be paid to ensure their effectiveness and prevent leakages. While I appreciate that untargeted subsidies were reduced to less than 2 percent of GDP, contrary to the authorities' view there still seems to be substantial potential for reduction. Therefore, I was disappointed that a further reduction of across-the-board subsidies is not mentioned as a "contingency measure" to secure additional financing for the case that risks to the program materialize. On the revenue side, I share the concerns of other speakers regarding the recent introduction of income tax holidays.

Moreover, to secure the necessary financing of the budget deficit, it is important for privatization to take place as scheduled. I understand that this is a delicate political issue. Since legislation as well as a regulatory framework is a prerequisite for the privatization measures ahead, I encourage the authorities

to do their utmost to overcome political resistance and to gain the necessary political support. As to market conditions, in my view it is dangerous to further postpone privatization in the hope of a substantial improvement, as not proceeding with privatization can itself contribute to poor market conditions.

With these comments I support the draft decision and wish the authorities well in their endeavors.

Mr. Schollmeier made the following statement:

We support the conclusion of the fourth review under the EFF and the augmentation. The requested waiver for the nonobservance of one performance criterion should be granted.

While progress continues to be made in implementing the program, major challenges still lie ahead. The reform agenda has by no means been completed. There are many weaknesses and there are many uncertainties.

As I broadly agree with the staff's analysis and policy recommendations, I will confine my comments to just a few points for emphasis.

First, elections for Parliament will be held on June 7, and the new President and Vice President will be elected in October or November. These political transition phases might cause further social unrest or problems, which could jeopardize or much slow down the reform process.

Secondly, the exchange rate assumptions might turn out to be too positive; the budget is based on an exchange rate of 7,500 rupiah/US$, which might be a rather optimistic view. If the exchange does not appreciate as expected, further adjustments or an additional budget will be necessary.

Thirdly, regarding fiscal policy, I just want to express my concerns on two issues: the somewhat optimistically expected receipts from privatization in the coming fiscal year and the very ambitious long-term tax holidays for new companies.

Fourthly, on banking restructuring, it is encouraging to find that major steps have been taken to restructure private banks. However, resolving the problems of state banks is still an open issue. Here we strongly endorse the staff's view that, given Indonesia's history of failed state bank restructuring, the temptation of recapitalization must be resisted until restructuring is credibly advanced.

We are very concerned about the concentration of loan collection problems in the state banks (page 23). We fully support the staff's view that prompt action needs to be taken to improve loan collection procedures. The negative interest spread at state banks should be seen as an extremely dangerous situation for these banks. It is not sustainable and should be terminated as soon as possible.

Finally, the reform process in the corporate sector is still only just beginning. So far only a few companies have concluded debt restructuring with their creditors. The bankruptcy process is not very convincing so far. Potentially serious setbacks to the restructuring process have arisen from recent dismissals by the courts of bankruptcy petitions.

Ms. Abdelati made the following statement:

In spite of the commendable effort of the Indonesian authorities to push forward with the reform agenda in a difficult environment, the staff report for Indonesia's Article IV consultation does provide a happy or reassuring picture. After a 16 percent decline in real GDP, the economy has not yet bottomed out and the outlook is strewn with risks, many of which are not easily controlled through policy actions. This is partly attributed to the inability to effect the assigned stimulative role to fiscal policy; the expected deficit of 3.6 percent of GDP is dramatically lower than the programmed 8.5 percent. And although the exchange rate weakened further following the short-lived ascent in the last quarter of 1998, export growth and its prospects remain weak. In the relatively optimistic medium-term growth scenario, the recovery is contingent on a smooth political transition and maintenance of social cohesion as well as significant progress in achieving a more efficient civil service, an independent judiciary, more credible banking oversight, and further progress in corporate debt restructuring—these are all complex and difficult areas to reform.

Adequate financing, including through augmentation, is essential to maintain overall confidence, prevent another spiral of rupiah depreciation, and keep the budget on course to stem and hopefully reverse the prevailing recessionary conditions. Without adequate financing, the programmed fiscal stimulus of 1 percent of GDP for 1999/2000 incorporated in the targeted 6 percent deficit would not be achieved. Given that fiscal revenues have been on the decline and projected to fall to 11 percent of GDP in the coming year, the granting of tax holidays to newly established corporations was probably inopportune, particularly as such incentives have not proved to be effective in attracting foreign investments. We are encouraged by the ongoing review of this and other tax incentives and the freeze on any additional concessions until the completion of this review. On the expenditure side, the authorities need to continue to strengthen the implementation and monitoring of the targeted subsidy programs and to expand the reach of these programs while reducing leakage outlets, the latter being essential for securing additional foreign funding for these programs.

While some progress was attained in bank and corporate restructuring, we concur with the staff's views that there are formidable obstacles facing meaningful progress in this critical area. In this regard, the recent government announcement regarding the 128 private banks is an important step, which needs to be implemented expeditiously and without reservation in order to avoid burdening the budget with much higher recapitalization costs as bank losses continue to accumulate. It is also important to push forward with restructuring of the seven state banks whose restructuring programs are still at

an early stage owing to the preoccupation of the authorities with other aspects of the reform agenda, and whose recapitalization costs have not yet been identified. Recovery of assets is essential to keeping the budgetary costs under control, and as such greater efforts are needed to strengthen the roles and capacities of IBRA and the Asset Management Unit. Banks should cease to depend on deposits lured by high returns to make up for the low collection rates on loans, as this practice is not sustainable. We hope the authorities are considering measures to discourage this practice.

After a long delay, corporate debt restructuring is starting off rather slowly with only 15 companies having so far concluded agreements with creditors. It is troubling that the recently amended bankruptcy law is not being applied as envisaged and that the recent bankruptcy petitions have been dismissed by the courts. Although we are encouraged by the initiation of a strengthened implementation strategy to address this problem, most of the outlined activities of the independent judicial subcommission could be quite lengthy, thereby holding up further progress with corporate restructuring. We are hopeful of accelerated progress in this area following today's approval by the World Bank Board of a technical assistance loan for corporate restructuring.

In spite of the hardships of the past two years, Indonesia still faces a thorny road ahead. The authorities are in the difficult position of having to implement unpopular policies and maneuver around pressures from various interest groups. The political uncertainties and trying security situation continue to limit the return of private and foreign investor confidence. The only actions that would appear to be in the hands of the authorities for restoring confidence are those that maintain macroeconomic cohesion and advance the needed economic restructuring, and such efforts deserve the full support of the Fund and international community. We commend the staff for their unwavering efforts in assisting the Indonesian authorities. We support the augmentation and wish the authorities every success in addressing the daunting tasks ahead.

Mr. Fernandez made the following statement:

At this stage, I will concentrate my comments on a few issues.

Despite progress on the stabilization front and some signs of bottoming out of activity, we agree with the staff and other speakers that the situation is extremely fragile. Full implementation of a program is essential to avoid further decline in investor confidence, particularly in the context of political transition. I would also like to thank the staff for this paper, which through the Article IV consultation gives a welcome perspective on the daunting tasks facing the authorities.

Now, a few more specific comments.

First, I was struck by staff's numerous references to governance issues in several key aspects of the program. Bank and corporate restructuring, fiscal

policy, the design of social safety nets, or the privatization program are all areas subject to scrutiny. In this context, I think that it is vital that the Indonesian authorities send strong signals of their willingness to ensure full implementation of the program, in all its dimensions, even if political costs are entailed.

Second, on fiscal policy, I have nothing to add to comments already made. I would only ask one question, which is related to public revenues. We would appreciate if staff could maybe after this meeting provide more detailed description of public revenues in order to facilitate our assessment of the situation, particularly regarding expected privatization receipts.

Further, on monetary policy, it seems that staff has dropped the precise reference to exchange stabilization in the conduct of monetary policy above from the evolution of the inflationary pressures. We do agree that no formal target range for the rupiah should be established, but the currency is currently significantly below the program assumptions and the situation of foreign exchange markets is still very volatile, justifying in our view some caution on the interest rate side. Staff comments would be appreciated.

Fourth, on banking and corporate restructuring, I have nothing to add except to insist once more on the importance of securing IBRA's independence.

Lastly, turning to program financing, I must say I remain somewhat frustrated by staff's first-round comments. While I do not dispute the necessity of a fiscal stimulus, I share other Directors' view that the case for an augmentation is not fully convincing. In addition to Mr. Kiekens's comments on this point, I believe that an assessment of the possibility to reallocate undisbursed foreign resources during this fiscal year should be taken into account to evaluate more precisely the actual financial gap to be filled. It should be noted that balance of payments figures on nonfinancial public sector disbursements in 1998/99 have been regularly revised downwards while corresponding figures for the following fiscal year remain broadly unchanged. I hope we will get some further comments from the staff on this point.

I would also like to support Directors' comments on the necessity to accelerate World Bank support to Indonesia and finally, I fully support Mr. Collins's and Ms. Brownlee's suggestion to maintain close monitoring of a program until the year-end. With these comments, and questions on the augmentation issue, I support the proposed decision.

Mr. Faini made the following statement:

It will not be a surprise to you if I just convey to the Board some comments.

The first issue I would like to focus on is the link between exchange rate stability and corporate and bank restructuring. The question is important, I believe, because the lack of exchange rate stability is likely to compound the process of bank and corporate restructuring. We know that half of the corporate debt is denominated in foreign currency, and without a stable exchange rate it is

extremely difficult to determine the valuation of firms and complete the process of both corporate and bank restructuring.

Under these conditions, there may be the temptation to postpone or to delay the restructuring process, but we believe that this temptation, like all temptations, should be resisted for a number of reasons. Reason number one, delay would jeopardize the process. Owners of bankrupt firms have an incentive to strip corporate assets before they lose control. Similarly, banks have little incentive to collect the nonperforming loans if they expect to be either closed or to be recapitalized by the government.

The second reason is that we believe that confidence itself and exchange rate stability could be restored by decisive action on the restructuring front. The strong exchange rate response to the recent restructuring of private banks is quite telling in this respect.

The third reason why we would urge the government to persevere on the road of fast corporate and bank restructuring regards state banks, and this is an issue which has still to be addressed. We believe that gradual action or, even worse, lack of action on this front would compound future problems. We know that the gap still existing between deposit and lending interest rates means that many of these banks are still making large flow losses. This could generate a vicious circle by shaking market confidence, preventing interest rates from falling, and putting in the medium run an unsustainable burden on the budget and pave the way, therefore, for protracted crisis.

The second issue I would like to focus my comments on is on fiscal policy, which I believe remains an area of concern. I would not dispute certainly the need for an additional fiscal stimulus. However, we are somewhat concerned about the long-run impact of the fiscal expansion. This is a concern this chair has repeatedly emphasized, namely the fact that countercyclical fiscal policies should be of a temporary nature, and rely on temporary measures that can be easily withdrawn when the need for a fiscal stimulus recedes. Our concern about the long-run stability is strengthened by some unfavorable long-run trends in the area. We know that in Korea, in Indonesia, the demographic trends are extremely unfavorable. The World Bank projects the share of population of 60 years of age to move from 6 percent to 12 percent in the next 15 years; in Korea it would be even faster.

A further factor of concern is the falling revenue ratio, the ratio of revenue to GDP. We understand that part of this decline is due to the fall in oil revenues, but if we look at the figures more carefully, we see that even non-oil revenues declined as a percent of GDP. This, in our opinion, highlights the weakness, the structural weakness of the tax system in the country, which ought to be addressed. In this sense, we fully agree with some previous speakers who have expressed a concern about granting tax holidays, which, and there is an enormous amount of evidence, have little effect in attracting foreign direct investment, but undermine—erode—the tax base in the short run.

On a less gloomy note, we would observe that the recent OPEC agreement should pave the way for some relief to the budget. We do not know how much, but this would be perhaps a factor which could be incorporated or will be incorporated in the future projection of the budget, and my understanding is that the staff has used a fairly conservative estimate, and possibly this may have to be revised.

Finally, I share the concerns of many other chairs about the request for augmentation. I did not find the staff explanation unconvincing. Mostly, I found it incomplete, and, well, I welcome certainly clarification of this point even if this has already been provided in earlier discussion.

Well, with these caveats, let me wish the authorities best luck on their difficult endeavors.

Mr. Wei made the following statement:

At the outset, let me say I fully share the view as expressed in Mrs. Hetrakul's very helpful statement that much progress has been made in the implementation of the program since the last Board discussion, especially in the restructuring of the private bank sector. However, the overall political and economic developments in the past three months have demonstrated the fragility of the situation. A lot of uncertainties still lie ahead; the authorities and the international community must continue their efforts to maintain and strengthen social and economic stability and place the economy on a track of sustainable recovery. In this context, we support the proposal to increase the Fund's financial assistance to Indonesia and welcome further commitments made by other international financial institutions and contributing countries. I agree with the thrust of the staff appraisal and would like to concentrate my comments on several issues for emphasis.

First, fiscal policy is the major policy instrument contained in the program to cushion the recession, so the more expansionary stance of the 1999/2000 budget compared with that of the present fiscal year is more than warranted, and much welcome. What is critical here is the financing of the fiscal deficit. It seems to us that great uncertainties remain, which include, among other factors, the possible overestimation of the proceeds of the sales of banks' assets and the underestimation of the cost of banking sector recapitalization. Therefore, we wonder whether the 5 billion extra in external financing is sufficient. Given the importance of fiscal policy in stimulating the economy, we share the staff's view that every effort should be made to avoid imposing new tax measures or expenditure cuts. In the meantime, the Indonesian authorities and the multiple and bilateral contributors are encouraged to strengthen their efforts to ensure that the disbursements will be made in a timely manner. As for the fiscal decentralization, it seems to us that a more cautious approach would minimize the possibility of a loss of fiscal control. The Fund and the World Bank are encouraged to strengthen technical assistance to Indonesia in this area.

Second, the hard-earned progress the Indonesian authorities made in the private bank restructuring was indeed welcome. This advancement not only marked a positive step towards the reconstruction of a viable banking system, but also indicated that the authorities are able to make difficult political decisions. This is a bold and healthy start. However, great difficulties and challenges remain ahead. Multilateral institutions, especially the Fund and the World Bank, are urged to continue their support and assistance in the implementation of the restructuring, and the authorities are encouraged to adopt the specific measures in a transparent and fair manner.

Third, as for the "people's economy," the diversification of ownership could contribute to the efficiency and growth of the economy if conducted in an orderly manner. We noticed the authorities' recent efforts in this direction. As staff pointed out in the paper, this initiative has wide-ranging economic implications and could pose great risks if not combined with careful deliberation and caution to make sure that this initiative would be advanced in the best interest of the Indonesian economy. In particular, this chair strongly encourages the authorities to respect and protect existing ownership rights. The enactment of the Competition Law was another effort of the authorities to promote the efficiency of the economy. However, a lot of issues are still unclear to us; for example, the criteria could be used by the Supervisory Commission to judge competitive behavior. In this context, we strongly encourage the authorities to formulate detailed implementation regulations of the Competition Law as soon as possible, and the multilateral institutions, especially the Fund and the World Bank, are urged to strengthen their assistance in this regard to ensure that the implementation of the new legislation is in line with the best of international practice and conducted in a transparent and fair manner. Moreover, in light of the extensive powers that the proposed Supervisory Commission might have, consideration should be given to the establishment of a mechanism to monitor the operation of this commission to ensure that it really functions as an institution to promote fair competition.

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

Mr. Yakusha made the following statement:

I would like to thank staff for presenting a clear and candid paper. The situation in Indonesia continues to be fragile despite progress made in restoring credibility since the mid-1998 crisis. Clearly, an orderly political transition, social cohesion, and a decisive response to the widespread governance problems would facilitate the restoration of a positive economic outlook. In addition, the authorities must pay close attention to the country's debt dynamics, to a restructuring of the banking and corporate sectors, and to establishing an independent and transparent judiciary. In general, I agree with the staff's analysis and recommendations; hence, I will limit my remarks to a few issues for additional emphasis.

In the fiscal area, the authorities must tackle the problem of the low level of revenues. This is essential in light of the fiscal stimulus to be applied to the economy. Clearly a restoration of confidence would jump-start the economy and create favorable conditions for an accelerated pace of privatizations. But the authorities must also proceed with courageous reforms. I welcome the decision not to grant any additional tax concessions until a broad assessment of the efficacy of existing tax incentives is made. I also welcome the efforts to further reduce untargeted subsidies and to rationalize other expenditures. Ultimately, however, the authorities must tackle the root of the problem, which is, inter alia, weak governance. In this regard, fiscal decentralization may have a positive effect. One, however, must proceed cautiously in light of the danger that such decentralization could interfere with the government's overall stabilization policy and result in loss of fiscal control.

The promotion of small and medium-sized enterprises and cooperatives within the context of a "people's economy" could also be a positive development, as it may reduce the political influence of powerful groups and hence improve overall governance. It is important, however, to stress that any such initiative must proceed with full respect to existing property rights. I also welcome the passage of the Competition Law, which is an important instrument in combating anticompetitive practices.

In the banking sector, the loan quality problem must be addressed promptly. The offering of high deposit rates to meet liquidity needs and cover increasing losses is clearly not sustainable. I agree with the staff that the short-term objective in this area must be to maintain public confidence while implementing a program of bank restructuring in a credible and transparent manner. I welcome the recapitalization steps taken in relation to private banks, which, despite their relatively small share of deposits, help enhance the government's credibility. More things, however, remain to be done to address the problems facing state banks. A restructuring of state banks will provide a test of the authorities' determination to address governance issues and take politically sensitive decisions. I agree with the view that a separation of bank supervision from the jurisdiction of the central bank at a time when Bank Indonesia is granted greater operating independence may send a wrong signal about the motives behind such a proposal.

An area of grave concern is corporate restructuring. It is indeed saddening to know that nearly half of all corporations find it difficult to meet their debt service obligations to domestic and external creditors. I am therefore troubled by the delays which have been observed in addressing this important problem. The recent rulings by courts, in particular, over the dismissal of bankruptcy petitions are indeed a cause of concern. I welcome efforts to enact legislation regarding judicial oversight and investigation of misconduct by judges. I also support measures to increase judges' wages and to enhance transparency.

Ms. Vtyurina made the following statement:

The recent developments in banking sector reform have brought a ray of light to the gloomy outlook for the Indonesian economy. Although still criticized by many, progress in the reform is evident, and I want to congratulate the Indonesian authorities for taking this important step in overcoming tough economic and political circumstances. I would like to provide a few comments on the content of the program before us today.

The overall macroeconomic situation remains vulnerable. Although I am encouraged by the staff's cautious approach to this year's outlook, I am still curious about the reasoning behind the assumptions underlying the inflation projections, which are based on a lower value of the rupiah of 7,500 to the U.S. dollar compared with the recent range of Rp 8,790 to Rp 9,450 and a depreciating pattern in recent months. I also have reservations about the predicted growth of between –2 to +1 percent of GDP as compared to a 16 percent decline last year. It appears that the economy has not bottomed out yet, and with political and structural uncertainties so evident, the outlook presented in the paper seems to be rather optimistic.

Overall, this year's economic program endorsed by the authorities appears to be quite appropriate and ambitious in light of the country's problems. On the fiscal side, I support the rationalization of expenditures and elimination of untargeted subsidies along with the continued presence of a fiscal stimulus achieved through increasing expenditures for social programs. However, the past fiscal stimulus target has not been achieved and the latest statistics on the poverty level, although better than projected, still highlight the absolute necessity of having a strong social protection program. Thus, the implementation of the social aid programs deserves careful quality and efficiency control. I would appreciate the World Bank representative's comments on recent developments in the monitoring of social programs.

I would like to thank the World Bank staff for their elaborate paper on corporate restructuring under the Jakarta Initiative. Corporate debt restructuring remains at the core of the adjustment efforts in Indonesia and, judging from the developments of the past three months, there has been considerable progress. The staff of the World Bank provide some useful insight into the main impediments to acceleration of the corporate debt restructuring. For example, it is clear from the paper that INDRA has not become a useful element in restructuring, which, in turn, points to the fact that elimination of foreign exchange risk in debt servicing is subordinate to the issues of reduction in the amounts of principal and the debt service profile. The World Bank staff say that the limited use of this facility was owing to a successful stabilization of the exchange rate and other macroeconomic variables. It would be interesting to hear the Fund staff's reasoning on this issue. In addition, the World Bank staff emphasize that the foreign banks are reluctant to accept write-offs, which, in turn, in the view of the staff, represents one of the serious barriers to the implementation of the Jakarta Initiative. I would appreciate it if the Fund staff provided their view on the reasons behind this strong unwillingness of foreign banks to accept write-offs.

Continuing with this topic, it was interesting to note that the staff echo the opinion of legal experts who participated in the recent Fund seminar on debt workouts when they say that the Fund's expectations with respect to the effectiveness of changes in the legal environment were too optimistic. Obviously, the experts count more on voluntary debt restructuring than on the power of law enforcement. However, this does not mean that less attention should be paid to the implementation of the bankruptcy law. Despite the fact that a group of companies has already gone through the bankruptcy procedures, the skepticism about the rightful implementation of the bankruptcy law is still in place. The authorities should make an extra effort to ensure equal treatment of Indonesian companies in the court of law. The recent sudden departure of the "father" of the Indonesian bankruptcy law is another worrisome sign that the bankruptcy procedures are far from being satisfactory. I encourage the authorities to persevere with creating a fair and prudent environment for corporate restructuring.

Finally, I support the augmentation of the arrangement and wish the authorities success.

Mr. Oyarzábal made the following statement:

I believe that significant progress has been made in Indonesia in the last few months in meeting the targets for output and inflation, while moderating the decline of GDP.

However, there remain many uncertainties ahead on the political and economic horizon. The electoral process for Parliament and the President, in the course of this year, is affecting confidence. On the economic side, I would like to point out a few of the many issues which I see affecting confidence: (a) the depreciation of the rupiah; (b) the pickup in inflation; (c) although the current account is still in surplus, the fall in exports owing to the reduction in contracts, as well as the difficulties in opening letters of credit—coupled to the deficit in the capital account—reflect a balance of payments situation that must be watched carefully; (d) the lack of progress on corporate debt restructuring is also a factor undermining the elusive market confidence.

The monetary stance is a very welcome sign; the strict and disciplined action through open market operations should be encouraged and would be expected to continue to address the rate of inflation, motivate confidence in the national currency, and eventually have an effect on the balance of payments.

The actions taken to address social concerns are most welcome. The special attention given to strengthening the social safety net, coupled to the stimulus on the fiscal side, should help mitigate the social pressures experienced in the recent past.

Even though there appear to be some downside risks, I would like to support the augmentation of the program, as proposed, and wish the Indonesian authorities success in the very difficult tasks ahead of them.

Mr. Erasmus made the following statement:

The Indonesian authorities should be commended for the progress that has been made in the move toward reestablishing economic stability. In this regard, it is worth noting that the rupiah has recovered substantially from the lows it had reached at the height of the crisis, the external account has improved, and the outlook for inflation has improved significantly. It is, however, clear that the economy has not yet turned the corner. Economic activity is still declining, there is still a long way to go with important structural reforms, and the exchange rate remains volatile. As the staff also points out, the authorities' efforts to restore confidence and reverse the impact of the currency crisis are affected to a significant degree by the process of political change that is occurring at the same time.

Against this background, we are in agreement with the course of action that has been plotted for economic policy over the short term. The budgeted increase in the overall fiscal deficit is appropriate given the need to support economic activity and protect the vulnerable groups. However, we join Mr. Collins, Ms. Brownlee, and others in urging the authorities to ensure full implementation of the proposed expenditure measures. In this regard we encourage the authorities to take the actions that are required to ensure the availability of external funding commitments. We, furthermore, share the concerns that have been raised regarding the weakening of public revenue, especially in view of the uncertainty with regard to the actual cost of the restructuring of the banking sector. We therefore urge the staff and the authorities to closely monitor this situation.

On monetary policy, we agree with the need for a continuation of a cautious stance. At present the exchange rate is well below that assumed in the program, and failure to achieve an appreciation close to this level could seriously undermine confidence in the program. We therefore agree with Mr. Daïri that vigilance will be required to prevent a premature lowering of interest rates.

As already pointed out by previous speakers, the most pressing challenge facing the authorities is achieving further decisive progress with the restructuring of the banking and corporate sectors. In this regard, we welcome the program that was announced on March 13 to deal with the private banks, an action that was also welcomed by the market. However, private banks represent only a small percentage of the banking sector, and we urge the authorities to ensure a timely and equally transparent program to deal with the restructuring of publicly owned banks.

The position of the corporate sector remains serious, an aspect that has an important impact on the health of the banking system. While we regret the delays that have been experienced with the implementation of the new bankruptcy legislation, we commend the authorities for the corrective measures that have been devised for improving the bankruptcy system. We join others in expressing hope that these and other measures to advance the process of corporate restructuring will soon lead to tangible improvements.

Finally, I want to briefly touch on the issues addressed in Box 4. The protection of basic labor standards, particularly those pertaining to child and forced labor, is an issue of particular interest to my South African authorities. I therefore join others in urging the authorities to accord sufficient priority to the refining of Indonesia's labor legislation in accordance with accepted international practice.

In conclusion, we commend the authorities for the efforts that have been made to return Indonesia to a path of strong growth, and wish them success in their difficult task of leading the economy out of the present difficulties.

Ms. Brownlee said that there had not been a response from the staff on the issue of whether monitoring would be quarterly or bimonthly and whether the staff could do more comprehensive sensitivity analyses in future papers.

The Deputy Director of the Asia and Pacific Department said that the recent problems with the bankruptcy law were not so much a matter of the law itself, which had been amended satisfactorily in 1998. Rather, there were problems regarding the law's implementation and its interpretation by the judiciary, which was why the strategy developed to address that issue focused on areas such as implementation, the consistency of judgments, the training of judges, and the appointment of ad hoc experts.

The effectiveness of corporate restructuring in Indonesia, as well as other countries including Thailand and Korea, depended on adequate means to enforce debtor compliance, the Deputy Director commented. Enforcing compliance had not been adequate to date; in fact it had declined in recent months. Therefore, the efforts to improve the functioning of the bankruptcy law were fundamentally designed to increase enforcement. Other crucial factors that were necessary to get corporate restructuring off the ground included improving governance and political will.

In the past few months there had been a distinct pause in interest rate reductions in light of developments in inflation and the exchange rate, the Deputy Director noted. The interest rates on state bank certificates had improved by about 2 percentage points. Also, there was agreement that interest rate reductions would not resume until there was enduring evidence that inflationary and exchange rate pressures had eased. Early evidence indicated that inflation figures for March 1999 were expected to be flat.

The staff had not done a quantified sensitivity analysis, the Deputy Director reported. However, as Ms. Brownlee's statement had indicated, the staff had tried to be candid about the risks facing the program without actually quantifying them in a scenario. That was because there was a wide range of possible outcomes for key variables, mostly linked to political uncertainty, and it was not considered useful to dwell on any kind of catastrophic scenario. The staff, however, would try to develop more quantified scenarios of sensitivity.

Regarding the exchange rate assumption for 1999–2000, the staff believed that the exchange rate remained overly depreciated in real terms, the Deputy Director pointed out. Although the rupiah had responded quickly and sharply to changes in market confidence, appreciating from its low of Rp 17,000 to the U.S. dollar last year to Rp 7,500 to the U.S. dollar a couple of months ago, even at Rp 7,500 to the U.S. dollar, real depreciation would be

more than 30 to 35 percent, which was well in excess of the real depreciation of other countries in Asia. The adjustment process would benefit from a real appreciation of the exchange rate.

It was expected that there would be fewer fiscal revisions in the coming year, the Deputy Director remarked. The current revisions had principally reflected the shortfalls in both spending and financing. However, looking ahead to next year, much more work had been done in firming up expenditure programs with the World Bank, including in the safety net, so fewer revisions were likely to be needed.

The case for augmentation rested on the exceptional uncertainty facing the authorities in the coming six months, including the change in government, the Deputy Director noted. There was a clear market perception that official financing would not be available and there would be a wait-and-see attitude by the official community during that period. Augmentation would make sure that sufficient financing was available. If there was no augmentation, and official financing was also unavailable, Indonesia could suffer another severe financial crisis. Another severe drop in the exchange rate, for instance to the previous year's levels, would be catastrophic for the world economy as well as Indonesia's. Augmentation was designed to prevent that, to keep the program on track, and to ensure official financing. Augmentation would also help meet an overall balance of payments deficit of $3 billion and allow an improvement of net reserves by $2 billion. These improvements were the minimum amount necessary to convince markets that the program remained on track.

Mr. Askari-Rankouhi said that as $400 to $500 million was scheduled to be distributed over the next six months, why was there also a $1 billion augmentation? That augmentation alone would not restore confidence in Indonesia; rather, implementation of the program was more critical.

The Acting Chairman said that, while program implementation was critical, it was important to recognize the complexities of the political and security situation, and that international agencies were playing a critical role in Indonesia. The fact that the Fund, the Bank, the AsDB, the Japanese government, and other bilateral donors were supporting the authorities and trying to keep the policies on the right track had been important. With such assistance, the authorities could implement the right decisions. If the implementation of the program improved, the currency would strengthen and the concerns outlined by the staff would not be relevant. However, the country faced enormous uncertainties, with an approaching election and violence throughout the country, which the government should have done more to control. Given the unusual circumstances in Indonesia, particularly the upcoming elections and the fact that the country's recovery required greater support than originally envisaged, an augmentation was necessary. The situation should improve once there was a stable government and a coherent administration in Indonesia; at present the situation was not ideal. The work of the Fund staff in difficult circumstances had been remarkable and had affected the economic, civil, and security situations in Indonesia. Management supported the augmentation because the situation in the country would continue to be complicated over the next few months, and also because the Japanese government had decided to enhance the Fund's contribution.

The Deputy Director of the Asia and Pacific Department said that the staff had envisaged moving from monthly program reviews to quarterly program reviews, with bimonthly reviews at the intermediate stage. However, the staff would not hesitate to

continue using bimonthly program reviews or to revert to monthly reviews if circumstances warranted.

Regarding the delay in bringing the review for the Board's consideration, the staff felt that the review could not be brought to the Board until the private bank recapitalization program had been decided, the Deputy Director explained. Even though there were plans to augment assistance, the staff would ensure that every measure was taken to sustain implementation.

Mr. Harinowo made the following concluding statement:

I would like to thank the staff, which has done an excellent job in answering all of the questions raised by Directors relating to economic developments in Indonesia, as well as the current program. All of the Directors' comments and suggestions are appreciated, as these are beneficial to us, adding strength to the fight against the long-lasting crisis. We also appreciate some of the criticism, which will be valuable for the authorities in their efforts to improve the implementation of the program. I will faithfully convey all of these comments and concerns to the authorities.

We are aware of the daunting tasks and challenges that lie ahead, particularly in the near future. To face these challenges, economic as well as political programs will have to be implemented in the period ahead. Their only aim will be to build a solid foundation for the future of the Indonesian economy. To that end, continued support and advice from the Fund will be valuable for Indonesia in overcoming the existing crisis. The Indonesian people fully realize that there is no shortcut to come out of the crisis. With support from other countries, the authorities are confident that they can face the challenges.

On behalf of the authorities and the people of Indonesia, I would like to extend my appreciation to management and the staff for their continued support of the Indonesian program. The authorities continue to appreciate and value the support they have received from the financial community, and look forward to further support and assistance from the international financial institutions.

The Acting Chairman made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They expressed satisfaction with the continued progress in implementing the program, while noting that recent political and security developments underscored the fragility of the current situation. Directors welcomed the announcement on March 13 of a major program of private bank recapitalization and closures, and the agreement reached with the Fund staff on strengthening macroeconomic and structural policies. However, recent export performance has been disappointing, there has been renewed volatility of the rupiah within a more depreciated range, inflation rose in December through February, and progress in corporate restructuring has been limited. These developments are all a reminder of the considerable risks that could lie ahead. Moreover, Directors noted that the recent incidents of social unrest and

the uncertainties related to the upcoming elections had also affected confidence.

Directors supported the proposed tightening of the monetary stance, which should help to consolidate the program's stabilization gains. They endorsed the efforts of the authorities in recent days to bring base money down substantially through vigorous open market operations, thereby offsetting the upsurge in liquidity that had occurred prior to the finalization of the bank restructuring package. Directors agreed that monetary policy should remain cautious in 1999/2000, and that the monetary stance should not be eased prematurely—before there were clear signs of improving confidence and lower inflation. However, concern was expressed about the inadequate availability of credit to the export sector. Directors were also concerned about the continuing negative spreads between the borrowing and lending rates of banks, which further underscored the urgent need for bank restructuring.

Directors expressed concern that fiscal stimulus had been slow to develop over the past year. This was due principally to delays in finalizing spending programs and improving their execution, as well as slower than anticipated disbursements of external financing. They considered that the size of the 1999/2000 budget deficit was appropriate to impart a larger stimulus to the economy than was achieved in 1998/99. Directors noted that the budget is projected to be fully financed without recourse to domestic bank financing, but cautioned that the budgetary framework needed to retain the flexibility to respond both to evolving circumstances—including the possibility of shortfalls in external financing—and to the need to maintain long-term sustainability.

Directors welcomed the planned expansion of well-targeted social spending in 1999/2000. They urged the authorities to ensure that spending goals on health, education, and employment generation were fully met, consistent with the overall deficit target, in order to limit the social impact of the crisis. Directors noted that this would require timely agreement with multilateral and bilateral donors on the transparent administration and monitoring of social safety net programs. On labor issues, they welcomed Indonesia's adoption of four of the International Labor Organization's seven core labor standards and encouraged it to subscribe to the other three, as well as to improve compliance with the standards already adopted.

Directors stressed that the large bank restructuring costs pointed to the urgency of intensifying asset recoveries from large corporate debtors and reversing the declining budgetary revenue effort. In this connection, they strongly urged the removal of the recently granted income tax holidays—for up to eight years to newly established corporations in 22 industrial sectors—in accordance with the recommendations of the Fund's Fiscal Affairs Department of earlier this month, and called for efforts to strengthen tax and customs administration.

Directors welcomed the commitments that had been made by Japan, the World Bank, and the Asian Development Bank to fill the external

financing gap in 1999/2000. They supported the further augmentation of the Fund-supported program, which they believed had helped to catalyze these resources, while noting that the relatively low level of disbursements from other multilateral institutions raised serious issues of burden sharing. Directors stressed the importance of avoiding delays in the disbursement of official external financing, especially in the next few months when private capital inflows are not expected. They noted that discussions are also ongoing with the London Club (on public debt) and on a second interbank exchange offer on private debt. In light of the financing assurances, Directors saw scope for the exchange rate of the rupiah, which is market determined, to appreciate significantly if economic and security conditions stabilize.

Directors stressed that successful bank and corporate restructuring were crucial to improve governance and sustain medium-term recovery. However, both were still at an early stage, and Directors urged that the processes be accelerated. They noted that the private bank recapitalization program will retain an important element of private ownership and management in Indonesia's banking system. Directors emphasized the particular importance of periodic checks of the soundness of the banking system, the successful restoration of which also depended critically upon the restructuring of the state banks and their early privatization. They stated that state bank recapitalization should be undertaken only after restructuring was completed and emphasized that sound and transparent restructuring of the state banks was critical to the success of the overall Indonesian economic stabilization and reform program.

Directors emphasized that the Indonesian Bank Restructuring Agency (IBRA) is central to banking system reform, especially for asset recovery. They stressed that the agency must be fully independent to provide assurances that the public costs of bank restructuring are being minimized. Directors underlined the importance of the Asset Management Unit's developing asset management procedures at an early date and stressed that it should remain fully independent and be provided with adequate resources. Strong political leadership and external monitoring will be required to ensure that this process is successful.

Directors urged the authorities to accelerate corporate debt restructuring under the Jakarta Initiative and take effective measures to counter growing debtor resistance. In this regard, they stated that the bankruptcy law must be applied as envisaged, in a manner consistent with international practice. Directors pressed for early implementation of legislation aimed at improving governance, including in the judiciary, which has already been sent to Parliament, and strengthening of the Commercial Court. They said that state banks and IBRA should aggressively pursue loan collection from their largest borrowers and quickly initiate bankruptcy filings against recalcitrant debtors. Directors expressed disappointment at the delays in privatization. While recognizing that in part this reflected weak market conditions, they urged the authorities to accelerate the privatization process, including by improving the regulatory and legislative framework.

Directors recognized that the authorities were trying to reorient the economic, financial, and government structure to broaden participation by weaker economic groups and regions. They strongly supported the authorities' commitments in this regard to respect existing ownership rights, move cautiously to avoid any loss of macroeconomic control, and consult with international institutions before implementing new initiatives. Consolidation of the new competition law and the first phase of fiscal decentralization would be the task of the successor government, and Directors observed that this would need to be an early and essential part of the Fund's dialogue with that government. In the meantime, they cautioned that, based on experience in other countries, devolution of revenue should be commensurate with expenditure responsibilities, and that a loss of overall macroeconomic control had to be avoided.

Directors concluded that the macroeconomic situation in Indonesia would remain difficult until the political transition was further advanced. Firm implementation of the program and the expected continued strong financial support of the international community should allow for the restoration of positive real growth from late this year. They underscored the importance of ensuring transparency in program implementation, especially with regard to corporate and bank restructuring, and the need to avoid political interference in these processes. Directors also stated that policy continuity after the elections and a clear political will for reform will be crucial to unleash new confidence in the adjustment program and to strengthen the country's medium-term growth prospects and its external position. Overall, Directors were satisfied that policies and developments continue to evolve as well as possible in a manner consistent with setting the stage for economic recovery, against a background of difficult and unsettled domestic conditions.

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

The Executive Board took the following decision:

1. Indonesia has consulted with the Fund in accordance with paragraph 3(c) of the Extended Arrangement for Indonesia (EBS/98/130, Sup. 3, 8/27/98) in order to review progress in implementation of the program and reach understandings on the policies and measures that the authorities intend to pursue during 1999. Indonesia has also requested that the total amount available under the Extended Arrangement be augmented by the equivalent of SDR 714 million.

2. The letter dated March 16, 1999, from the State Coordinating Minister for Economy, Finance, and Industry, with attached Supplementary Memorandum of Economic and Financial Policies (Supplementary MEFP), shall be annexed to the Extended Arrangement, and the letter dated July 29, 1998, from the State Coordinating Minister for Economy, Finance, and Industry, with attached memorandum, shall be supplemented and modified by the letter dated March 16, 1999 (with its attached memorandum).

3. Accordingly,

(a) Paragraph 1 of the Extended Arrangement shall be revised to replace "SDR 4,669.1 million" with "SDR 5,383.1 million."

(b) Paragraph 2 shall be deleted in its entirety and replaced with the following:

"2(a) Purchases under this Extended Arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 4,384.5 million, provided that purchases shall not exceed the equivalent of SDR 2,786.7 million until March 15, 1999; the equivalent of SDR 3,123.7 million until May 15, 1999; the equivalent of SDR 3,460.7 million until July 15, 1999; the equivalent of SDR 3,797.7 million until September 15, 1999; the equivalent of SDR 4,134.7 million until November 15, 1999.

"(b) The right of Indonesia to make purchases during the year 2000 shall be subject to such phasing as shall be determined."

(c) The performance criteria for March 31, 1999, and May 31, 1999, set out in paragraph 3(a) of the Extended Arrangement shall be as specified in Table 1 and Table 2, respectively, of the Supplementary MEFP.

(d) Paragraph 3(c) of the Extended Arrangement shall be revised by replacing "August 14, 1999" with "May 14, 1999; July 14, 1999; September 14, 1999; November 14, 1999" and adding after "the attached letter" with "and the fifth paragraph of the letter dated March 16, 1999."

4. The Fund decides that the fourth review contemplated in paragraph 3(c) of the Extended Arrangement for Indonesia is completed and that Indonesia may continue to make purchases in accordance with the provisions of the Extended Arrangement, notwithstanding the nonobservance of the structural performance criterion for end-December 1998 specified in paragraph 3(b)(iii) the Extended Arrangement. (EBS/99/41, Sup. 1, 3/16/99; and Sup. 1, Cor. 1, 3/23/99)

Decision No. 11926--(99/32), adopted
March 25, 1999

4. USE OF CONTROLS ON CAPITAL MOVEMENTS AND ISSUES IN THEIR ORDERLY LIBERALIZATION—COUNTRIES' EXPERIENCES

The Executive Directors continued their consideration of a staff paper on countries' experiences with the use of controls on capital movements and issues in their orderly liberalization (SM/99/60, 3/5/99), together with a background paper (SM/99/60, Sup. 1, 3/5/99).

The Acting Chairman made the following summing up:

Executive Directors welcomed the opportunity to discuss members' experiences with the use of capital controls and their liberalization.

Directors underscored, first, the need to consider the use or removal of capital controls within the broader context of an internally consistent macroeconomic policy framework, on the one hand, and the level of development of financial market supervision and regulation, on the other; second, as regards the sequencing and pacing of capital account liberalization, in view of countries' different starting positions, there was no unique prescription for all countries; and third, the central importance of the strength and full commitment to undertaking supporting policies in achieving an orderly liberalization. Several Directors pointed to the possible usefulness of capital controls, including temporary capital controls, in certain circumstances.

While commending the staff for the extensive amount of work in preparing the papers, and recognizing the difficulties in undertaking a quantitative assessment of the impact of controls, Directors pointed to shortcomings in the methodology used in the empirical analysis. In particular, they noted the problems of establishing cause-and-effect relationships, data and measurement problems, and the assumption of other things being equal. Some Directors also pointed to the need to adopt a longer-term perspective that incorporates a country's development strategy. Given the implications of these limitations for the paper's findings, several Directors felt that a more balanced treatment of the advantages and disadvantages of capital controls would have been desirable. In this regard, several Directors called for a more detailed analysis of specific country cases, which could yield valuable lessons on the potential benefits or costs of capital controls, including in the context of crisis situations.

Directors welcomed the increased attention by the staff to monitoring the regulatory regimes for capital movements and viewed the increased coverage of underlying capital transactions as helpful and generally appropriate. They noted that there had been a trend toward the liberalization of capital accounts in recent years, and that there had been no general resurgence of capital controls as a result of the recent currency crisis.

Directors acknowledged that, particularly in the context of weaker financial systems, capital controls have sometimes been used to achieve prudential objectives. However, many Directors stated that this was a second-best solution, and that capital controls are not well designed to address the specific risks involved in cross-border transactions—namely, currency, interest rate, liquidity, and credit risks. Directors noted that a body of best prudential practices had evolved to address such risks, and that these risks were generally better addressed through the use of prudential controls. Directors recognized, however, that the use of capital controls for prudential reasons may be justified in the context of a weak domestic institutional and regulatory environment. Furthermore, a number of Directors also saw a role for such controls in the face of market pressures, stating that they had helped

several countries to withstand the full brunt of the recent financial crisis. Nevertheless, all Directors underscored the desirability of speeding up financial sector reforms and implementing best prudential regulatory practices, because the use of capital controls could also increase the risks to financial systems and can inhibit the efficient mobilization and allocation of financial resources. Some Directors stressed that it was equally necessary to enhance the supervision of investors, including those providing highly leveraged resources, and thought that consideration should be given to developing international standards in this area as well.

While the evidence did not permit a fully rigorous assessment of the effectiveness of capital controls, Directors generally agreed that the reimposition of controls on capital outflows has not usually been a very effective policy instrument in a crisis. The controls would need to be sufficiently wide-ranging and strict if they were to be effective even for a temporary period; however, the more wide-ranging and strict are such controls, the more likely they are to interfere with commercial transactions and debt service and, therefore, to discourage debt rollovers and new inflows. Several Directors considered that in a crisis, in the context of a broader adjustment effort and in close collaboration with the Fund, the reimposition of restrictions on outflows—together with the appropriate involvement of the private sector—could play a useful role. However, most Directors believed that experience showed that, in a world of rapidly evolving financial instruments, the effectiveness of such controls was limited in the face of strong incentives to circumvent them. The resort to capital outflow controls could increase the severity of external constraints and adjustment burdens and have longer-lasting damaging effects on countries' access to international finance. A few Directors thought, however, that the analysis of recent cases was not sufficient to reach a final view.

Directors noted that, while there was controversy about the effectiveness of controls on capital inflows in reducing the volume of inflows, the evidence was stronger that such controls shifted the composition of inflows toward longer-term flows. Directors emphasized that when countries imposed inflow controls, they should not unduly delay taking the necessary policy adjustments. Many countries that had used such controls had not avoided severe capital flow reversals when policies had been inappropriate. Directors, therefore, stressed that resorting to capital inflow controls could not substitute for taking more fundamental policy actions, and that, when adopted, such controls should be part of a broader policy package.

Many Directors stressed that one of the main lessons to come out of recent experiences with capital movements and capital controls was the need to ensure an internally consistent macroeconomic policy framework, especially as regards the exchange rate–monetary policy mix. Inconsistencies in this policy mix could give rise to strong incentives for larger and potentially volatile capital movements. Thus, in the face of significant capital movements, either the exchange rate should be allowed to adjust while domestic interest rates were oriented to meeting a domestic nominal anchor, or interest rates would have to be allowed to adjust in the case of a fixed or closely managed

exchange rate. In practice, this might mean that countries should either have a very strong commitment to a pegged exchange rate or adopt a flexible exchange rate regime. However, in the view of several Directors, as the rigorous policy commitment required for a credible exchange rate peg may not be possible in many countries, a case for more flexible exchange rate policies appeared to be generally in order. Some Directors suggested that the staff should be more forward-looking in assessing exchange rate regimes and identifying exit strategies in the context of the Fund's surveillance activities.

Directors noted that the precise pace and sequencing of capital account liberalization have generally reflected the objectives of broader economic reforms and the starting conditions of the country. As a consequence, countries have followed very diverse approaches as regards the speed and sequencing of liberalization. The outcomes of these liberalizations appeared to reflect a complex range of factors that made it difficult to determine a unique best approach to the pace and sequencing of reform. It was important in this regard to pay sufficient attention to the different stages of development and economic systems of countries, as well as to their cultural and noneconomic national priorities. Among the domestic financial sector reforms that should precede or accompany capital account liberalizations, Directors stressed the importance of early attention to banking sector reforms, such as the restructuring of weak banks and the adoption and implementation of appropriate prudential regulations; and structural reform measures in support of efficient monetary and exchange rate policy management, including the development of financial markets and instruments that could help to manage capital flows. Directors suggested that the staff integrate its assessments of capital account regulatory frameworks with those of domestic financial systems in the context of both surveillance and technical assistance.

As regards the liberalization of short-term capital flows, most Directors recognized the difficulties of distinguishing between different types of capital flows for the purposes of regulation, and that the recorded data on the maturity of different types of flows might not always provide a reliable guide to the underlying stability of the flows. Moreover, it would not be appropriate, and could be potentially damaging, to restrict all short-term flows, in view of their critical role in trade finance and in the development of foreign exchange and other financial markets for the hedging of risks. Nevertheless, Directors recognized that the liberalization of flows that tended to be short term in nature was potentially highly risky, especially if liberalization was not sufficiently supported with appropriate monetary and fiscal policies, and even more so when combined with implicit or explicit exchange rate guarantees. Directors urged countries to avoid such circumstances. Several Directors recommended that the opening up of the economy to short-term inflows therefore be deferred until a strong banking and regulatory framework is in place. A number of Directors also recommended an early liberalization of foreign direct investment flows as part of a broader economic reform strategy. Despite ongoing financial market innovation that has increasingly obscured the difference between short- and long-term flows, the latter—and especially foreign direct investment—were generally regarded as more stable than short-term flows and as offering greater potential benefits in augmenting

domestic savings and facilitating transfers of technology and management skills.

Directors supported an active role for the Fund in facilitating, assisting, and advising members in implementing orderly, well-supported capital account liberalization. In that context, they pointed to the available means, such as policy advice under Article IV consultations and technical assistance. Several Directors reiterated their support for making capital account liberalization one of the purposes of the Fund. Some other Directors felt, however, that no change in the Fund's Articles of Agreement was required to realize such a role. A number of Directors also noted the role an extension of the Fund's jurisdiction to capital flows would serve in providing confidence to the international community that capital controls would be reimposed only in well-defined circumstances, and in promoting an orderly and well-supported approach to capital account liberalization. In this regard, they underscored that jurisdiction did not imply that the Fund would impose liberalization on members. However, a majority of Directors could not support extending the Fund's jurisdiction at this time, and considered that the Fund should focus its efforts on developing a deeper understanding of the many complex issues surrounding capital account liberalization; in their view, the Articles provided sufficient scope for the Fund's role in this area.

Concerning further work, while some Directors called for a more rigorous empirical analysis of country experiences, others felt that an approach based on detailed case studies would be preferable. Such case studies could focus on the use and effectiveness of specific capital controls, including the use of controls to mitigate the potentially destabilizing effects of short-term capital flows, and on experiences with the sequencing of liberalizations of the different components of the capital account and seek to draw conclusions for best practices. A few Directors considered that the issues related to capital account liberalization should be accorded greater focus in the Fund's surveillance, to help develop comparative country reviews and enhance our understanding of the liberalization process. Some Directors noted that work was needed on capital flows data in view of the increasing problems of distinguishing between the different components of the capital account. A few Directors noted the need for further work on the behavior of investors.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/99/31 (3/24/99) and EBM/99/32 (3/25/99).

5. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAM/99/44 (3/23/99) is approved.

APPROVAL: November 12, 2001

SHAILENDRA J. ANJARIA
Secretary